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TESTIMONY OF

JOHN WALSH
ACTING COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

September 30, 2010

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.

Chairman Dodd, Senator Shelby, and members of the Committee, I appreciate the opportunity to describe the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Committee's letter of invitation asked the OCC to address several key topics: (1) the OCC's priorities in implementing the Dodd-Frank Act and the progress we have made; (2) the OCC's plans for integrating the staff and functions of the Office of Thrift Supervision (OTS) into the OCC; (3) the OCC's plans for identifying employees for transfer to the Bureau of Consumer Financial Protection (CFPB); and (4) our views about how Basel III will further the objectives of the Dodd-Frank Act. My testimony addresses each of these areas in turn. We also offer some additional thoughts for the Committee's consideration on a few aspects of the legislation that present particular implementation challenges.

I. Rulemaking and Policy Initiatives

The Dodd-Frank Act directs the OCC to draft rules, some jointly with other agencies and others on a coordinated basis, on a broad range of topics, including: regulatory capital; permissible proprietary trading, hedge fund, and private equity fund investments (the so-called Volcker rule); derivatives margin requirements; executive compensation; and real estate appraisals, among others. The OCC will need to revise some regulations to address statutory changes. Moreover, our new role as primary supervisor for federal savings associations will require us to review and republish rules issued by the OTS. For each of these rulemaking obligations, we have established an interdisciplinary team of agency experts dedicated to lead the OCC's efforts and to work with interagency teams, where appropriate, to develop the new rules.

The legislation also requires other financial regulatory agencies to consult with primary supervisors as those other agencies draft studies or develop regulations or standards, since there may be implications for the safety and soundness of depository institutions. Accordingly, we have designated OCC experts to advise the other financial regulatory agencies about the potential impact on the institutions we supervise and their customers.

Taken together, these responsibilities constitute an implementation challenge of unprecedented scale. A large number of staff professionals will be assigned to work on the financial regulatory reform provisions of the Dodd-Frank Act, and we have established a senior management oversight group within the OCC to direct and coordinate our effort.

Among our efforts, the OCC is supporting the organization of the Financial Stability Oversight Council (FSOC), which is chaired by the Secretary of the Treasury and includes as members, among others, the heads of the Federal banking agencies, including the Comptroller of the Currency; the Director of the CFPB; the Chairs of the Securities and Exchange Commission (SEC) and Commodities Future Trading Commission (CFTC); and the Director of the Federal Housing Finance Agency (FHFA). The FSOC's mission is to identify risks to financial stability that could arise from the activities, material financial distress, or failure of large, interconnected financial companies; to recommend standards for implementation by the agencies in specified areas; to promote market discipline; and to respond to emerging threats to the stability of the U.S. financial system.

In addition, a number of implementation projects are already underway. In August, we sought comment through an Advance Notice of Proposed Rulemaking (ANPR) on the implementation of section 939A of the Dodd-Frank Act. This section directs the federal agencies to review regulations that require an assessment of the credit-worthiness of a security or money market instrument, and remove any references or requirements involving credit ratings and substitute an alternative standard of creditworthiness. Apart from capital rules, the OCC's regulations use credit ratings in several different ways, most significantly in setting the criteria for determining which "investment securities" national banks may acquire as permissible investments. Through the ANPR, the OCC sought comment on the implementation of section 939A with respect to these regulations and others governing securities offerings and international activities where credit ratings are referenced. The ANPR also set forth considerations underlying the reliance on credit ratings and requested comments on potential alternatives to the use of credit ratings.

Separately, we also joined in an interagency ANPR to assess the impact of section 939A on the banking agencies' regulatory capital rules, which currently reference credit ratings in four general areas: (1) the assignment of risk weights to securitization exposures; (2) the assignment of risk weights to claims on, or guaranteed by, qualifying securities firms; (3) the assignment of certain regulatory capital add-ons for trading assets held by banks with large trading portfolios; and (4) the determination of the eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules.

One active interagency project involves standards for uncleared swaps. Sections 731 and 764 of the Dodd-Frank Act require the banking agencies, the Farm Credit Administration, and the FHFA to promulgate margin requirements for uncleared swap transactions by swap dealers and major swap participants subject to the agencies' jurisdiction. The agencies are engaged in discussions to establish the design of the margin requirements and margin levels, in light of the risk standards for such rules established by the Dodd-Frank Act.

On another front, an interagency group consisting of the federal banking agencies, the SEC, Housing and Urban Development (HUD), and the FHFA, has begun to discuss the design of several rulemakings mandated by section 941 risk-retention requirements. Section 941 generally mandates that the agencies publish rules requiring securitizers (and in some cases, originators of securitized assets) to retain at least five percent of the credit risk of the loans they package and sell through securitizations. Lower risk retention levels may be allowed for specific loans, particularly mortgages, if they are underwritten according to prudential standards to be set by the agencies through the rulemaking process.

The OCC has also begun work on the provisions in section 956 which require the federal agencies jointly to prescribe regulations or guidelines requiring the disclosure of certain incentive-based compensation arrangements and prohibiting compensation arrangements that encourage inappropriate risk-taking by financial institutions.

In addition, an interagency working group consisting of the FSOC's member agencies has begun providing input to the FSOC as it initiates its study of proprietary trading and hedge fund and private equity fund investments with a view to making

recommendations to the banking agencies and the SEC when they promulgate regulations for the implementation of section 619.

As we begin to implement the Dodd-Frank Act, we also have identified some notable implementation challenges that may be of interest to the Committee. These include the practical effects of prohibiting the use of credit ratings in regulations under section 939A. Ambiguities in section 171, relating to baselines for existing and future leverage and risk-based capital requirements, also raise a number of issues that pose implementation challenges and, as in the case of section 939A, could pose significant burdens on smaller banking institutions. There also appears to be an inconsistency in the duties assigned to the banking agencies and the CFPB with regard to fair lending that creates confusion in responsibilities. These issues are more fully discussed in Attachment A to this testimony.

II. Transfers of Agency Functions

The Dodd-Frank Act transfers from OTS to the OCC supervisory responsibilities for federal savings associations, as well as rulemaking authority relating to all savings associations. Under the statute, all OTS employees will be transferred to either the OCC or the Federal Deposit Insurance Corporation (FDIC) no later than 90 days after the "transfer date," which is one year after enactment unless extended for an additional six months by the Secretary of the Treasury. The allocation is to be based generally on the proportion of federal versus state savings associations regulated by the OTS.

The Dodd-Frank Act also establishes the CFPB as an independent bureau in the Federal Reserve System. Certain existing authorities of the banking agencies, HUD, and the FTC for consumer protection regulations are to be transferred to the CFPB, along

with responsibility for overseeing compliance with a number of listed consumer protection standards applicable to depository institutions with assets of more than $10 billion. Employees from the banking agencies, HUD, and the FTC will be transferred to the CFPB as part of this process.

Thus, the OCC is uniquely challenged with respect to transfers of functions under the Dodd-Frank Act because we are both absorbing significant new functions and a significant number of new staff as a result of the integration of the OTS into the OCC, while at the same time transferring functions and some associated personnel in connection with the organization of the CFPB.

Integration of Specified OTS Functions into the OCC

Although the legislation preserves the thrift charter and the Home Owners' Loan Act, the OTS is abolished 90 days after the transfer date. The OCC recognizes its important responsibilities under the Dodd-Frank Act to ensure the orderly and effective transfer of functions and personnel from the OTS to the OCC and to assure efficient and effective supervision and regulation of federal thrifts, and we have already taken a number of steps to begin this process. To centralize efforts in this area, the OCC established a transition team and appointed a senior agency official to coordinate and supervise the implementation of all issues involving the integration of OTS functions and responsibilities. Transition team members have begun working with their counterparts at other agencies to identify and address mutual concerns and issues for resolution. While it is early in that process, and many details are yet to be determined, I can provide some details regarding our planning for the transfer of personnel and supervisory functions, as

well as the transfer of funds, property, and systems.

Transfer of Personnel and Supervisory Functions

The Dodd-Frank Act provides that the OCC will become the appropriate federal banking agency for federal savings associations, and the FDIC will assume that role for state savings associations. All OTS employees are to be transferred to the OCC or FDIC no later than 90 days after the transfer date. The Director of the OTS, the Comptroller of the Currency, and the Chairperson of the FDIC will jointly determine the number of OTS employees needed to perform the functions transferred and identify employees for transfer to the OCC or FDIC. While the final number of OTS employees who will transfer to the OCC has not yet been determined, the preponderance of OTS-supervised institutions are federal savings associations that will be supervised by the OCC and, thus, under the personnel transfer provisions in the Dodd-Frank Act, a correspondingly large portion of OTS employees would be transferred to the OCC. We believe that the orderly transfer of these individuals from the OTS to the OCC is essential to the success of integrating the supervision of federally chartered savings associations into the OCC. We also recognize that these staff members have critical knowledge and insight into the unique mission and resulting supervisory challenges associated with the thrift industry. The OCC is working with the OTS to plan and ensure an orderly transfer of authority and responsibilities to ensure the effective supervision of both national banks and federal thrifts.

To ensure the success of this transition, we are guided by a basic principle that informs the legislation, that there will be no gaps in supervision as we expand our

supervisory framework to include federal thrifts. Our goal is a rigorous, consistent, and balanced supervisory approach for all of the institutions that we will supervise.

The 1,300 nationally chartered community banks that we currently supervise use a variety of business models, including a significant number of institutions that look very similar to thrifts with a preponderance of long-term assets. We also supervise other types of specialized institutions, including credit card banks and trust banks. Because of this diversity of experience, our examiners understand the importance of evaluating the condition and future prospects of each institution based on its unique characteristics and performance, as well as its local market conditions.

We also recognize the importance of communicating regularly with the industry throughout this process. Among other things, the OCC is developing an outreach program for thrift executives to provide information and perspective on the OCC's approach to supervision and regulation. This one-day program will be held at various locations throughout the country and will be co-hosted by an OCC District Deputy Comptroller and an OTS Regional Director. During these sessions, our senior examiners will explain how we examine banks, including the development of individually tailored supervisory strategies based on the unique risks facing each institution. The program also will describe the functions of our district counsel and district licensing activities. We expect these events to take place in the first and second quarters of 2011.

In addition to the thrift-focused programs, OCC bank supervision managers have begun participating in industry events that provide interaction with thrift executives in group settings as well as individual conversations to expand the industry's awareness of the OCC, its policies, procedures, and supervision philosophy. I also sent a personal

letter to the chief executive officers of all federal savings associations to begin the process of communication that will be so important to the transition.

As part of our transition effort, our human resources specialists are also working closely with their OTS counterparts to review employee positions, duties, and responsibilities to ensure proper alignment of transferring OTS staff in the combined organization. Consistent with the legislation, this process will ensure that OTS employees are treated equitably with regard to status and tenure, and that pay and other benefits will be protected.

We are undertaking a business line approach in these early stages. Each of our business units is coordinating with its counterparts at the OTS to review positions, responsibilities, and business processes to determine the best means of integrating staff and their functions into the OCC. We have found this interaction at a business line level promising in establishing relationships and identifying issues of mutual concern. To the extent practicable, transferred employees will be placed in OCC positions with functions and duties similar to those they had prior to their transfer. In some instances, we already have jointly identified opportunities to detail OTS staff to assist with our current responsibilities.

Our general intent is to integrate transferred employees into the OCC's organizational structure and pay plan as soon as possible and to maintain existing OCC human resources policies. At the same time, we will work closely with our OTS counterparts to review and analyze personnel policies and practices and to identify and resolve any significant differences.

The transition team also is reviewing and comparing employee benefits and any related contracts, including those under the Financial Institutions Retirement Fund (FIRF), which covers some OTS employees, and other supplemental retirement benefits. The OCC is reviewing the FIRF plan to determine what actions need to be taken to ensure that it is in a position to meet obligations to employees and retirees under that program. As reported in the OTS Annual Report for fiscal year 2009, the estimated OTS FIRF pension shortfall as of July 1, 2009, was $80.7 million.

One area that we have identified as critical to the combined success of the OCC and the OTS is the role of training, even at this early stage in the integration process. As a result, we have begun to review each agency's training and certification programs to ensure that existing and transferred employees have the training and skills necessary to supervise both national banks and federal savings associations. This review will identify areas where OCC and OTS training programs overlap, as well as gaps that need to be addressed. While the legislation does not require additional certification for transferred OTS employees to continue supervising the types of institutions that they supervised prior to the transfer, additional training may be required before transferred employees can supervise national banks. As a first step in integrating our examination workforce, we are developing plans to enroll recent OTS hires in OCC national bank examiner training courses.

Effective communication is key to managing organizational change as large as this and, as we work through these details over the next ten months, I recognize the importance of keeping employees fully informed. Our communications staff and bank supervision leadership team are working closely with OTS managers to keep employees

informed throughout this transition, to demonstrate that the OCC recognizes the importance and value of OTS employee experience, to communicate expectations clearly, and to ensure that OTS employees are aware of the value provided by the OCC's professional work environment and comprehensive benefits and compensation package. While we are still working on answers to many employee questions, establishing regular communication helps to ensure that employees remain focused on their mission while having access to information they need to make informed decisions about their careers.

As OTS employees look toward this transition, I am confident they will find the OCC a supportive and rewarding place to continue their careers. We are proud that responses from our own employees documented by the Office of Personnel Management's Employee Viewpoint Survey placed the OCC in the top five places to work among more than 220 federal agency subcomponents. As our staff expands to include former OTS employees, we will continue our commitment to providing a competitive, comprehensive package of compensation and benefits that meets our employees' needs and allows us to retain and attract the talent and experience necessary to perform our important and expanded mission.

Transfer of Funds, Property, and Systems

The OCC's Chief Financial Officer is working closely with his counterparts to review the financial position, statements, and existing obligations of the OTS to ensure that the OCC will have the financial resources necessary to support the supervision of the federal savings associations and meet the obligations the OCC must assume in the transfer, particularly relating to the unfunded OTS liabilities of the FIRF noted previously. This review includes determining any changes that may be needed to the

assessment structure to provide for combined supervision in the future. As this review progresses, the OCC is committed to working closely with the OTS and the FDIC to keep supervised financial institutions fully informed.

Also, as we review the financial considerations associated with integrating the OTS into the OCC, we are working closely with the OTS to review the status of leased office space supporting the mission of thrift supervision, including the leasing decisions required over the next two years. This review includes an assessment of space needs to support thrift supervision staff throughout the country, as well as the continuing space requirements for more than 3,000 current OCC employees.

Another important issue relating to the transfer of OTS functions to the OCC involves the transfer and integration of information technology systems and assets. The OCC's Chief Information Officer is working closely with his OTS counterpart to develop a comprehensive inventory of assets and systems, to compare OCC and OTS systems, and to determine the most effective method of integrating these assets and systems. In developing this transition plan, the OCC is sensitive to the impact that systems change can have on the employees, as well as the industry, and will take care to minimize any potential disruption.

While today's testimony provides a high-level view of the processes the OCC has begun to ensure the effective transfer of staff and functions from the OTS to the OCC, the OCC also is working with the OTS, FDIC, and Federal Reserve Board to develop the report to Congress that is due in January 2011. This report will provide additional details of the initiatives taken to implement the Dodd-Frank Act.

Transfers of Specified Functions to the CFPB

The Dodd-Frank Act transfers to the CFPB authorities of specified agencies to issue rules, orders, and guidelines under certain federal consumer financial laws, plus the authority of the federal banking agencies to supervise and examine insured depository institutions of over $10 billion in asset size for compliance with enumerated federal consumer financial laws.

In addition, the legislation provides for the transfer of personnel to the CFPB for two purposes. First, each transferor agency, including the OCC, must jointly determine with the CFPB the number of employees necessary to support the rulemaking and supervision examination functions transferred to the CFPB. Second, the CFPB and each of the agencies must jointly determine the number of employees necessary to perform certain additional functions that are authorized to the CFPB, but that also continue to be performed by the agencies. These functions include, for example, research, financial literacy, and responses to consumer complaints.

We are working with the Treasury staff that are organizing the CFPB until a Director is appointed to set up a process to identify personnel that could be transferred. This involves identifying those OCC employees who have both the skills needed by the CFPB and are interested in transferring to the CFPB. To facilitate this, we have solicited expressions of interest from employees who may be interested in moving to the CFPB.

To further the understanding of our current operations, we also have provided extensive materials to Treasury staff, including organizational charts describing our consumer protection functions, details about the national banks with more than $10 billion in assets that the CFPB will assume responsibility to examine, position

descriptions, and FTE requirements for supervision. In addition, we have provided extensive information about the complaint processing function performed by the OCC's Customer Assistance Group, including key operating statistics. As the CFPB's organizational activities accelerate, we are prepared to work with appropriate Treasury staff that is working on the CFPB start-up to follow-through on all these areas.

III. Relationship Between the Dodd-Frank Act and Basel III

The recent initiatives of the Basel Committee on Banking Supervision (Basel Committee), including establishing additional prudential standards for large, internationally active banks and setting contingent capital requirements, are focused on many of the same issues and concerns that the Dodd-Frank Act sought to address.

In response to the financial crisis, the Basel Committee initiated a comprehensive reform package designed to strengthen global capital and liquidity requirements and promote a more resilient banking sector. These reforms, often referred to as "Basel III," seek to improve the ability of banks to absorb the shocks of economic stress, thereby strengthening the financial system and reducing risks to the real economy. As described in more detail below, the OCC believes that implementation of the Basel III rules by the federal banking agencies will serve to advance the objectives of the Dodd-Frank Act, and certain other Basel-initiated measures may also satisfy particular requirements of Dodd-Frank.

Current Basel III Proposal

The Basel Committee published two consultative papers in December 2009, seeking comment on a series of substantive changes to the standards governing internationally active banks. These changes involved the tightening of the definition of

what counts as regulatory capital by placing greater reliance on higher quality capital instruments, expanding the types of risk captured within the capital framework, establishing more conservative minimum capital ratio and buffer requirements, providing a more balanced consideration of macroprudential and systemic risks in bank supervision practices and capital rules, and establishing for the first time an international leverage ratio requirement and global minimum liquidity standards. As a complement to the consultation process, the Basel Committee also initiated a quantitative impact study to better assess the impact of these proposals on individual banks.

On July 26, 2010, the Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, reached broad agreement on the overall design of the capital and liquidity reform package. On September 12, 2010, the GHOS and the Basel Committee announced an agreement on the remaining major elements of the Basel III revisions – the calibration of the new, higher capital ratios that banks will be expected to maintain and phase-in arrangements of the revised framework. A more detailed description of the enhancements introduced by the Basel III rules is provided in Attachment B to this document.

The establishment of higher minimum ratios significantly strengthens existing capital requirements by requiring more capital per dollar of measured exposure. This change alone will materially enhance the resiliency of the banking sector and broader financial system to economic shocks. The September GHOS agreement also sets forth harmonized implementation and transition arrangements for national authorities, with implementation of the new requirements beginning January 1, 2013, with all aspects of the revisions fully phased-in by 2019. This transition period is intended to give

institutions the opportunity to implement the new prudential standards over time, and thus alleviate the potential for associated short-term pressures on the cost and availability of credit to households and businesses.

The Dodd-Frank Act and Basel III

The provisions of the Dodd-Frank Act relating to capital and liquidity share the broad objectives and address many of the same issues as the Basel III enhancements noted above. Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, the steps the OCC and other agencies are taking to implement Dodd-Frank may present an opportunity to integrate the Basel III agreement with the heightened standards required by Dodd-Frank in various areas.

Enhancing the Level, Quality and Stringency of Capital Requirements

Basel III and the Dodd-Frank Act both seek to establish conservative, stringent capital standards, especially for large financial institutions. In addition, Basel III and the Dodd-Frank Act enhance the quality and consistency of regulatory capital, limiting the ability of trust-preferred securities and other similar instruments to qualify as Tier 1 capital. More generally, Basel III raises the level, quality, consistency, and transparency of capital instruments. Significantly, the Basel Committee has focused considerable attention on common equity, which is superior to other capital instruments in its ability to absorb losses, and articulated a more conservative basis for what qualifies as regulatory capital. Basel III also revises regulatory requirements to ensure that all material risks confronting financial companies – especially the risks held in trading portfolios and the risks posed by complex structured finance transactions, including certain securitization positions – are appropriately reflected in regulatory capital requirements. Finally, Basel

III establishes materially higher minimum ratio requirements for internationally active banks.

Macroprudential and Systemic Risk Considerations

Both Basel III and the Dodd-Frank Act focus increased attention on macroprudential and systemic risk considerations in bank supervision practices and capital rules, including efforts to address excessive interconnectedness of financial sector exposures and the establishment of improved incentives for the use of central clearing houses for OTC derivatives. The Dodd-Frank Act also establishes more formal mechanisms and requirements to identify risks to the financial stability of the U.S. through the establishment of the FSOC and compels action to prevent or mitigate such risks, especially as they relate to large, interconnected financial institutions..

Mitigating Procyclicality of Regulatory Requirements

Both Basel III and the Dodd-Frank Act focus on cyclicality concerns and the potential benefits of contingent capital instruments. Basel III seeks to mitigate procyclicality in the regulatory capital regime through the development of counter-cyclical buffers and the study of the potential uses and design of contingent capital instruments. Similarly, the Dodd-Frank Act requires the federal banking agencies to make capital standards countercyclical and provides the agencies discretion to require large interconnected financial institutions to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

Leverage Ratio Requirements

Basel III and the Dodd-Frank Act advance similar objectives in seeking to limit excessive leverage in the banking system. Basel III establishes for the first time an

international leverage ratio requirement that seeks to discourage excessive leverage in the banking system. The U.S. currently limits leverage based only on a bank's on-balance sheet assets. However, the Basel III leverage ratio also accounts for certain off-balance sheet exposures that could contribute to the build-up of leverage. Along the same lines, the Dodd-Frank Act mandates that large, interconnected financial institutions be subject to more stringent prudential standards and requirements, including standards relating to leverage limits.

Liquidity Requirements

Both the Dodd-Frank Act and Basel III call for the establishment of minimum liquidity standards to promote bank resilience to stressed funding conditions, such as those experienced during the recent financial crisis. In this regard, Basel III addresses both short-term resilience and long-term structural liquidity mismatches. Basel standards are consistent with the Dodd-Frank Act, which mandates that large, interconnected financial institutions be subject to more stringent prudential standards and requirements relating to liquidity.

Next Steps

While the key elements of the Basel III framework have been set forth, much work will be needed to implement those enhancements plus the related elements of the Dodd-Frank Act. For example, over the remaining months of 2010, the international agreements need to be more fully articulated as a concrete set of standards. This will be followed in the U.S. by a formal rulemaking process that will take into account, through public notice and comment, the views of all interested parties. In addition, there are also

many details in terms of the interaction between the Dodd-Frank Act and Basel III provisions that need to be sorted out.

The OCC fully supports the Basel III reforms to capital and liquidity standards. The agreements represent a significant step forward in reducing the likelihood and severity of financial crises, and lay the foundation for a more stable banking system that is both less prone to excessive risk-taking and better able to absorb losses. We think the framework strikes an appropriate balance between introducing more stringent requirements for banks, while allowing the banking system to continue to perform its essential function of providing credit to creditworthy households and businesses. Furthermore, the extended transition period minimizes any short-term disruptions in financial services during a period of fragile economic conditions.

IV. Conclusion

The OCC appreciates the opportunity to testify on the initiatives we have taken to date to implement the provisions of the Dodd-Frank Act. We also would be pleased to provide additional information as the Committee continues to review Dodd-Frank Act implementation.

Attachment A- Particular Implementation Issues That May Warrant Clarifying Amendments

Section 939A – Review of Reliance on Credit Ratings

Section 939A of the Dodd-Frank Act requires each federal agency to review "(1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings." Each federal agency must then "modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." In developing substitute standards of credit-worthiness, an agency "shall seek to establish, to the extent feasible, uniform standards of credit-worthiness" for use by the agency, taking into account the entities it regulates that would be subject to such standards.

The federal banking agencies are considering a wide range of approaches for developing alternative credit-worthiness standards. Any alternative must appropriately measure credit risk, should provide for timely and accurate updates as the quality of a particular asset deteriorates or improves, and must be transparent and replicable so that banks of varying size and complexity, as well as supervisors, can arrive at the same assessment for similar assets. However, various approaches present certain advantages and disadvantages. For example, developing broad exposure categories based on objective criteria established by regulators, similar to the current approach of the agencies' general risk-based capital rules, could be relatively easy to implement, but any such standard likely would be both over- and under-inclusive because it would lack risk sensitivity. More risk-sensitive approaches could include developing broad qualitative and quantitative credit-worthiness standards that banking organizations could use, subject to supervisory oversight, to measure the credit risk associated with various exposures. However, a more refined differentiation of credit risk may be achievable only at the expense of greater implementation burden, and if the alternative is not reasonably simple to implement, it may be an undue burden, especially for smaller banking institutions.

The federal banking agencies' risk-based capital rules currently reference NRSRO credit ratings in four general areas: (1) the assignment of risk weights to securitization exposures; (2) the assignment of risk weights to claims on, or guaranteed by, qualifying securities firms; (3) the assignment of certain regulatory capital add-ons for trading assets held by banks with large trading portfolios; and (4) the determination of the eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules. For example, in the case of asset-backed securities, a security rated AAA will receive a risk weight of 20 percent, whereas a security rated BB will receive a risk weight of 200 percent.

In addition to the OCC's capital rules, regulations regarding permissible investment securities, securities offerings, and international activities each reference or

rely upon NRSRO credit ratings. For example, to be bank permissible, an investment security must not be "predominantly speculative in nature." The OCC rules provide that an obligation is not predominantly speculative in nature if it is rated investment grade or, if unrated, is the credit equivalent of investment grade. The term "investment grade," in turn, is defined as a security rated in one of the four highest rating categories by two or more NRSROs (or one NRSRO if the security has been rated by only one NRSRO). In addition, under current OCC rules, a security that is offered and sold pursuant to SEC rule 144A is deemed marketable if it is rated investment grade or the credit equivalent of investment grade.

OCC regulations also require disclosures related to national bank-issued securities that include references to investment grade ratings. For example, the regulations establish an optional abbreviated registration system for debt securities that meet certain criteria, including a requirement that the security receive an investment grade rating.

Finally, pursuant to section 4(g) of the International Banking Act (IBA), foreign banks with federal branches or agencies must establish and maintain a capital equivalency deposit (CED) with a member bank located in the state where the federal branch or agency is located. The IBA authorizes the OCC to prescribe regulations describing the types and amounts of assets that qualify for inclusion in the CED, "as necessary or desirable for the maintenance of a sound financial condition, the protection of depositors, creditors, and the public interest." Among the assets the OCC has deemed permissible are certificates of deposit, payable in the U.S., and banker's acceptances, provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument.

Issues surrounding credit ratings were a significant factor in market overconfidence that contributed to subsequent losses in the markets for mortgage-backed securities in 2008-2009. The Dodd-Frank Act implements measures to address these issues, including structural changes at the ratings agencies, greater SEC oversight of the ratings process, and loan-level disclosures to investors in asset-backed securities.[1] However, the prohibition against references to ratings in regulations under section 939A goes further than is reasonably necessary to respond to these issues. Rather than disregard credit ratings, it may be more appropriate to assess their strengths and weaknesses and to supplement ratings with additional analysis in appropriate cases. We suggest that section 939A be amended to direct regulators to require that ratings-based determinations be confirmed by additional risk analysis in circumstances where ratings are likely to present an incomplete picture of the risks presented to an institution, or

[1] The Dodd-Frank Act gives the SEC significantly enhanced oversight authority over NRSROs. It creates the Office of Credit Ratings within the SEC that would be responsible for promoting credit rating accuracy and credit rating agency independence. This would include conducting annual examinations of NRSROs; promulgating requirements to eliminate conflicts of interest; and creating a form that would be used to explain to users of credit ratings information relating to the assumptions and data used in developing each rating, along with other information about the NRSRO. The Dodd-Frank Act also directs the SEC to prescribe rules concerning qualitative and quantitative methodologies used to determine credit ratings.

where those risks are heightened due to concentrations in particular asset classes.

Section 171 – Leverage and Risk-Based Capital Requirements

Section 171 of the Dodd-Frank Act, relating to leverage and risk-based capital requirements, states that the capital requirements applicable to large systemically important financial institutions must be at least as strict as the requirements that apply to all other banking institutions. The section also provides that the federal banking agencies may not amend the current capital rules in a way that would lead to "quantitatively lower" capital requirements in the future. However, the language describing the appropriate way to measure the baseline for determining whether one capital requirement is more strict, or not "quantitatively lower" than another, as well as the language describing the baseline from which such measurements must be made, is unclear. Depending on how the federal banking agencies interpret section 171, it could be read to require some or all banks to calculate their capital requirements several different ways using multiple different frameworks. In addition to implementation and burden issues, the confusion surrounding the applicability of different capital requirements could serve to undermine recent international efforts to improve bank capital requirements.

Resolution of these ambiguities is important to the agencies' efforts to improve their regulatory capital requirements and comply with other sections of the Dodd-Frank Act. For example, as discussed above, compliance with the provisions of section 939A will require the federal banking agencies to amend their respective capital rules to remove and replace references to credit ratings. Because doing so will require substantial amendments to their capital requirements, the agencies will have to resolve how section 939A and section 171 can be read together. For example, complications could arise if section 171 is read to require banks to calculate and compare their minimum capital requirements under any new capital rules with those in place at the date of enactment of the Dodd-Frank Act because this comparison would result in banks having to apply rules that require the use of credit ratings.

Respective Roles of the Banking Agencies and CFPB in Fair Lending Matters

Other implementation difficulties arise outside the rulemaking context. One example concerns the respective roles of the banking agencies and the CFPB in supervising and enforcing fair lending provisions for insured depository institutions with total assets greater than $10 billion. The federal banking agencies currently oversee depository institutions' compliance with the Fair Housing Act, the Equal Credit Opportunity Act, and the Federal Reserve Board's Regulation B, using interagency exam guidelines issued by the Federal Financial Institutions Examination Council. This includes a program of screening using data reported under the Home Mortgage Disclosure Act and other factors for risk-based identification of institutions for further assessment, as well as random sampling of institutions.

Under the Dodd-Frank Act, the banking agencies will continue to perform this function for institutions under our supervision with $10 billion or less in total assets. For

larger institutions, the legislation assigns exclusive supervisory responsibility for "federal consumer financial laws" to the CFPB. The definition of "federal consumer financial laws" includes the Equal Credit Opportunity Act and Regulation B, but not the Fair Housing Act. If the intent of the legislation is for the CFPB to supervise larger institutions for compliance with the Equal Credit Opportunity Act and Regulation B, but for the federal banking agencies to supervise such institutions' compliance with the Fair Housing Act, this result risks significant inefficiency and potential confusion regarding accountability in this area. We urge reconsideration of this jurisdictional split.

Attachment B – Basel III Changes to Basel II

Changes to the Definition of Capital

The Basel III framework recognizes the importance of banking organizations maintaining a strong capital base with a significant proportion consisting of common shareholders' equity that is most able to absorb losses. Thus, the framework defines two components of Tier 1 capital, common shareholders' equity (Tier 1 common) and additional going concern Tier 1 capital (Tier 1 capital), and establishes minimum risk-based capital ratios for both measures.

In addition, the framework strengthens the definition of Tier 1 capital to exclude hybrid instruments that did not prove to be loss absorbing during the recent financial crisis. Basel III contains a detailed set of criteria that an instrument must satisfy in order to qualify as Tier 1 capital. The criteria include a requirement that the banking organization has complete discretion to cancel any dividends or distributions (e.g., the instrument must be non-cumulative) and that the instrument be perpetual. As a result, trust-preferred securities issued by U.S. bank holding companies would not qualify as Tier 1 capital under the Basel III changes.

Basel III also establishes criteria for the inclusion of minority interest[1] in the definition of Tier 1 common. Minority interest issued in the form of common stock by a subsidiary that is a bank will be eligible for inclusion in Tier 1 common of the parent banking organization. If the amount of minority interest exceeds the minimum capital requirement of the subsidiary, the excess amount will be deducted from Tier 1 common in proportion to the minority interest share.

Basel III specifies a number of deductions and adjustments that must be made to Tier 1 common to ensure its ability to absorb losses. The deductions and adjustments would be made to Tier 1 common prior to calculating the risk-based capital ratios. While U.S. banking organizations currently apply a number of deductions and adjustments to Tier 1 capital under the existing capital rules, in several cases the Basel III deductions are more conservative. Under Basel III, the total amount of mortgage servicing assets, deferred tax assets related to timing differences, and significant investments in financial institutions will be limited, in the aggregate, to 15 percent of a banking organization's Tier 1 common, with each item separately limited to 10 percent of Tier 1 common.[2] Any

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[1] A minority interest is the portion of the equity in a consolidated subsidiary attributable to the owners of the subsidiary other than the parent. Minority interests also are known as non-controlling interests.

[2] Under the agencies' existing risk-based capital rules, mortgage servicing assets, in conjunction with purchased credit card relationships and nonmortgage servicing assets, are includable in Tier 1 capital up to an amount equal to 100 percent of Tier 1 capital with no more than 25 percent of Tier 1 capital consisting of purchased credit card relationships and non-mortgage servicing assets. The amount includable in Tier 1 is the lesser of 90 percent of the fair value or 100 percent of the remaining unamortized book value. (Basel III requires the full deduction of purchased credit card receivables and non-mortgage servicing assets). Under the agencies' existing risk-based capital rules, deferred tax assets generally are includable in Tier 1 capital up to the lesser of (a) the amount of those assets that the banking organization could reasonably expect to realize within one year based on its estimate of future taxable income, or (b) 10 percent of Tier 1

amount of those assets held by a banking organization above those limits will be fully deducted from Tier 1 common. All intangibles other than mortgage servicing assets would be fully deducted from Tier 1 common.

Under Basel III, unrealized gains and losses on all AFS securities would be included in Tier 1 common. In other words, the impact of unrealized gains and losses on AFS securities would flow through to Tier 1 common, such that Tier 1 common would be reduced by any unrealized losses and increased by any unrealized gains on AFS securities. This approach follows the accounting treatment of including unrealized gains and losses in common shareholder's equity, which was used by many market participants during the financial crisis to assess banking organizations' financial strength and solvency. In contrast, under the agencies' existing regulatory capital rules, unrealized gains and losses on AFS debt securities generally are excluded from Tier 1 capital.

Changes to the Measurement of Risk (Risk-Weighted Assets)

In addition to the changes in the measurement of capital, Basel III also enhances the measurement of risk. That is, the denominator of the risk-based capital ratios has been changed to incorporate more fully certain risks that were not appropriately addressed previously.

One of the more significant changes is the treatment of exposures held in a banking organization's trading account. The revisions to the capital requirements for the trading book include the following:

- Stressed Value at Risk – this charge is similar to the currently measured value at risk, but with the model calibrated to a period that reflects significant financial stress appropriate to the banking organization's current portfolio.
- Incremental Risk Capital – the standards have been revised to better capture the default and credit migration risk of positions held in the trading book.
- Securitization positions – the capital requirements for securitization positions in the banking book has been replicated for similar positions in the trading book, thereby addressing a significant regulatory capital arbitrage.

A second significant change relates to the expansion of the capital framework to cover risks resulting from the volatility of the "credit valuation adjustment." The current framework addresses counterparty credit risk as a default and credit migration risk, but does not fully account for market value losses that can materialize because of a counterparty's deterioration short of default.

A third change contained in Basel III requires that estimates of counterparty credit risk must include data from a period of market stress, thereby increasing the conservatism of these estimates. Furthermore, Basel III will continue to provide capital-related incentives to clear derivative transactions with a central counterparty.

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capital. The existing risk-based capital rules do not require the deduction from Tier 1 capital of significant investments in financial institutions.

Basel III will increase the amount of capital held for credit exposures to large financial companies to better capture the interconnectedness of these firms and the potential contagion effects. The new calibration will require roughly 25 percent more capital than the previous calibration for a bank's credit exposure to large financial companies and highly leveraged entities such as hedge funds.

International Leverage Ratio

The Basel III revisions also introduce for the first time an international leverage ratio as a supplementary measure to the risk-based framework. The leverage ratio is intended to help contain the build-up of excessive leverage in the banking system and introduce additional safeguards against model risk and measurement error.

Unlike the current leverage ratio in U.S. capital regulations, the Basel III ratio also incorporates the potential leverage generated by off-balance sheet exposures. In addition, the Basel III leverage ratio makes adjustments to capture potential leverage resulting from derivative transactions and makes adjustments with respect to derivatives to adjust for international accounting differences.

The New Minimum Thresholds of the Ratio of Capital to Risk-Weighted Assets

The Basel Committee conducted a Comprehensive Quantitative Impact Study(CQIS) to estimate the effect on the measured capital ratios arising from the various proposed changes to the definition of capital and the measurement of risk-weighted assets. Based on that survey, as well as comments from banking organizations, the Committee discussed a range of possible minimum required thresholds for each of the three risk-based ratios and the leverage ratio. The Basel Committee reached a consensus on the minimum thresholds shown in Table 1.

Table 1
Minimum Required Risk-Based Capital Ratios

	Tier 1 Common	Tier 1 Capital	Total Capital
Minimum	4.5%	6.0%	8.0%
Conservation Buffer	2.5%		
Minimum plus Buffer	7.0%	8.5%	10.5%
Range for Countercyclical Buffer	0.0 – 2.5%		
Leverage Ratio	-	3.0%	-

The new minimums for the required risk-based ratios are substantially higher than under Basel I and II. However, these new minimums will be phased in over a relatively long transition period, as shown in Table 2 below.

Liquidity

The Basel III changes also introduced for the first time global minimum liquidity standards. The Basel Committee has sought to address two separate but complementary objectives through the development and implementation of these standards.

The first objective is to increase the short-term resiliency of a bank's liquidity risk profile. This can be accomplished by ensuring that banks have a sufficient level of unencumbered high quality liquid resources to survive an acute supervisor-specified stress scenario lasting for one month. The Basel Committee developed the Liquidity Coverage Ratio (LCR) to achieve this objective. The LCR essentially requires a bank to maintain a stock of unencumbered "high quality liquid assets" that should at least equal the estimated "net cash outflows." Net cash outflows are the expected cash inflows minus cash outflows adjusted for stressed conditions. The standard is defined as follows:

$$\frac{Stock\ of\ \ High\ Quality\ Liquid\ \ Assets}{Net\ Cash\ Outflow\ over\ 30\ days} \geq 100\%$$

The stock of high quality liquid assets will be defined to include two tiers. Tier I assets are comprised of the most liquid assets – cash, central bank reserves, marketable securities, and government or central bank debt. Tier II assets, while still meeting the standards required of "high quality liquid assets," possess a lesser liquidity value than Tier I assets and, therefore are subject to valuation haircuts and maximum contribution limits. Specifically, Tier II assets include: high quality corporate and covered bonds, with a 20 percent haircut; and government and public sector entity assets qualifying for the 20 percent risk weighting under Basel II, with a 10 percent haircut. The overall size of Tier II assets will be capped so that Tier II assets can contribute no more that 40 percent of the total stock of liquid assets. In the United States, GSE debt and GSE guaranteed mortgage-backed securities fall within the definition of public sector entity assets and, therefore, are subject to the 10 percent valuation haircut and the maximum contribution limit.

The second objective of the Basel Committee in this area is to increase the medium- and long-term resiliency of banks' liquidity risk profile. This can be accomplished by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. The Basel Committee developed the Net Stable Funding Ratio (NSFR) to achieve this objective and to complement the short-term requirements of the LCR. The NSFR requires a minimum amount of funding that is expected to be stable over a one-year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. The NSFR essentially requires that a bank's "available stable funding" should at least equal its "required stable funding." The metric is defined as follows:

$$\frac{Available\ Amount\ of\ Stable\ Funding}{Required\ Amount\ of\ Stable\ Funding} \geq 100\%$$

Available Stable Funding (ASF) includes capital, preferred stock maturing in one year or more, liabilities with maturities of one year or more, and stable deposits. Required stable funding (RSF) includes a broad spectrum of a bank's assets and off-balance sheet exposures. Supervisory assumptions are used to calculate ASF and RSF.

The Basel Committee issued its proposal in December 2009. In 2010, the Committee analyzed industry comments and conducted a CQIS in order to assess the effects of the proposals on the banking industry. In July 2010, the Committee issued a revised set of calibrations of the liquidity standards contained in the December 2009 proposal. However, work continues on both standards with an expected revised draft due by year-end 2010. At that time, the standards will enter into an observation period before final implementation (for details see Table 2 below).

Transition

The phasing in of the minimum Tier 1 common threshold will begin on January 1, 2013. This two-year delay is intended to give banks ample opportunity to prepare for the higher standard. The transition to the higher Tier 1 common standard will encompass a three-year interval, with the minimum requirement starting at 3.5 percent in 2013 and increasing by one-half percentage point in each of the subsequent two years. The 2.5 percentage point conservation buffer will be phased in starting in January 2016, and will last four years. At the conclusion of 2018 (on January 1, 2019), the minimum ratio plus the capital conservation buffer will be fully implemented.

The Basel Committee settled on this gradual phase-in based on the substantially higher level of the fully phased-in Tier 1 common minimum. The fully phased-in minimum requirement of 4.5 percent is more than two times the current *de facto* U.S. and international minimum of two percent.[3] In addition, the calculation of this higher minimum is more conservative, as described earlier. Adding to this 4.5 percent minimum an additional conservation buffer of 2.5 percentage points, which banking organizations must meet to avoid dividend and compensation constraints, results in a ratio that is almost four times the current requirement for common equity.

The other Basel III enhancements, including new leverage requirements and liquidity standards, are also subject to a gradual monitoring and implementation schedule to ensure that they operate as intended. The full phase-in schedule is restated below.

[3] The current *de facto* two percent common equity standard is based on the fact that the current Tier 1 standard is four percentage points, with the expectation that common equity comprise the predominant form of the Tier 1 measure.

Table 2
Phase-In of New Minimum Regulatory Capital and Liquidity Ratio Threshold Requirements
(January 1 of each year)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Monitoring		Parallel Run/Disclosure 1/1/2015						
Minimum Common Equity			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						.625%	1.25%	1.875%	2.5%
Minimum Common Equity plus Conservation Buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-In of Deductions from Common Equity				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Conservation Buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as Tier 1 or Tier 2 capital			Phase out over ten years beginning 2013						
Liquidity Coverage Ratio	Observation period begins				Introduce minimum standard				
Net Stable Funding Ratio		Observation period begins						Introduce minimum standard	