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TESTIMONY OF
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COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I appreciate this opportunity to discuss the Discussion Draft of the Financial Stability and Improvement Act, which was released by the Committee two days ago.

My testimony discusses five key areas: first, the role of the Financial Services Oversight Council; second, the respective roles and responsibilities of the Federal Reserve Board and primary federal banking regulators; third, agency consolidation and restructuring; fourth, other proposed changes in financial regulatory scope and standards; and finally, measures intended to address the “too-big-to-fail” problem.

As my testimony describes, we support many of the key initiatives in the Discussion Draft, but also have concerns about certain of its provisions. Given the very short time we have had to review the Draft, we are continuing our review and may well identify other areas that warrant further comment. We will submit those comments promptly to the Committee.

FINANCIAL SERVICES OVERSIGHT COUNCIL

We know from the financial crisis that systemic risk can be posed not just by individual institutions, but also by particular financial products or instruments, such as subprime mortgages, or by financial markets, such as the credit default swap market, or by other parts of the economy. We do not now have a formalized regulatory mechanism or regime that focuses on such risks, and we should. To address this need, the Discussion Draft establishes the Financial Services Oversight Council (“Council”), which the OCC supports.

We believe that the proposed roles and responsibilities of the Council, as contemplated in the Discussion Draft, are appropriate. The Council, by providing a centralized and formalized mechanism for the federal financial regulators to gather and share systemically significant

information, would be well positioned to monitor and address developments that threaten the financial system as a whole; identify gaps and arbitrage opportunities in the financial regulatory framework; make formal recommendations to individual regulators; assess whether potential spillovers among financial firms or across markets could lead to financial contagion; and resolve jurisdictional disputes between member federal financial regulatory agencies. To promote transparency and accountability, the Council should periodically report to Congress and the public about emerging systemic risks and make recommendations for dealing with those risks.

In addition, the Discussion Draft provides that the Council would play a critical role in helping to ensure that all major financial firms are subject to strong consolidated supervision and regulation. That is, the Council would have the responsibility for identifying those financial companies and financial activities and practices that require heightened prudential supervision and stricter prudential standards. We believe assigning this responsibility to the Council is appropriate.

ROLE OF THE FEDERAL RESERVE AND PRIMARY REGULATORS

Strong supervision of any individual firm that poses systemic risk to the financial system is the next crucial component of a new framework to address regulatory gaps revealed by the recent financial crisis. During the last two years, the absence of strong consolidated supervision to identify and address problems at large securities firms, insurance companies, and government-sponsored enterprises that were not affiliated with banks proved to be an enormous problem, as a disproportionate share of the financial stress in the markets was created by these institutions. The absence of a regulator applying a consistent and coherent regulatory regime to these firms helped mask problems in these nonbanking companies until they were massive. And once the problems emerged, gaps in the regulatory regime constrained the government's ability to deal

with these firms. The Discussion Draft would extend the Federal Reserve's consolidated bank holding company regulation to systemically significant nonbanks, appropriately addressing the regulatory gaps.

The Discussion Draft establishes the Federal Reserve Board as the systemic supervisor by providing it with enhanced, consolidated authority over any firm that poses significant systemic risk and all of its subsidiaries. This structure builds on and expands the current system for supervising bank holding companies, where the Federal Reserve already has consolidated authority over the holding company, and the prudential bank supervisor is responsible for direct bank supervision.

In testimony on regulatory reform, I have repeatedly urged Congress to preserve a robust, independent bank supervisor that is solely dedicated to the prudential oversight of depository institutions. Dedicated supervision assures there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability. Supervision takes a back seat to no other mission, and the result is a strong culture that fosters the development of the type of seasoned supervisors that are needed to confront the many challenges arising from today's banking business.

In practice, many of the companies likely to be identified as posing significant systemic risk will have, at their heart, very large banks, many of which are national banks. Indeed, in many such companies, the bank constitutes the overwhelming portion of the company's assets. It is the responsibility of the prudential bank supervisor to ensure that the bank remains a strong anchor within the financial company as a whole. This is our existing responsibility at the OCC, which we take very seriously through our continuous on-site supervision by large teams of resident examiners in all of our largest national banks. And we perform this function in a

cooperative relationship with the Fed, which is consolidated supervisor of the largest bank holding companies now.

The bank is by far the most intensively regulated part of the largest bank holding companies, and this has translated into generally lower levels of losses of banks within the holding company versus other companies owned by that holding company – including those large bank holding companies that have sustained the greatest losses. That is why, in the context of regulatory restructuring for systemically significant financial firms and financial activities and practices, we believe preserving a fundamental role for the prudential supervisor of the bank in a complementary relationship with the systemic supervisor is so important. Allowing the prudential supervisor's role to be subsumed or overtaken by the systemic supervisor both undermines the bank supervisor's authority, responsibility, and accountability, and would further stretch the role of the Federal Reserve. The Federal Reserve relies on and collaborates with the OCC as primary bank supervisor in complex organizations that are often involved in many businesses other than banking, and this model is well suited for use in a new regulatory framework where the Federal Reserve assumes substantial new responsibilities for companies that pose significant systemic risk but do not have bank subsidiaries at all.

Key parts of the Discussion Draft are consistent with this complementary relationship between the Federal Reserve and the prudential bank supervisor. For example, the Discussion Draft requires the Federal Reserve to establish heightened prudential standards for those financial holding companies identified by the Council as systemically significant. These heightened standards may include, for example, increased risk-based capital requirements, leverage limits, liquidity requirements, prompt corrective action requirements, and any other standards the Federal Reserve deems advisable. In addition, the Federal Reserve is authorized to

recommend that the primary federal regulatory agency for a functionally regulated or depository institution subsidiary prescribe the same heightened prudential standards for a subsidiary. Implementation, examination for, and enforcement of these standards remains with the primary supervisor, and the supervisor, if it chooses not to impose the heightened standards, must support its decision in writing to the Federal Reserve and the Council.

The Discussion Draft sharply departs from that model, however, with respect to the Federal Reserve's separate authority to impose heightened prudential standards and safeguards with respect to certain financial activities and practices (as opposed to certain institutions) that the Council identifies as presenting systemic risk. Once the Council makes this identification, the Federal Reserve would have unilateral authority to establish a broad range of standards and safeguards for such activities and practices – but without seeking public comment and without consulting with primary supervisors, even where the primary supervisor has greater expertise and experience with respect to such activities. These standards would then be imposed on any financial company, including a bank, that engaged in the identified financial activity or practice. If the primary supervisor chose not to impose the heightened standards and safeguards recommended by the Federal Reserve, the Federal Reserve would have the authority to impose, examine for, and enforce these standards against subsidiaries for which the primary supervisor ordinarily is responsible. This approach has the twin risks of producing less effective standards and undermining the effectiveness of the primary banking supervisors.

It would be far more sensible to maintain the lines of responsibility and accountability that now exist between the primary supervisor and the Fed in this area, just as for systemically significant institutions as discussed earlier. There will certainly be instances in which the primary supervisor has substantial experience and expertise in supervising a financial activity or

practice because the institutions it supervises are engaged extensively in such activity or practice. In these cases, the primary supervisor should have the opportunity to apply its knowledge and provide meaningful input into setting the standards. The present cooperative relationship has worked well, and without this shared responsibility, too much regulatory and standard setting authority would be concentrated in the Federal Reserve.

Separately, while the Discussion Draft provides additional authorities as described above, it does not address the current, significant gap in supervision that exists within bank holding companies. In today's regulatory regime, a bank holding company may engage in a particular banking activity, such as mortgage lending, either through a subsidiary that is a bank or through a subsidiary that is not a bank. If engaged in by the banking subsidiary, the activity is subject to required examination and supervision on a regular basis by the primary banking supervisor. However, if it is engaged in by a nonbanking subsidiary, it is potentially subject to examination by the Federal Reserve, but regular supervision and examination is not required. As a policy matter, the Federal Reserve had previously elected not to subject such nonbanking subsidiaries to full bank-like examination and supervision on the theory that such activities would inappropriately extend "the safety net" of federal protections from banks to nonbanks. The result has been the application of uneven standards to bank and nonbank subsidiaries of bank holding companies.

For example, in the area of mortgage lending, banks were held to more rigorous underwriting and consumer compliance standards than nonbank affiliates in the same holding company. While the Federal Reserve has since indicated its intent to increase consumer protection examination of nonbank affiliates, it is not clear that safety and soundness

examinations will be required, or if conducted, will be as regular or extensive as the examination of the same activities conducted in banks.

Leveling the regulation and supervision of the same activity conducted in different subsidiaries of a single bank holding company takes on added importance for a systemically significant holding company because, by definition, the firm as a whole presents systemically significant risk. One way to address this problem would be to include in the legislative language an explicit direction to the Federal Reserve to actively supervise nonbanking subsidiaries engaged in banking activities in the same way that a banking subsidiary is supervised by the prudential supervisor, with required regular exams. Of course, adding new required responsibilities for the direct supervision of more companies may serve as a distraction both from the Federal Reserve's other new assignments under the Proposal as well as from the continuation of its existing responsibilities.

An alternative approach would be to assign responsibility to the prudential banking supervisor for supervising certain nonbank holding company subsidiaries. In particular, where those subsidiaries are engaged in the same business as is conducted by an affiliated bank – for example, mortgage or other consumer lending – the prudential supervisor already has the resources and expertise needed to examine the activity. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank. This approach also would ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.

The Discussion Draft also provides that, as part of its examination and enforcement authority over identified financial holding companies, the Federal Reserve would have explicit authority to require a holding company to sell assets or business lines if necessary to mitigate

systemic risk. In the case of assets or business lines that are within a bank, we think the bank's primary regulator should have the primary role in making those determinations, in consultation with the Federal Reserve. Moreover, in those instances where the identified financial holding company is a bank holding company, we believe the primary banking supervisor should have a say when the holding company makes certain acquisitions – such as where the size of the firm being acquired is material to the company, and it is envisioned that some or all of the acquired firm will ultimately be merged into the holding company's subsidiary bank. I note, for example, that the OCC had no role in approving, or the ability to intercede in, the acquisition of Golden West by Wachovia's holding company parent, despite the effect that that acquisition ultimately had on the national bank.

AGENCY CONSOLIDATION AND RESTRUCTURING

The Discussion Draft transfers the bulk of the functions of the Office of Thrift Supervision (“OTS”) into the OCC, while providing a framework in which the federal thrift charter is preserved, with federal thrift regulation being conducted by a newly established Division of Thrift Supervision within the OCC. The mechanics of the proposed transfer appear to be both sensible and workable. Based on our preliminary review, the Discussion Draft appears to be fair and equitable to employees of both agencies. There are important technical areas, including assessments, transfer of property and personnel, and clarification of the agency's independence, that we continue to work through, and we will have additional comments on the Discussion Draft.

Following the transfer of OTS functions to the OCC, supervision of savings and loan holding companies will be transferred to the Federal Reserve. For those savings and loan holding companies authorized to engage in activities beyond those financial in nature, we

support the approach taken in the Discussion Draft, which would allow for the reasonable grandfathering of such activities in order to prevent undue disruptions and dislocations.

In sum, while I have previously testified in support of the phase out of the thrift charter, we recognize the important considerations that Congress must weigh in favor of preserving the charter. The draft legislation provides a framework for doing so that we believe would be productive and practical.

OTHER CHANGES IN FINANCIAL REGULATORY SCOPE AND STANDARDS

The Discussion Draft makes additional changes in the scope and standards of financial regulation. First, the Discussion Draft provides the Federal Reserve with additional authority over any financial institution that provides payment, clearing, or settlement services identified by the Financial Services Oversight Council as “systemically important.” The Federal Reserve is authorized to prescribe risk management standards (after consulting with Council and the relevant supervisory agency) for the systemically important payment, clearing, or settlement activities conducted by financial institutions. We generally support the concept of enhanced regulation of systemically important payment, clearing, or settlement activities. As we continue to review the Discussion Draft, we may have some specific comments on these provisions.

A second change in the scope of financial regulation made by the Discussion Draft is to eliminate the exemption from coverage under the Bank Holding Company Act for so-called “limited purpose banks,” such as industrial loan companies and credit card banks. To avoid undue disruptions to, or the need for drastic divestitures of, these institutions, the Discussion Draft requires any company controlling such an institution to organize a Section 6 holding company and to conduct all activities that are financial in nature within the Section 6 holding company. We support the general concept of Section 6 holding companies as a reasonable

approach to dealing with institutions that were not part of the problems triggering the financial crisis.

ADDRESSING TOO BIG TO FAIL

While many of the proposals that I have discussed would protect the stability of the financial system as a whole, the Discussion Draft includes additional measures to address the so-called “too-big-to-fail” problem. In particular, the Discussion Draft establishes a new regime to facilitate the orderly resolution of failing, systemically important financial firms (separate from the bank resolution regime). This new resolution regime would permit the government to wind down a failing systemically important firm in a way that reduces the risks to financial stability and the economy. Such a regime makes good sense, and we support it.

The decision to resolve a failing, identified financial holding company under this new regime would be made by the Treasury Department, the Federal Reserve, and the FDIC (or the SEC in certain cases). Under the draft legislation, the failing firm would be put into an FDIC-managed receivership, analogous to the regime currently used by the FDIC for banks. I support this basic approach.

The purpose of the receivership under the new regime would be to unwind, dismantle, restructure, or liquidate the systemically important financial firm in an orderly way at the least all-in cost to taxpayers and the financial system. Similar to its role in the bank resolution regime, the FDIC would have the authority to operate the financial firm, enforce or repudiate its contracts, and pay its claims. As receiver, the FDIC could provide the firm with emergency assistance, in the form of loans, guarantees, or asset purchases, but only with the concurrence of the Secretary and after determining such assistance is necessary to preserve financial stability. In doing so, however, there would be a strong presumption that the FDIC, as receiver, would

remove senior management. Even more important, shareholders, subordinated creditors, and any other provider of regulatory capital to the firm could not be protected; they would absorb first losses in the resolution to the same extent as such stakeholders would in an ordinary bankruptcy. This mandatory exposure to first loss by shareholders and creditors is a substantial change from the Administration's original proposal, and is an appropriate and effective way to maintain market discipline and address the too-big-to-fail problem.

Losses resulting from the use of the systemic risk exception would be recouped through after-the-fact assessments on financial firms with more than \$10 billion in assets. Importantly, the Discussion Draft requires that the FDIC, in imposing the systemic risk fund assessments on these companies, must take into account assessments imposed on insured institution subsidiaries of the firms. We agree that it is appropriate to offset deposit insurance premiums paid by insured institutions from this calculation. Such assets must be excluded from assessment under this enhanced resolution regime to ensure that the Deposit Insurance Fund is not affected.

Based on our preliminary review, the OCC supports the measures described above. Establishing a resolution regime for systemically important financial firms that imposes losses on shareholders and key creditors is essential to credibly address the too-big-to-fail problem and the moral hazard issues it has created.

CONCLUSION

The OCC appreciates the opportunity to testify on regulatory reform. We will continue to review the Discussion Draft and, as I have indicated, we will promptly provide our additional comments to the Committee. We also would be pleased to provide additional information as the Committee continues its consideration of this important legislation.