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TESTIMONY OF
KATHRYN E. DICK
DEPUTY COMPTROLLER FOR CREDIT AND MARKET RISK
COMPTROLLER OF THE CURRENCY
BEFORE THE
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
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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

Good afternoon Chairman Reed, Ranking Member Allard and members of the Subcommittee. My name is Kathy Dick and I am a Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency (OCC). I am pleased to be here today to testify at the Subcommittee's hearing on Reducing Risks and Improving Oversight in the Over-The-Counter (OTC) Credit Derivatives Market.

As you know, the OCC charters, regulates, and supervises all national banks. At the end of 2007, there were 1,709 banks in the national banking system, with total assets of \$7.8 trillion; that is one of every five banks in the United States, with 70 percent of all commercial banking assets. These include the country's largest, most complex banks, a number of which are significant participants in the derivatives markets. Although more than 1,000 commercial banks reported holdings of derivatives in their first quarter call report filings, the bulk of derivatives activity within the commercial banking industry is concentrated in a small number of institutions, most of which are national banking organizations.¹ It is the OCC's view that bank derivatives businesses are appropriately concentrated in these large national banks because they have the resources, including risk management expertise and control systems, to control derivatives-related risks in a safe and sound manner. This concentration also reflects the important role these large national banks serve as financial intermediaries for a wide range of clients who use derivatives to manage and facilitate their business transactions and risk exposures. Given banks' role as financial intermediaries, ensuring that the OTC derivatives market operates

¹ Please see the attached OCC Quarterly Report on Bank Trading and Derivatives Activities – First Quarter 2008.

efficiently and effectively is of concern for both the OCC and the banks we supervise. Accordingly, the OCC spends a considerable amount of time and resources evaluating the risk control systems these banks use to manage risks in derivatives markets.

I have structured my testimony to focus on the areas of particular interest to this Subcommittee, as outlined in your June 27, 2008, letter of invitation. My testimony today will include the supervision of credit derivatives activities in national banks, the work being done to strengthen the infrastructure in the credit derivatives market, the OCC's view on benefits that may be derived from establishing a central counterparty for clearing credit derivatives and the possible implications of an exchange for credit derivatives, and finally the OCC's view on the need for additional legislation in this area.

First, I will provide background on what credit derivatives are, the size of the credit derivatives market and the volume of this activity in the banks supervised by the OCC.

Credit derivatives are financial contracts that allow market participants to take, or reduce, credit risks. For example, an institution can reduce the credit risk associated with a loan or bond by purchasing credit protection on the obligor using a credit default swap. Similarly, credit default swaps enable financial institutions to manage their credit risk profile by purchasing credit protection against obligors in an industry where an undesirable concentration of exposures exists and to further diversify their credit risk by selling protection on entities in other industries where the institution has little or no exposure. Like other financial derivatives, when used properly, credit derivatives can help to diversify credit risk, improve earnings, and lower the risk profile of an institution.

The credit derivatives market experienced significant growth over the previous four years, coinciding with a period in which both interest rates and credit spreads were historically low. In this benign market environment, investor demand for higher yielding products drove banks and dealer firms, in their capacity as risk intermediaries, to structure investment products that sometimes included a credit derivatives component. For example, collateralized debt obligations may contain both cash credit instruments, such as loans and bonds, as well as credit derivatives as the source of underlying exposures.

Based upon financial information from quarterly call report data, the credit derivatives market among all U.S. insured commercial banks totals more than \$16 trillion in notional exposure as of March 31, 2008, up from \$1.0 trillion at year-end 2003.² This compares with a total notional amount of \$180.3 trillion for all derivatives in U.S. insured commercial banks at the end of the first quarter of 2008. Credit derivatives have grown at a compounded annual growth rate of 100% since 2003, while total notional derivatives have grown at a rate of 21% over the same period. It is important to note that the total notional amount is not a good proxy for risk in derivatives contracts, but generally is indicative of levels of business volumes.

The primary derivatives-related risks focused on by the OCC are credit risk, price risk, and operational risk. Credit risk in derivatives transactions arises from the exposure that exists to the counterparty in the transaction. This counterparty credit risk is significant and varies over time because it changes as market factors change. Banks therefore use models to estimate how much exposure they will have to a counterparty over the life of a portfolio of derivatives contracts, as well as shorter time intervals, as

² OCC's Quarterly Report on Bank Trading and Derivatives Activities - First Quarter 2008.

appropriate. During the last twelve months, financial institutions experienced a significant growth in current credit exposure, driven by decreasing interest rates, widening credit spreads, and ongoing market volatility. At the end of the first quarter, net current credit exposure from all derivatives reported by insured U.S. banks was \$465 billion, 50% higher than in the fourth quarter and 159% higher than a year ago. Gross counterparty exposures from credit derivatives have grown even more rapidly, increasing 86% in the first quarter, and 500% over the past 12 months.

Unlike credit risk, price risk in derivatives activities – that is, changes in the market value of derivatives contracts – in the large national banks has traditionally been low because of their primary role as financial intermediaries. For example, the current credit risk exposure for the three largest national banks' derivatives activities was \$311 billion as of the end of the first quarter and by comparison, the quarterly average Value at Risk (VaR) reported for these three firms was \$553 million. Price risk is typically controlled and measured by a VaR system, which is a statistical measure that banks use to quantify the maximum loss that could occur, over a specified time horizon and at a certain confidence interval, during normal market conditions.

Of growing concern in the OTC derivatives markets over recent years has been the issue of operational risk, which includes losses that may occur due to back office and process failures. The significant growth in the credit derivatives market over the last several years has contributed to greater levels of operational risk exposures due to system infrastructure constraints and the potential for operational errors. To date, we have not identified any significant operational losses that have arisen in national banks due to back office or processing problems, but the vulnerability is greater today due to the increase in

the size of the credit derivatives market as well as the rising levels of concern about counterparty and underlying obligor credit quality.

II. OCC Supervision of Derivatives

As I noted earlier, derivatives activity in the U.S. commercial banking system is dominated by a small group of large financial institutions. The top five banks involved in the trading of derivatives are national banks supervised by the OCC. These five large commercial banks represent 97% of the total commercial bank industry notional amount and 93% of total trading revenues as of March 31, 2008. Looking specifically at credit derivatives, these same five institutions conduct nearly all of the trading activity for U.S. commercial banks.

The OCC has been, and continues to be, a leader in the supervision of derivatives activity. In 1993, the OCC issued comprehensive guidance on the risk management practices required to conduct the derivatives business in a safe and sound manner (OCC Banking Circular 277). OCC examiners conducted the first horizontal review for derivatives activities in 1994 using that guidance. In subsequent years, the OCC issued additional guidance to both field examiners and bankers highlighting our supervisory expectations regarding this activity. In 1996, when credit derivatives were first becoming prominent, we issued guidance to examiners on supervisory issues related to banks' use of these products. These guidelines were supplemented with the "Risk Management of Financial Derivatives" examination handbook that was issued in 1997. In 1999, we updated Banking Circular 277 and our examination handbook with guidance that summarized key lessons learned from the market disruptions associated with

deterioration in Asian, Eastern European and Latin America countries and the failure of Long Term Capital Management. Later this year, we plan to issue another update of our guidance to reflect lessons learned from the current market disruption.

In 1995, the OCC began conducting a quarterly analysis of the derivatives market using financial information from call report data submitted by national banks. We originally designed and published this work in an effort to help others to evaluate risks in the national banking system and to understand the risk profile of these institutions with regard to trading activities. In addition, this analysis allows us to identify trends in derivatives activity or potential risk management concerns systemically and for individual institutions, which we then discuss with our field staff.

The foundation of the OCC's supervisory efforts in the derivatives area is our continuous, on-site presence of examiners at each of our largest banks. Supervisory strategies are developed for each institution that are risk-based and focused on the more complex banking activities. Our risk-based supervision is flexible, allowing strategies to be revised to reflect the changing risk profile of the supervised institutions.

Our supervisory goal is to ensure banks have sound risk governance processes given the nature of their risk-taking activities. At these large banks, resident teams of OCC specialists in capital markets and credit risk, supplemented by PhD economists trained in quantitative finance, engage in evaluations of the suite of risks arising from derivatives activities in general, and also credit derivatives activities specifically. This process involves regular monitoring of risk positions as well as periodic, targeted examinations of specific trading areas or business operations including credit derivatives. The purpose of our targeted examinations is to validate that management has appropriate

practices in place to identify, measure, monitor and control trading risks. We evaluate the integrity and effectiveness of their risk management systems, and perform transactional testing. We also evaluate the level of operational risk associated with trading activities and the appropriateness of position valuations and financial reporting.

Our supervisory conclusions, including any risk management concerns, are communicated directly to bank senior management. Thus, not only is there ongoing evaluation, but there is also a process for timely and effective corrective action when needed.

III. Strengthening the Credit Derivatives Infrastructure

As the volume of credit derivatives activities increased in recent years, there were early warning signs that the system infrastructure, with its manual processing environment for trade confirmations, was not keeping pace. The early warning signs arose in the form of metrics released by the International Swaps and Derivatives Association (ISDA) in its annual margin survey which showed deteriorating trends with respect to the volume and length of time that confirmations were remaining outstanding in all derivatives portfolios, but significantly in credit derivatives space.

The Federal Reserve Bank of New York convened a group of global supervisors and key market participants in September 2005 to begin what has become an ongoing dialogue on over-the-counter derivatives infrastructure issues. This initiative and continual dialogue between supervisors and the industry has driven significant market improvements in a relatively short time horizon. Collectively, supervisors have focused industry attention on reducing the volume of outstanding confirmation backlogs while

increasing automation to ensure a stronger financial market infrastructure going forward. As a result of this effort, we have seen an average reduction of 86% of outstanding confirmations greater than thirty days among participants from initial peaks. This effort has been aided by the 2005 ISDA Novations Protocol, which reinforced industry requirements to obtain the proper consent of affected parties when processing transferred or novated contracts. Similarly, automation of credit derivatives has more than doubled since September 2005, such that approximately 91% of all trades are now processed electronically.

This collaborative effort has delivered other significant milestones in industry infrastructure improvements. The industry developed a trade information warehouse that holds records of many legacy and current credit derivatives trades. This centralized trade information should aid in future trading, quarterly payments and credit event management. It has already helped in early stage central settlement of quarterly premium payments by netting those payments and thereby reducing the dollar flow of cash payments by approximately 98%.

Despite this improvement, however, supervisors recognized last summer that bank processing platforms were still sensitive to volume changes, as evidenced by rising confirmation backlogs resulting from the volume spike that occurred at the beginning of the current turmoil in credit markets. As a result, bank supervisors redoubled efforts to reduce confirmation backlogs, and shifted the focus to front-office initiatives to address the scale issues exposed by last year's market turmoil. The front-office focus emphasizes the need for dealers to routinely match and clear trades on the trade date, and to maximize efficiency through standardization and automation.

As the primary regulator for national banks, the OCC has been an active participant in this interagency effort. For the institutions we supervise, the OCC has been responsible for evaluating the monthly operational risk reports, identifying systemic risk issues, and discussing implementation issues. We have provided input to the industry group regarding the adequacy of the industry-wide solutions and commitments, and the development of appropriate risk metrics. The OCC participates in regular conference calls with supervisors from around the globe to discuss industry progress and to reinforce the infrastructure improvement goals.

The recent joint meeting among supervisors and key derivatives market participants on June 9, 2008, involved the discussion of several newer initiatives and resulted in us reaching agreement on an expanded set of future goals. The industry is in the process of developing a new commitment letter to supervisors that will address new processing goals, a central counterparty clearinghouse, a credit event management mechanism, a reduction of outstanding trade volumes via multilateral trade terminations, and an extension of the project across other derivatives markets including interest rate, equities, foreign exchange and commodity derivatives.

IV. Central Counterparties and Exchanges

As I noted earlier, bank derivative trading activities pose material counterparty credit and operational risks. In the interest of bank safety and soundness, as well as for the health of the entire financial system, the OCC encourages market-based efforts to promptly reduce these risks. The OCC does not have a position, however, on the specific

format or vehicle to achieve that objective, provided that it effectively reduces these credit and operational risks.

One initiative under consideration by supervisors and industry participants is the development of a central counterparty for the clearing of credit derivatives. This is a concept that would enhance risk mitigation by providing for multilateral netting among the major dealers. A central counterparty could facilitate the management of counterparty credit risk exposures and reduce operational risks across the industry. The central counterparty would manage both counterparty credit and operational risks by truncating the volume of trades among counterparties via a multilateral netting process and by implementing forward-looking margin requirements. Multilateral netting permits long and short positions among multiple counterparties to “net down” to a much smaller volume of open transactions because the central counterparty serves as the seller to every buyer, and the buyer to every seller. With a smaller volume of contracts to be tracked and managed left outstanding, the clearinghouse helps to reduce operational risk.

A clearinghouse model provides a central counterparty and involves ownership guaranty funding and participant margin structure to protect against counterparty credit risk. Given a variety of system, standardization, risk analysis, and pricing issues that may need to be resolved, a clearinghouse might initially have limited application to only index trades and there may be additional challenges that would need to be addressed as it progresses to other credit derivatives products.

Another issue under consideration is an exchange concept for credit derivatives. It is our understanding that the introduction of an exchange structure to the OTC credit derivatives market would require significant standardization and potentially transform the

nature of that market. Given the proven success of the OTC derivatives markets to deliver customized financial products, and current market-based efforts underway to address credit and operational risks, we do not see a need for the OCC to favor one solution over another.

V. Legislative Oversight Evaluation

The OCC has had a longstanding position that we do not believe that OTC derivatives products need to be regulated, in part because the vast majority of significant participants in these markets are regulated. As I have described, the OCC carefully monitors the participation of national banks in OTC derivatives markets and we spend considerable resources, individually and collectively with other supervisors, providing direct supervisory oversight to the largest national banks who actively participate in these markets.

More broadly, the OCC works closely with other domestic and international regulators to exchange information and coordinate the supervision of key market players that could pose systemic risks to the financial system. In addition to the collaborative credit derivatives infrastructure project previously discussed, the OCC is an active participant in the President's Working Group on Financial Markets, the Senior Supervisors Group, the Basel Committee on Banking Supervision, the Financial Stability Forum, and the Joint Forum of senior bank, insurance, and securities supervisors that Comptroller Dugan chairs. These working groups recently released a number of reports, discussing key lessons learned and setting forth recommendations for financial

institutions and their supervisors to enhance market and institutional resilience.³ We contributed to and support these initiatives.

Through these various mechanisms, we are satisfied that we have the necessary tools at our disposal to effectively supervise these banking activities and as such, we do not see a need for legislative intervention to supplement our ability to regulate the credit derivatives of national banks.

VI. Conclusion

As I described earlier, it is our belief that credit derivatives, when used properly, can help financial institutions to diversify credit exposures, improve earnings, and lower their risk profiles. Large national banks that are active participants in this market, serve primarily as financial intermediaries for bank clients interested in achieving a particular credit risk profile or exposure. The OCC closely monitors the activities of these national banks to ensure that they have appropriate senior management oversight, robust risk management systems and the necessary infrastructure to support these risk intermediation activities. While the growth of the credit derivatives market has placed visible strains on some firms' operational infrastructures, the OCC and other global supervisors are actively working with industry participants to resolve these issues, and we have seen meaningful progress in these efforts to-date.

³ Senior Supervisors Group Report, "Observations on Risk Management Practices," at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf; Senior Supervisors Group Report, "Leading-Practice Disclosures for Selected Exposures" at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf ; President's Working Group, "Policy Statement on Financial Market Developments," at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf; Financial Stability Forum, "Enhancing Market and Institutional Resilience," at http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.