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TESTIMONY OF

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before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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Statement Required by 12 U.S.C. § 250:

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

I. Introduction

Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to be here today to update the Committee on recent events in the financial markets and the condition of the national banking system. When I testified before this Committee in March, I reported that two powerful and related forces were exerting real stress on banks of all sizes and in many different parts of the country. One was the large and unprecedented series of credit market disruptions that was precipitated by declining house prices and severe problems with subprime mortgages. The other was the slowdown in the economy, which had begun to generate a noticeable decline in credit quality in a number of asset classes.[1] As we assess the impact of these forces today, I would say this: credit markets are better, while credit quality — meaning the performance of loans and other credit extensions to which banks are exposed — is worse.

On the first point, we are beginning to see improvement in several key segments of the credit markets, which several months ago had, essentially, come to a standstill. In particular, there is significantly more liquidity in money markets, and spreads on credit default swaps have narrowed. Financial institutions have raised unprecedented amounts of capital since October 1 of last year — over $100 billion by national banking organizations alone — and this shoring up of their balance sheets has helped restore confidence and liquidity in the interbank market. In addition, the pipeline of hung leveraged loan deals has slowly begun the clearing process.

While these are all good signs of progress, we clearly are not out of the woods. In particular, securitization channels for residential mortgages remain largely closed except

[1] Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, March 4, 2008, p. 3.

for conforming mortgages sold to the GSEs and FHA. This lack of liquidity is severely constraining new originations and refinancings for nonconforming mortgage products. Although banks and other portfolio lenders have taken up some of this slack, they have not and cannot provide the same level of credit to this important part of the mortgage market as was previously provided by securitization markets. In addition, the number of homes in foreclosure continues to rise. In this regard, we support the significant new options that are provided to help borrowers refinance their homes rather than face foreclosure that are contained in the legislation recently passed by this Committee.

Moreover, there continues to be considerable uncertainty among market participants about the underlying strength of the economy and the ongoing effects the recent market disruption and economic downturn are having on financial counterparties, consumers, and commercial borrowers. This uncertainty may lead to continued volatility in the financial markets that we and the institutions that we supervise will need to monitor carefully.

On the second point – credit quality – the downturn in housing and the broader economy is indeed continuing to have an adverse effect on national banks' loan portfolios, with the levels of nonperforming and past due loans increasing. Responding to deteriorating credit quality will continue to be a major focal point for supervisors and bankers in the months ahead. In light of these conditions, we believe the substantial increases that banks have made both to loan loss reserves and to capital in recent quarters are both prudent and warranted. Indeed, should credit performance continue to worsen, as we expect, additional loan loss reserves will be needed, and in some cases, additional capital. As always, we support maintaining strong, conservative reserves, and we plan to underscore this message to bankers, the accounting standard setters, and bank auditors.

In the context of these two points, my testimony today provides an update on market conditions since the Committee's March hearing and an overview of national banks' performance during the first quarter of this year. I will then discuss some of the areas on which we will focus our supervisory efforts in the months ahead. I conclude with a discussion of some of the policy and supervisory initiatives we are undertaking in conjunction with other domestic and international supervisors to identify and implement lessons learned from recent market events.

II. Update on Market Conditions

In March, when I testified before the Committee, many segments of the credit and capital markets were experiencing very thin trading or transaction volume. Many market participants were choosing to stay on the sidelines until underlying market conditions and the health of key counterparties and monoline insurers became clearer. This was particularly evident in the corporate, leveraged lending, and interbank markets. By early March, modest improvements that we had seen earlier in the year in the leveraged loan and high yield bond markets had largely disappeared.

In recent weeks, we have started to see signs of increased liquidity as investors slowly return to many markets and once again begin to differentiate risk among issuer names. The cost of credit default swaps on most U.S. commercial banks – a barometer of investor concerns about the financial sector – has improved substantially from the levels observed in March. The spreads between U.S. Treasury bills and interbank rates such as LIBOR have declined (even though still high by historical standards), another sign of improved investor confidence. The leveraged loan market has started showing renewed strength with the launching of several large primary issues and continued firming in secondary market prices. In addition, banks are reporting increased market appetite for high quality credit card securitizations and other non-complex transactions. Asset-backed commercial paper (ABCP) markets continue to show modest improvements. The market for commercial mortgage backed securities, which essentially had shut down in January and February, is also beginning to show signs of renewed activity, albeit at substantially lower volumes than in recent years. And financial institutions' raising of significant amounts of capital has also helped restore investor confidence after the announcement by these same institutions of very significant losses.

All of these are positive developments that, if they continue, can help reduce the overhang of loans that banks have had to fund on their balance sheets and thus free up capacity for additional lending. More stable and liquid markets may also reduce the volume and rapidity of mark-to-market write downs that we saw in the third and fourth quarters of last year and, to a lesser extent, in the first quarter of this year.

Notwithstanding these developments, any near-term return to the volume or pricing of credit that existed before last year's market disruption is unlikely. In addition, it is clear that certain market segments, such as non-conforming residential mortgage loans and some auction rate securities (ARS), particularly student loan ARS, remain severely constrained. In particular, while liquidity has slightly improved in some residential mortgage-related markets, the securitization market remains essentially closed to loans that cannot be sold to the GSEs and FHA. Recent Congressional action to increase the GSE and FHA loan limits should help improve the market for larger eligible loans. And recent housing legislation that has moved through this Committee and the House of Representatives is intended to help stabilize the housing and mortgage markets. However, until that stabilization occurs and significant liquidity returns to the non-agency market, the origination for sale of subprime, Alt A, and jumbo loans not eligible for GSE and FHA programs is likely to remain severely constrained. As a result, the volume of new and refinanced non-conforming mortgages has declined substantially as banks are tightening underwriting criteria and solely originating these products for balance sheet retention.

All of this suggests the need for continued vigilance by bankers and supervisors.

III. Update on National Banks' Condition and First Quarter 2008 Performance

While the dislocations in the credit and capital markets appear to be abating, the downturn in the housing markets and the broader economy has adversely affected the credit quality of banks' loan portfolios. For some banks and portfolio segments, these adverse effects will likely worsen in the months ahead, as many borrowers now find themselves overextended.

This trend was reflected in recent earnings reports. While national banks' earnings rebounded in the first quarter of 2008 from the fourth quarter of 2007 (4Q:07), they were significantly lower than those reported in 1Q:07. Aggregate net income for 1Q:08 totaled $12.0 billion, compared to $4.8 billion in 4Q:07 and $21.1 billion in 1Q:07. Much of the improvement from 4Q:07 to 1Q:08 stemmed from smaller write-downs and mark-to-market adjustments in banks' trading and held for sale portfolios. Write-downs of collateralized debt obligation (CDO) exposures at the five largest national banks, for example, declined from $27.9 billion 4Q:07 to approximately $9.7

billion in 1Q:08. In contrast, banks' provision expenses continued to increase in 1Q:08, reflecting both the need to cover higher levels of charge-offs and a desire to increase loan loss reserves. Aggregate provisions to net charge-offs climbed to 194 percent in 1Q:08 compared to 111 percent in 1Q:07, while the loan loss reserve coverage as a percentage of total loans increased by 49 basis points from 1.14 percent to 1.63 percent.

The cumulative increase in loan loss reserves by national banks during the last four quarters is consistent with the deterioration in credit quality. National banks' ratio of noncurrent loans – the percentage of bank loans that are 90 days or more past due and on nonaccrual - rose to 1.56 percent in 1Q:08 compared to 0.85 percent a year ago. While this overall level of noncurrent loans remains very low by historical standards, there have been fairly rapid increases within certain portfolio segments, most notably those tied to the real estate sector. In particular, noncurrent loan rates for residential construction loans have jumped from 1.11 percent in 1Q:07 to 8.38 percent in 1Q:08, while those for other construction loans are up 244 basis points from 0.68 percent in 1Q:07 to 3.12 percent in 1Q:08. Noncurrent rates for home equity lines of credit have also risen significantly, from 0.41 percent in 1Q:07 to 1.01 percent in 1Q:08.

Despite the challenging economic and credit environment, the national banking system remains fundamentally sound: virtually all national banks meet or exceed the "well capitalized" regulatory capital requirements, and they continue to serve the needs of their communities by providing credit to creditworthy consumer and commercial borrowers. Indeed, in 1Q:08, total loans on the books of national banks increased by 16.8 percent compared to a year earlier. Adjusting for mergers and charter conversions, the increase was 12.2 percent, a rate of expansion that is actually somewhat above that experienced in recent years. Net loan growth continued in almost all lending categories for both small and large banks.

As I reported in my March testimony, we have been directing banks to maintain strong capital cushions and adequate loan loss reserves; to develop diversified funding sources supplemented with realistic contingency funding plans; and to restore more discipline in credit underwriting and loan administration practices. A bank's adherence to these fundamentals has and will continue to be critical in determining its ability to weather the current environment.

Indeed, the vast majority of national banks are taking steps to bolster their operations and strengthen their balance sheets. As previously noted, national banks have significantly increased their loan loss reserves over the last four quarters. The largest national banking organizations continue to increase capital and debt levels through both public and private offerings, raising over $100 billion since October 1 of last year—an unmistakable sign of the underlying long-term viability that investors see in these franchises.

In the wake of the market disruptions of last year and, more recently, the experience of Bear Stearns, larger national banks are also working to strengthen their liquidity positions. To do this, they are increasing retail deposits, improving management of collateral that can be pledged for borrowings, and, as market opportunities permit, extending liability maturities. Core deposits, the most stable source of bank funding, have continued to grow. At the five largest national banks, core deposits rose by 7.9 percent in 1Q:08, measured year-over-year.

Our annual underwriting survey, which we will be releasing later this month, shows that after several years of increasingly accommodative credit terms, there is a renewed focus by national banks on credit fundamentals. This year's survey covered the largest 62 national banks, the combined loan portfolios of which represent approximately 83 percent of all outstanding loans in the national banking system. The results indicate that, in response to deteriorating economic and borrower conditions, many banks are strengthening their underwriting standards across an array of credit products.

With respect to commercial credit, examiners reported a net tightening of underwriting standards at approximately half of the surveyed banks; less than ten percent of the banks have eased commercial loan underwriting standards. Not surprisingly, products with the highest incidence of stricter underwriting standards included leveraged loans and commercial and residential real estate construction loans. But tighter standards were generally observed across all commercial loan products. The stricter underwriting standards are being imposed through a variety of mechanisms, including stronger loan covenants, reduced borrower leverage, additional collateral requirements, and adjustments to loan pricing to better reflect risk.

With respect to retail credit, examiners reported stronger underwriting standards at nearly seventy percent of the surveyed banks. No examiners reported an overall easing of retail underwriting standards. Stronger underwriting standards were most prevalent for residential real estate, home equity, and credit card loans – portfolios that have sustained deterioration in borrower performance. Adjustments to collateral requirements (*e.g.*, lower loan-to-value ratios), credit scorecards, and documentation requirements are methods that banks are using to tighten their retail underwriting standards.

While the vast majority of national banks have the financial capacity and management skills to weather the current environment, some will not. Of these, some will be able to find stronger buyers – in some cases at our insistence – that will enable them to avoid failure and resolution by the Federal Deposit Insurance Corporation. In other cases, that will not be possible. In these other cases, our goal, consistent with the provisions of the Federal Deposit Insurance Incorporation Improvement Act, is to effect early and least-cost-resolution of the institution. We have had three such failures since the beginning of this year. The two most recent involved banks that engaged in significant out of market commercial real estate (CRE) lending to borrowers that were adversely affected by the economic and housing downturn. One of the banks had rapid loan growth and an elevated concentration of residential construction and development loans. Although the banks' boards and management made commitments to address deficiencies that we had identified and directed the banks to correct, they were unable to deal effectively with the banks' asset quality problems in the face of a weakening economy. They were also unable to generate or attract sufficient new capital to restore the banks' financial condition and sound operations.

IV. Areas of Examination Focus

In my March testimony, I observed that, as market conditions began to stabilize, the focus of supervisors and bankers would increasingly turn to the more traditional challenges of identifying and managing problem credits. That shift in focus has begun to occur as our examiners are increasingly drilling down and assessing banks' loan portfolios. One major facet of this assessment, the federal banking agencies' annual Shared National Credit Program (SNC), is currently underway. This program, focused on our largest institutions, provides on-site reviews by examination teams of large syndicated credits that are shared by three or more banks. The current SNC portfolio totals $3 trillion in commitments to approximately 6,000 borrowers. This year's on-site reviews will encompass approximately 30 percent of this total commitment. Target areas of focus include commercial real estate, leveraged finance for mergers and acquisitions, and non-bank lenders.

A second initiative underway is focused on our smaller banks that have sizable concentrations of CRE loans. As reported in my March testimony, approximately one quarter of the community banks supervised by the OCC now have CRE-related concentrations exceeding one or both of the thresholds contained in the interagency CRE guidance issued in December 2006.[2] The share is even higher in areas that experienced rapid appreciation followed by downward pressures on home prices.

For each community bank that has exceeded one or both thresholds, our district examination staffs have prepared summary reports that identify the bank's exposures; our recent and current supervisory activities; and the examiner's assessment of management's ability to manage the bank's CRE exposures in the current environment. These reports have been reviewed and discussed within our district senior management group to identify those banks that we believe have the highest potential risk, and to ensure that our planned supervisory activities for those banks are appropriate. For all identified high risk banks, we will conduct asset quality reviews targeted on the bank's CRE portfolio by year end.

[2] The concentration thresholds articulated in the guidance are commercial real estate loans (excluding owner-occupied real estate) exceeding 300 percent of risk-based capital, or construction and development loans exceeding 100 percent of risk-based capital.

Our goal in conducting these reviews is to work with bankers to identify potential problems at an early stage so that bank management can take necessary remedial action. Let me stress, however, that they are not intended to curtail prudent CRE lending. Because the issues and risks associated with CRE lending can vary by geography and product, our reviews are not broad brush in approach. They are tailored to the specific facts and circumstances of each bank, the nature of its CRE lending activity, and its local market. These reviews are already underway and in some cases have been completed.

Because of our concerns about national banks' CRE exposures, on April 18 our senior deputy comptrollers for bank supervision conducted a nationwide conference call with our examiners to discuss our policies and expectations with regard to CRE concentrations. The call also reviewed key policy guidance and issues that examiners may encounter during examinations to ensure that they take a consistent and balanced approach across our districts and lines of business. These issues include determining when a nonaccrual designation may be warranted; evaluating the use of interest reserves; and measuring project performance for construction and development loans.

One of the most controversial practices associated with the significant real estate downturn in the late 1980 arose in circumstances where the sharp decline in markets meant that appraisals had become outdated. In too many instances, because bankers were reluctant to adjust appraisals to reflect current market conditions, examiners were forced to unilaterally make such adjustments.

This time around, we have stressed to bankers, and reiterated to examiners during this call, that our objective is to minimize the need for such action. To achieve this objective, examiners will direct bank management to obtain new appraisals when needed due to market or project changes, and to take necessary action should those appraisals indicate that loans are no longer adequately supported by collateral values. In many cases, an adjustment by bank management to original appraisal assumptions to reflect current market conditions, rather than a full reappraisal, may be sufficient. We emphasized that examiners should give bankers reasonable time frames for obtaining updated appraisals and making their assessments. We also reiterated the importance of maintaining open and constructive communications with bankers throughout this process.

With regard to retail credit exposures, our monitoring and examination efforts are focused primarily on residential mortgages, home equity lines of credit, and credit card portfolios. With respect to residential mortgages, as I reported in March, we are requiring the largest national bank mortgage servicers to submit comprehensive mortgage data to the OCC on a monthly basis so that we can do something that has not really been done before: collect mortgage data on a loan-level basis using standard data elements and definitions and a prescribed file format. This new approach to mortgage data collection allows the OCC to collect more comprehensive mortgage data and conduct data validation in order to make "apples-to-apples" comparisons between and among banks regarding various aspects of mortgage performance. For example, the data reflects both asset quality and loss and foreclosure mitigation actions using standardized definitions of prime, Alt-A, and subprime loans. The scope of the OCC's data collection covers all mortgages held on national bank balance sheets and those national banks service for others – which in total represents over 40 percent of all mortgages originated in the United States.

We recently received the first data submissions for the six month period ending on March 31 of this year. We have been actively working with servicers to verify the accuracy and reliability of this very substantial amount of loan level data. Our current plan is to issue later this month – perhaps as early as next week – our first public report of key aspects of the data. This will depend, however, on our ability to complete our validation efforts, which have taken a significant amount of time given the large size of this data collection.

Strains in the housing market are also adversely affecting the performance of home equity lines of credit. The home equity loan industry experienced rapid growth over the last six years. Aggregate outstanding lines have doubled since 2002 and currently stand at $1.1 trillion. National banks account for approximately half of this market, with much of this lending concentrated in our largest institutions. As with residential first lien mortgages, competition in the home equity lending market resulted in liberalized underwriting and increased risk layering. As housing prices have fallen and borrowers have become more leveraged, past due levels have accelerated and are expected to increase. While this continued deterioration may place a strain on some banks with sizeable portfolio concentrations, we believe the problem is likely to be manageable.

Mortgage spillover effects, coupled with the strains consumers are experiencing from rising food and gas prices, also are beginning to appear in national banks' credit card portfolios as delinquency and net loss rates have trended upward. The credit card industry began reacting early to the deterioration, with losses just now hovering around historical averages. We do expect some further deterioration in this asset class.

Prompt recognition of losses and the maintenance of strong loan loss reserves and capital buffers are critical during periods of economic stress. Ensuring banks maintain adequate loan loss reserves has been, and will continue to be, a point of emphasis during our examinations. Similarly, we will also continue to evaluate the adequacy of banks' liquidity positions and liquidity risk management processes, especially at those institutions with significant concentrations in their loan or liability portfolios.

Notwithstanding these efforts, we expect to see an increase in the number of problem banks that will require more intensive supervisory focus. In anticipation of this increase, we are taking steps to ensure that we can redeploy resources, as needed, to assist with the supervision of these institutions.

V. Policy Responses – Strengthening Supervision and Risk Management

At the Committee's March hearing, members requested information on initiatives underway to strengthen supervision and promote enhanced risk management practices among financial institutions, drawing upon lessons learned from the recent market disruptions. As the Committee is aware, a number of reports have recently been issued by various domestic and international work groups, discussing key lessons learned and setting forth recommendations for financial institutions and their supervisors. These reports include the March 6th and April 11th reports by the Senior Supervisors Group (SSG) on "Observations on Risk Management Practices during the Recent Market Turmoil" and "Leading-Practice Disclosures for Selected Exposures," respectively; the March 13th "Policy Statement on Financial Market Developments" issued by the President's Working Group on Financial Markets (PWG); and the April 7th report by the Financial Stability Forum (FSF) on "Enhancing Market and Institutional Resilience," (collectively referred to as the reports).[3] These reports have been supplemented by a series of papers on credit risk transfers, identification and management of risk concentrations, and customer suitability in the retail sale of financial products and services by the Joint Forum, an international group of senior bank, insurance, and securities supervisors for which I currently serve as chairman.[4]

While the reports have a somewhat different focus, they share several common themes and recommendations for supervisors and institutions. Broadly speaking, their recommendations call on institutions to:

- <u>Strengthen risk management practices</u>. Specific recommendations include ensuring an independent risk management function; managing the pipeline risk associated with "originate-to-distribute" lending and securitization business strategies; conducting appropriate due diligence, rather than relying solely on ratings, when investing in complex structured products; more fully evaluating the reputation and residual risks arising from various off-balance sheet activities, including off-balance sheet conduits and asset management businesses; identifying and managing concentration risks; and strengthening liquidity risk management practices and contingency funding planning.
- <u>Enhance transparency, disclosure, and valuation practices</u>. Specific recommendations in this area include improved disclosures with respect to

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

[4] Copies of these reports are available at: http://www.bis.org/list/bcbs/index.htm.

off-balance sheet commitments, including commitments to support conduits and other off-balance-sheet vehicles. Improved disclosures should also apply to the underlying distribution of assets and associated risks for various structured products such as CDOs and asset-backed commercial paper conduits. Institutions are also being directed to ensure that they have rigorous valuation processes and to provide robust disclosures on their valuations.

- Improve stress testing and firm-wide capital planning processes. These recommendations focus on ensuring that an institution's stress tests and capital planning process fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm, and that capital planning and estimates of potential credit losses are appropriately forward looking and take account of uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

The reports also highlighted areas for enhanced supervisory oversight by banking supervisors. The recommendations generally fall into three broad categories: 1) providing additional guidance to institutions with regard to the risk management and disclosure practices noted above and monitoring institutions' actions to implement those recommendations; 2) enhancing the various aspects of the Basel II framework; and 3) improving the exchange of supervisory information and sharing of best practices.

On April 16, the Basel Committee on Bank Supervision announced a series of steps that address a number of these recommendations.[5] Consistent with the findings and recommendations by the PWG and FSF, the Basel Committee reiterated the importance

[5] "Basel Committee on Banking Supervision announces steps to strengthen the resilience of the banking system" at http://www.bis.org/press/p080416.htm.

of implementing the Basel II framework and outlined several proposed revisions to more fully capture the risks of certain complex structured credit products and off-balance sheet exposures. Specifically, the Basel Committee plans to establish higher capital requirements for resecuritizations, such as collateralized debt obligations that are comprised of asset-backed securities. These structured securities experienced the most significant losses during the recent market turmoil because of their high degree of leverage and the difficulty in establishing reliable estimates of the correlation of defaults among the exposures in the underlying portfolios. The capital treatment of liquidity facilities that support ABCP conduits will also be enhanced.

In addition to these two proposals, the Basel Committee is working with the International Organization of Securities Commissions to propose revisions to the current market risk capital framework for trading account activities. The planned revision would introduce a capital element for incremental event risk to better reflect potential exposures arising from the larger proportion of complex, less liquid credit products that institutions now hold in their trading portfolios. While this revision to the market risk framework is being developed, the Basel Committee plans to adopt an interim capital charge that would substantially eliminate the difference in required capital for certain structured securities that are held in the trading book relative to the banking book.

In addition to these revisions to the Pillar 1 (explicit capital charge) component of the Basel Framework, the Basel Committee also plans to strengthen guidelines for Pillar 2 (supervisory review) and Pillar 3 (market discipline/disclosure). The Pillar 2 enhancements, aimed at strengthening risk management and supervisory practices, will focus on the management of firm-wide risks, stress testing and capital planning, and off-balance sheet exposures and associated reputational risks. These enhanced guidelines are expected to be issued later this year.

The Pillar 3 revisions will promote enhanced disclosures for complex securitization exposures, ABCP, and the sponsorship of off-balance sheet vehicles. These revisions are expected to be issued in 2009. The Basel Committee also reiterated its intention to monitor and assess the effect of Basel II on banks' capital levels over the credit cycle and to make further revisions, if needed, to ensure that it provides a sound capital framework for addressing banks' evolving and complex risks.

The Basel Committee also plans to issue for public comment sound practice standards for the management and supervision of liquidity risks. These standards are intended to address many of the issues identified during the recent market disruptions, including the need to fully assess the potential liquidity draws stemming from various off-balance sheet vehicles and other contingent commitments.

The OCC has been actively involved in the various work groups that issued these reports, and we support their recommendations. We are taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations. Many of these institutions already have begun an internal assessment of their practices to identify gaps where improvements are needed.

The OCC has existing guidance that addresses some of the issues and concerns highlighted in the recent SSG, PWG, and FSF reports. We plan to provide examiners at our large banks with a summary and cross reference of these policies to assist them with their on-site evaluations. We also will evaluate whether some of our existing policies need revisions to incorporate recent market developments and lessons learned. In particular, we plan to update our guidance on derivatives and structured products (OCC Banking Circular 277, “Risk Management of Financial Derivatives”) to reflect developments in these markets.

Finally, I would like to bring to the Committee’s attention one recommendation in the PWG’s report that does not directly involve the OCC but which is of vital interest to us and the institutions we regulate: the need for the Financial Standards Accounting Board (FASB) to evaluate the role that accounting standards played in the current market turmoil. While recent accounting changes, such as the greater application of fair value accounting, may provide benefits, I think we need to carefully review how the application of these standards may have influenced product structures and market behavior, including the market recent disruptions. The OCC would be pleased to provide any assistance the FASB may need as it undertakes this analysis. In this regard, I would also note that many of our larger institutions have begun to disclose the potential impact that the FASB’s planned changes to FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as it relates to qualifying special purpose entities, may have on their balance sheet structures and business lines. Here again, I think we need to carefully evaluate how these changes may affect markets and institutions, and to ensure that appropriate transition periods are provided if significant changes are adopted. We will be working with the other federal banking agencies to assess this impact and plan to provide comments to the FASB on this proposal when its exposure draft is released.

VI. Conclusion

In conclusion, it is clear that current economic and borrower conditions continue to pose challenges to financial institutions. We are closely monitoring these conditions and their potential effects on individual banks and the national banking system as a whole. As I have described in my testimony, we are stressing the need for banks to maintain strong loan loss reserves and capital buffers and to identify and correct weaknesses in their risk management systems that have been revealed by recent market events. We are also working closely with our supervisory colleagues on the Basel Committee to further strengthen the risk-based capital standards and disclosure practices for large internationally active banks.