

Remarks by
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Thank you. It's a pleasure to be here with you today, and to have this opportunity to speak to a group that represents such a broad range of participants in the securitization business. Securitization is sometimes maligned and frequently misunderstood, and its importance to our nation's economy is often not fully appreciated. Whether in mortgages, credit cards, auto finance, or student loans, meeting the needs of American consumers depends heavily on securitization. It is hard to imagine full recovery of the financial system without the liquidity and funding avenues provided by a well functioning securitization market. Certainly, it is hard to foresee a strong recovery for the housing industry without securitization. And it seems unlikely we will experience strong and sustained economic growth without a rebound in the housing sector.

Unfortunately, the fragile state of securitization is a result, in part, of its role in the financial crisis. While the principal trigger of the crisis was poor credit underwriting, particularly of subprime mortgages, securitization of those mortgages fueled the surge in bad lending by transferring risk from the originator of the loan to other investors. The tranching of pooled instruments into different investment classes offered a means of matching risk and risk appetite, promoting the depth and liquidity of markets, but many

of these financial structures did not withstand the stress of a market meltdown.

Structured finance and the credit ratings on which it was based were discredited, and securitization itself came to be seen as a significant cause of the crisis in the financial markets.

Clearly, a range of abuses triggered and sustained the crisis, and the Dodd-Frank Act took a number of steps to deal with them. And when I say a “number of steps,” believe me, I know all too well just how many steps there actually are. Since the day that Dodd-Frank was signed into law, we at the OCC and our colleagues at the other financial regulatory agencies have been devoting an enormous amount of time to implementing the law.

Some of the provisions of Dodd-Frank were aimed at early identification of risks with potentially systemic consequences, and at heightened supervision and orderly resolution of systemically significant firms, particularly those outside the safety net like AIG, Bear Stearns, or Lehman Brothers. Creation of the Financial Stability Oversight Council, or FSOC; heightened supervisory standards for firms of systemic consequence; and FDIC orderly resolution authority are the responses to these challenges.

Other provisions were directed at perceived sources of risk that were implicated in the crisis, and would change the way certain businesses are conducted inside banking entities and other financial institutions. The risk retention rule, the Volcker rule, limits on use of credit ratings, and derivatives regulation all fall into this category, and have proven more controversial.

The problems the Dodd-Frank Act tackled are very real, but the new law came at them from many directions. Risk can be mitigated through activity limits or prohibitions,

through increases in capital and liquidity requirements, through new standards for underwriting or product offerings, through enhanced supervision and controls on risk taking and leverage, and through enhanced transparency and disclosure. Dodd-Frank does some of all of these things, in the process making very significant changes in the way business is done by financial institutions. There are so many moving parts that it is very hard to judge how these many approaches will interact, or what their cumulative effect will be.

In our rulemaking, the goal of the agencies must be to strike a balance that meets the objectives of Dodd-Frank, while enabling financial firms to continue conducting business in a manner that is safe, sound, and profitable; ensuring appropriate monitoring and management of risk; promoting healthy and liquid markets; and supporting a strong and growing economy.

The challenges we face in formulating some of these very complex rules offer good news and bad news. The news is good if you believe that the time it is taking to develop consensus among diverse agencies defers regulatory burden; it's bad if you believe that delay in implementation translates to delay in recovery of financial markets. Markets hate uncertainty and struggle with adjusting to the unknown.

So let me turn to a couple of the issues on which we are working that I think are of specific interest to this audience, then finish with some thoughts on the role of derivatives in banking and financial markets. We're in the midst of rulemakings that affect these issues, so I will of necessity be somewhat more limited than I might like in what I can say. But these are extremely important matters, and it's worth taking some time to update you on where we are.

The risk retention proposal has been of great interest to the American Securitization Forum, and we are intensely involved in reviewing the comments received and discussing them with our interagency colleagues. The proposed rule included a number of approaches to risk retention, including vertical slices, horizontal slices, and the Premium Capture Cash Reserve Account, as well as a proposed definition of a Qualified Residential Mortgage, or QRM, securitizations of which would be exempt from risk retention. I don't have to describe for you the extent of the comments or the many aspects of the risk retention proposal they addressed, because many of you wrote them. But I don't think any element of the proposal attracted as much criticism as the QRM.

Clearly, Congress intended the risk retention requirement as a discipline on the quality of the loans securitized—and thus indirectly on the quality of the loans made. The debate is over the scope of the QRM exception from that risk retention premise. Should the exception be narrow—to recognize the unusual nature of a total exemption from the statute's risk retention premise? Or should it be broader—recognizing that a range of mortgage types could demonstrate acceptably low default rates? These are the types of issues under discussion among the rulemaking agencies right now.

The role of credit ratings is another challenging area, particularly because of the role such ratings play in the Basel capital framework, and in part because so many small banks lack the capacity to do the kind of independent analysis that would be necessary without some degree of reference to credit ratings. We were unable to persuade Congress to ease Dodd-Frank's total prohibition on references to credit ratings in regulations, but even without the ban, we would have been moving in this direction. Having seen the highest-rated tranches of asset-backed securities generate huge losses during the financial

crisis, it was clear that myopic reliance on ratings was not acceptable—not by investors and not by regulators. In this area, different alternatives to credit ratings may be appropriate depending on the context. In the OCC’s proposed rulemaking addressing the use of credit ratings in our regulations—such as the criteria for investment securities in which national banks may permissibly invest—we proposed alternative definitions for such investment securities and reemphasized longstanding guidance on the need for independent assessment of risks. In the more complex context of the market-risk capital rule, where credit ratings translate into multiple risk weighting categories, the OCC and the other federal banking agencies have proposed a different approach that looks to different sources of substitute criteria to establish risk weights of various assets for market-risk capital purposes.

Let me turn now to the Volcker Rule proposal. Implementing the Volcker Rule provisions of the Dodd-Frank Act is a very complex undertaking, even though the general objective of the statute—barring banks from engaging in proprietary trading or investing in or sponsoring “hedge funds” and “private equity” funds—initially seems straightforward. As the interagency group drafted the proposal, it became clear that this rule could have a significant impact on securitizations; so we wrote more than two dozen questions directly related to securitization, asking commenters to supply us with additional information.

For example, one question asks whether securitization vehicles could be subject to the Volcker Rule’s restrictions on proprietary trading, as well as the rule’s detailed compliance regime, because of the nature of the relationship between the vehicle and a

depository institution. We asked if this result would increase the costs of securitization, deter banking entities from the securitization business, or have other consequences.

Another important set of questions relates to whether various securitization vehicles would be considered “hedge funds” under the proposal. Banks could find it more difficult to structure securitizations with vehicles that were considered “hedge funds,” so the proposal asks several questions about whether the definition of “hedge fund” captures current securitization structures. We also asked several questions on how we should interpret a rule of construction in the statute stating that the Volcker Rule should not be construed to limit or restrict the sale or securitization of loans. Comments on the proposal are due by February 13, and I encourage you to take a close look at the proposal and comment on these and other issues that affect securitization structures and practices.

Finally, we and the other federal regulatory agencies have a number of rulemakings in the works to address Dodd-Frank provisions aimed at managing risks inherent in the use of swaps and other types of derivatives. This is the issue I’d like to spend the rest of my time on, in part because it has such important implications for banks and the economy, and in part because it is perhaps the least understood.

This is an area in which the OCC has considerable expertise. We supervise the large banks that dominate this market, and we have devoted very substantial resources to monitoring and managing the risks posed by derivatives. We maintain full-time teams of examiners within our large banks, and they are supplemented by specialists who provide support for the most complex activities. These include Ph.D. economists and examiners recruited from the industry for their specialized knowledge. Our quarterly report on bank

trading and derivatives activities has become the most important source of data available on the subject, and we are well aware of both the risks and benefits that arise from the use of derivatives by banks. So, as you might imagine, we have followed very closely the debate over derivatives.

In the popular retelling of the financial crisis, derivatives played a crucial role in both hiding and amplifying risk. The Financial Crisis Inquiry Commission, for example, characterized the moment in 2008 when our largest financial institutions were teetering on the brink of failure as a “derivatives crisis.” The Commission focused on unknowns involving counterparties and individual holdings, among other things. The report went on to say, “Market participants and regulators would find themselves straining to understand an unknown battlefield shaped by unseen exposures and interconnections as they worked to keep the financial system from collapsing.”

Clearly, some problems did arise specifically because of the way that derivatives were used by financial institutions in the run-up to the crisis, and as a starting point, it’s important to acknowledge them. Credit default swaps shifted risk exposures among market participants in ways that were sometimes unclear and often highly-leveraged, and they enabled the creation of synthetic securitizations that sometimes multiplied the risk from one set of poorly-underwritten loans many times over. The lack of transparency in derivatives transactions among dealer banks and between dealer banks and their counterparties did create uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. The Proposed Swaps Margin Rule under Dodd Frank is intended to incent institutions to migrate business to exchanges

to address the transparency and interconnectedness issues that proved problematic during the financial crisis.

But, the critique of derivatives that has emerged is far broader than the specific instruments or circumstances implicated in the crisis. Warren Buffet colorfully labeled derivatives “financial instruments of mass destruction” and, for some, they are not just a sophisticated component of a bank’s product portfolio, but toxic instruments that should be pushed out of the banking system entirely. That is a vast overreaction, and it worries me that misperception could motivate redesign of the system.

Lack of understanding feeds misperception, and derivatives are not particularly well understood, even by some top policymakers. This is not just a matter of the risks involved, but extends even to the size of the market. The OCC’s most recent quarterly report on bank trading and derivatives activities noted that the notional value of derivatives contracts was \$248 trillion at the end of September, which is a multiple of the world’s annual economic activity. The notional value of derivatives contracts is a number that is frequently cited in somber terms to describe the size—and risk—of the market, but of course that’s far from the mark. I’m not trying to suggest that this isn’t a big market or that it doesn’t involve sizeable risks, but the risk ascribed to derivatives is often many orders of magnitude greater than the reality.

As the members of the American Securitization Forum know all too well, the biggest risk from derivatives is not the market risk, but rather the credit risk. At the end of the third quarter of 2011, insured U.S. commercial banks had \$504 billion of net current credit exposures from derivatives contracts. That’s after accounting for legally enforceable netting agreements and represents just 0.2 percent of the notional values.

When we consider liquid collateral protection, the net uncollateralized exposure number drops to \$181 billion—or less than one tenth of one percent of the notional values. Now, that’s still a significant amount of credit risk, so the OCC spends a lot of time evaluating the counterparty credit risk exposures of bank derivatives portfolios.

Since 1997, banks have charged off an average of about \$117 million of their derivatives exposures each quarter. While the numbers have increased recently, reflecting the adverse economic environment and rising exposures, charge-offs are running at 0.02 percent—just two basis points of the net current credit exposures. Banks are in business to take credit risk, which is the key risk in derivatives activities. The data demonstrates that banks have effectively managed these credit risks over time and, going forward, the mandate in Dodd-Frank to move toward central clearing of derivatives transactions should lead to a reduction of these credit exposures.

Then, to the extent that an appropriate worry is the role played by credit default swaps, CDS represent only 6.3 percent of total derivative notionals and 8 percent of the gross credit risk, a distant third in order of magnitude. Interest rate contracts comprise 79 percent of risks with foreign exchange representing an additional 11 percent. Can CDS still be used to replicate securities? The answer is “yes”, but the core problem was not CDS but synthetic CDOs based on the replication of poorly underwritten sub-prime mortgage securitizations which are being directly addressed through the risk retention provisions.

But even if we accurately recalibrate the risks involved, the financial crisis demonstrated the need to improve regulation of derivatives. Dodd-Frank includes a number of provisions aimed both at mitigating risk and increasing transparency, through

improved risk practices, increased official oversight, and the use of clearinghouses and exchanges. Again, however, provisions that seem straightforward in theory have proven to be controversial in practice.

For example, the OCC, along with other federal regulators, published a proposal to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants subject to agency supervision. The agencies proposed to require swap entities to collect margin for all uncleared transactions with other swap entities and with financial counterparties. One element of the proposal involved the application of margin requirements to foreign branches and affiliates of U.S. banks. Commenters strenuously opposed this aspect of the proposal and indicated it would have a severe effect on their competitive position.

These commenters noted that U.S. regulators are ahead of their G20 counterparts in formulating margin requirements, and imposition of U.S. margin rules on their foreign derivatives business at a time when foreign competitors are not required to collect margin from similar customers will effectively destroy this aspect of their business. They called for the agencies to delay imposition of this aspect of the proposal and work with foreign authorities to harmonize margin requirements internationally, phasing them in on a coordinated basis.

We understand these concerns, and we will be carefully considering all of the issues raised in the comment letters as we move ahead on the regulation.

Our rulemakings in this area are likely to be of great consequence to many of you, given how important derivatives are in securitizations. Derivatives are commonly used to

hedge risk in securitization deals. Many securitizations include swaps that trade floating-rate interest payments for fixed-rate payments, for example, or hedge foreign exchange risk. And, credit default swaps that offer protection against negative credit events will continue to be important to investors in securitized assets.

All of which brings me to my final point. Even if derivatives were implicated in the market collapse of 2008, they continue to provide important benefits for lenders and their customers. Derivatives provide the banks we supervise with important and prudent means of managing credit exposures; for example, hedging the risk of a loan by using a credit default swap for protection in the event that the borrower defaults. Likewise, banks can help customers hedge against risk; for example, selling a “cap” to a borrower with a floating-rate loan to hedge against the risk of rising interest rates.

And of course, there are the classic examples of derivatives being used by bank customers to guard against price increases in commodities that are important to their businesses. Airline companies hedge fuel costs; farmers lock in prices for their harvests and protect against the possibility of bad weather; and manufacturers protect themselves against increases in the prices of their raw materials. These are products that benefit bank customers and that banks offer in a safe and sound manner. As we write regulations to address the excessive risk taking and failures of risk management that helped bring on the financial crisis, we must take care to avoid making it more difficult for banks to manage their own risks and to serve the legitimate needs of their customers.

Much work remains to complete the implementation of the Dodd-Frank Act and to restore the health of the financial system. Strengthening risk management and improving market transparency for derivatives is an important part of this, as is ensuring

sound underwriting in securitizations. While these are diverse objectives, what they have in common is that new regulatory frameworks are being erected around them, and the way in which we set limits and define terms in those frameworks will importantly affect which activities remain part of the basic business of banking, how banks manage their own risks, and how they provide liquidity to markets and financial intermediation to customers. New regulatory contours are being laid out in the provisions I have described, and I encourage the industry to engage actively in the comment process to make sure we get it right when we fill them in.

Thank you for your attention.