Comptroller's Viewpoint

When I signed the "Comptroller's Viewpoint" last year as Acting Comptroller of the Currency, it was with no expectation that I would do so again in 2011. Implementation of Dodd–Frank was just getting under way and looked to be the dominant theme for the next year and beyond. And indeed it has been dominant, but other events—other echoes of the financial crisis—have intervened to make this an even busier year than anyone could have imagined.

Almost every area of financial regulation was affected by events of the year, often in very significant ways. As expected, Dodd–Frank implementation was the major preoccupation of the OCC, especially the provisions that became effective in July 2011. New Basel initiatives in the areas of capital and liquidity—especially heightened standards for systemically important banks—expanded, and in some ways complicated, the Dodd–Frank reform agenda. Then the foreclosure mess came to light, resulting in a series of major enforcement actions to address failures in mortgage servicing and foreclosure processing. As we work to put regulation after regulation in place to create a future free of crisis, it is impossible to avoid recalling similar efforts after the savings and loans crisis 20 years ago. The lesson of economic history seems to be that we are doomed to repeat it. But whatever questions there may be about the likely impact of the reform program, the implementation task is clearly far from over.

The sweeping Dodd–Frank Act will bring changes in the operations of large banks and the way the agencies monitor and manage systemic risk. In addition, the law mandated new regulations aimed at curbing abuses in mortgage lending and securitization that helped bring on the financial crisis. In all, Dodd–Frank set in motion nearly 100 projects at the OCC, including a yearlong effort to remake the agency by absorbing most of the staff and responsibilities of the OTS. That single requirement not only reshaped the agency but also greatly expanded our supervisory and regulatory presence in the area of mortgage lending.

After a year spent working on interagency rulemakings to implement Dodd–Frank, most of that work remains unfinished and a number of the ambitious deadlines in the law have been missed. Not so the transfer of staff and responsibilities from the OTS into the OCC. I'm pleased to report that we worked our way through the logistical and policy challenges involved in the integration, and 670 OTS employees reported to work at OCC offices throughout the country on Monday, July 18, 2011, ahead of the official July 21 transfer date.

I have spent considerable time thanking our combined staffs for accomplishing all this so smoothly, but let the record show that the only simplification of the U.S. regulatory framework mandated by Dodd–Frank was achieved without fanfare—essentially without notice by the outside world. Our goal was to make the transition as smooth as possible, both for the federally chartered thrifts that were subject to OTS oversight and for the staff of the OTS that joined the OCC, and that was accomplished. We need every bit of the talent and experience of former OTS staff to help fulfill our combined supervisory mission, and the men and women joining us from the OTS have been fully integrated into policy and field units where their talents can best be utilized.

We also recognized at the outset how important it would be to pursue outreach to the thrift industry, and we established a robust communication program to ensure that thrift executives knew what to expect from the combined agency. We held 17 outreach meetings around the country, attended by more than 1,000 thrift executives. That program was supplemented

by letters to thrift chief executive officers, outreach at the district level, Web postings, and other actions that made information available to the industry. Feedback we have received indicates that these efforts were successful in smoothing the transition for the thrift industry.

Another of our challenges was to move the entire body of OTS regulations into the OCC regulatory framework. Most of this was good housekeeping, conforming and streamlining the rule books, but our new, uniform preemption rule for banks and thrifts proved highly controversial. The former OTS preemption standard was repealed in favor of the OCC standard, as directed by Dodd–Frank. The key issue was whether Dodd–Frank had upended the basic conflict-preemption standard for national banks embodied in the *Barnett* Supreme Court decision or left it intact. We believe the standard was preserved and asserted our conclusion in a revised preemption regulation that attracted some criticism. I am happy to report that three federal court cases so far have reached the same conclusion about the impact of Dodd–Frank on the *Barnett* preemption standard. Preemption for national banks as we know it is preserved.

We also worked closely with the Consumer Financial Protection Bureau (CFPB), the new agency created by Dodd–Frank, to ensure that it had the information and support it needed to start up on July 21, 2011. Because the CFPB has such important responsibilities for rulemaking across the financial system and compliance supervision for large banks and previously unregulated nonbanks, it is vital that we and the other bank regulatory agencies develop an effective working relationship with them. A key concern we expressed during the legislative process was to ensure an appropriate balance between safety and soundness and consumer protection, and that will require serious attention to the interagency consultation obligations of the CFPB that are built into Dodd–Frank. We have signed a number of memoranda of understanding regarding information sharing and collaboration, and I am hopeful these will prove effective in guiding our future working relationship.

At the same time, the OCC has participated actively in the Financial Stability Oversight Council, or FSOC, the intergovernmental body created by Dodd–Frank to identify risks to the financial system, extend supervision to systemically significant nonbanks, and respond to emerging threats to financial stability. I truly believe that this will be one of the most significant reforms mandated by Dodd–Frank. By bringing together agencies with responsibilities for every sector of the financial services industry, FSOC will examine risks across the entire financial system and help to avert future financial crises.

Among the other Dodd–Frank issues pending as we moved into the new fiscal year that began on October 1, 2011, were two exceptionally complicated rulemakings—risk retention and the “Volcker rule.” These two rules will have a dramatic impact on the way financial institutions serve consumers and businesses.

Clearly, one of the root causes of the financial crisis was poor credit underwriting, particularly in the area of subprime mortgages, and securitization fueled that surge in bad lending by transferring risk from the originator of the loan to other investors. Congress responded by requiring that sponsors of asset-backed securitizations retain at least 5 percent of the credit risk. An exception was made for loans that are underwritten to very high standards, such as qualified residential mortgages (QRM). While the standards proposed for the QRM have proven highly controversial, it is important to remember that the QRM was intended to be an exemption from risk retention, and not a comprehensive new mortgage underwriting standard.

In fact, Dodd–Frank was emphatic in calling for most lending to be subject to risk retention, and, at the end of the day, as the securitization market regains its footing, it is likely that will be the case. While the proposed rule was drafted to provide flexibility, all of the risk retention options in the proposal were designed to create financial disincentives against packaging loans that are poorly underwritten. The draft rule has proven highly controversial, and there is much work remaining before it can be put in final form.

The “Volcker rule” presents similar challenges. The premise behind this Dodd–Frank provision was simple: Congress believed that

banks and bank holding companies were taking excessive risks by engaging in proprietary trading and investing in hedge funds and private equity funds, and these activities should be prohibited. The draft proposal was anything but simple: It is very hard to distinguish some prohibited activities from permitted market making and permissible investments. So the rule runs to almost 300 pages and includes nearly 400 questions on issues still to be resolved. All of us would like a simpler rulemaking, but the fact is that these distinctions are not easily drawn and going too far would cause unintended damage to the system.

In terms of impact, it would be impossible to ignore the changes that are under way affecting bank capital. We have not yet finished implementing Basel II, but the financial crisis highlighted weaknesses in capital policy that resulted in development of increased capital for market risk—so called Basel II.5—and overall increases in minimum capital requirements under Basel III. In addition to raising the amount of capital that banks must hold, setting an international leverage limit, and directing new liquidity standards, the Basel III standards also call for improvements in the quality of capital by requiring that Tier 1 capital consist almost exclusively of common equity. In September 2011, the Basel Committee on Banking Supervision agreed to add a surcharge of up to 2.5 percent for large and systemically important banks. These Basel III initiatives will apply to U.S. banks when U.S. regulators promulgate revisions to U.S. capital regulations that embody the new standards.

Dodd–Frank also addressed capital and covered some of the same ground as the Basel Committee. The law requires more stringent prudential standards, including capital and liquidity requirements, for larger, more systemically important bank holding companies, and touches upon the quality of regulatory capital by limiting the use of certain hybrid instruments in capital calculations. Dodd–Frank also established specific requirements related to the leverage ratio, and it mandated studies on contingent capital.

It will be a challenge to implement all of these objectives in a sensible way, in part because the two frameworks are complicated, and in part because they do not always mesh well together. But we are working very hard on an interagency basis to make these new requirements work.

Finally, the OCC has devoted very significant resources to addressing the deficiencies in mortgage servicing and foreclosure processing that were revealed in late 2010—the first quarter of this fiscal year.

The volume of problem mortgages overwhelmed the capacities of the larger mortgage servicers, and shoddy practices like "robo-signing" resulted. Bank managers failed to pay enough attention to how simple, ordinarily low-risk aspects of the business were being done. Bank servicers, including the law firms and other vendors they employed, were skipping steps in back-office operations and mismanaging case files in systemic dimensions.

In retrospect, everyone should have realized the dangers lurking in the unprecedented volume of foreclosures being processed. Without question, regulatory agencies, including the OCC, should have caught this sooner.

However, once the problem came to light, we set to work immediately. We directed our banks to conduct self-assessments while we prepared to launch an intensive set of "horizontal" examinations that would look at these issues across a field of 14 large servicers across the system. Our examiners then documented the seriousness of those problems.

While all of the loans in the sample we looked at were seriously delinquent, we also uncovered critical deficiencies and shortcomings that constituted unsafe and unsound banking practices, and that resulted in violations of various laws and rules. Along with the Federal Reserve and the OTS, we took enforcement actions, entering into orders with each of the servicers aimed at fixing what was broken, compensating borrowers who were harmed, and ensuring a fair and orderly foreclosure process going forward. With the transition of the OTS into the OCC, we are now responsible for 12 of the 14 servicers.

This is a huge undertaking, and it will take a year and more to bring it to a conclusion. To illustrate its scope, the servicers estimate that as many as 4.5 million borrowers

and former homeowners could potentially seek a review of their cases. We have directed the servicers to use sampling techniques to evaluate these portfolios of borrowers, but more importantly, we have also put in place a process that will allow any borrower who believes he or she was financially harmed by the unsafe and unsound practices addressed in the orders to request an independent review of his or her case. As a result of these reviews, identified financial harm will be remedied for such borrowers.

This is only one of the many important issues we are dealing with, but it may be the most important. Getting the real estate sector back on its feet is one of the keys to economic recovery, and solving the foreclosure problem in a way that ensures fair treatment of America's families is necessary to reestablish trust in our financial system.

It is unfortunately true that significant numbers of homeowners continue to face the loss of their homes in our slow-growth economy, but it must also be true that troubled borrowers can expect to be treated fairly. I am confident that our enforcement actions will do just that: ensure that at-risk borrowers get a fair chance to stay in their homes, while assuring that those who do find themselves in foreclosure receive appropriate protection and due process of law.

The challenges ahead are significant, but the U.S. economy will not be restored to full prosperity without a strong banking system. An economy as large as ours needs large banks to finance it, but it also depends on the diversity and personalized service provided by small and midsize banks. Such diversity has long characterized our banking system, and that is unlikely to change since economic systems naturally organize in this way.

Federally chartered institutions, operating under uniform national standards, are a critical part of that system. We at the OCC have worked hard over the last year to restore and ensure the viability of the institutions we supervise, aiming to make that system

- a safe system that manages risk and maintains ample liquidity and strong capital;
- a sound system that provides innovative service to businesses and individuals, complies with applicable laws, and earns a reasonable profit; and
- a well-managed system that is efficient and responsive to the needs of the communities it serves.

What remains is for the banks and federal savings associations that make up the federal system to put the lingering effects of the financial crisis behind them and restore the trust and confidence of the American people. Our goal is to make that happen.

John Walsh
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of the Currency