Remarks by
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Thank you. John Dugan, Comptroller of the Currency and chairman of the Joint Forum, sends his regards and asked me to express his disappointment that he is not be able to be here with you today. He's been looking forward to this meeting, but as you know, there's just a lot going on in Washington these days, and so he felt it necessary to forego a number of previously scheduled out-of-town speeches to be on hand at the office.

But while he's disappointed, I'm very happy that I now have this opportunity to be here with you in this beautiful city to discuss the work of the Joint Forum. I'd like to thank the IAIS and Michel Flamée, Chairman of the IAIS Executive Committee, for the invitation to speak. And thanks also to the Hungarian Financial Supervisory Authority for hosting the 2008 Annual Conference here in Budapest.

To provide you with some context for my remarks, I am the Deputy Comptroller for International Banking Supervision at the Office of the Comptroller of the Currency. I serve as Mr. Dugan's senior advisor on international supervision matters such as the Joint Forum, a member of my management team is the OCC's Joint Forum member, and my group provides support to Mr. Dugan in his role as Chair of the Joint Forum. As you may know, the OCC is charged with oversight of some of the largest, most systemically important banks in the world, as well as a large number of small and mid-sized banks. The national banks we supervise represent about 70 percent of the U.S. commercial banking industry's assets. I could go on about the national banking industry, but today I want to focus my remarks on the work of the Joint Forum.

First, let me give you some background. As you may know, the Joint Forum brings together senior supervisors of the insurance, securities, and banking sectors. Currently the members represent agencies from 13 major countries. The Joint Forum is comprised of an equal number of supervisors, nine, from each sector. As the membership implies, the work of the Joint Forum encompasses issues common to all three sectors and those relating to financial conglomerates.

For over ten years, the Joint Forum has brought together supervisors to address cross- sector issues of common interest. In fact, the Joint Forum is the only cross sector international supervisory-focused group. The group has tackled an impressive list of topics, including: liquidity, risk identification and aggregation, corporate governance, credit risk transfer, risk concentrations, customer suitability, and business continuity, as well as establishing cross-sector core principles. Many of the reports produced by the Joint Forum are public. From a practical standpoint – like supervisors around the globe – most of the work is done behind the scenes, by technical experts.

The value in the Joint Forum is not only from its technical work, which I will expand on in a moment. The intangibles are just as important. Past and present Joint Forum members will tell you that they have benefited greatly from the understanding that they have gained by seeing the financial world through another set of lenses. For those of us from the banking world, just understanding the differing terminology used within the insurance industry is an accomplishment itself. And in today's unsettled markets, a deeper understanding of the differing approaches we take to supervision can only help us do our jobs better.

Other intangible benefits include the opportunities for discussions with experts from financial conglomerates during our Joint Forum meetings; the knowledge gained from serving together on working groups; and the professional contacts that facilitate our day-to-day work. These opportunities to share experiences and learn from each other are invaluable. The group builds the cooperative spirit necessary to address the supervisory challenges arising from financial conglomerates and provides for a better understanding of cross-sector issues. Most notably, this leads to better policy-making, a goal that is more important than ever right now.

Before discussing the work of the Joint Forum, I'd like to mention the role insurance supervisors play. The Joint Forum is under the aegis or sponsorship of what we refer to as the three parent committees, which are the International Association of Insurance Supervisors, the International Organization of Securities Commissions, and the Basel Committee on Banking Supervision. These three parent committees are ultimately the bodies to which the Joint Forum reports. The Secretary Generals of each of the parent committees is also a member of the Joint Forum. So in addition to insurance supervisors as members of the Joint Forum, the IAIS Secretary General is a member.

The Chairmanship of the Joint Forum rotates among the three parent committees. The last Joint Forum Chairman was Dirk Witteveen who preceded Mr. Dugan and represented the insurance sector. I understand that Mr. Witteveen, who was the Executive Director of the Dutch Central Bank and had a very distinguished career, is being honoured during this conference. Although his tenure as Joint Forum chair was unfortunately shortened due to illness, Mr. Witteveen was passionate about the cross-sectoral and cross-border contributions the Joint Forum brought to supervisory issues and discussions. He worked extremely hard to ensure the active participation of all three groups (IAIS, IOSCO and the BCBS) on all Joint Forum projects -- including the three significant papers published during his leadership.

Mr. Witteveen and the current IAIS leadership recognize that insurance supervisors are an important part of the Joint Forum. They contribute in critical ways. Besides serving as Joint Forum members, insurance representatives participate on the Joint Forum's technical working groups that study cross-sector issues. Insurance supervisors contribute their expertise and experience to work products that have a global reach and influence. These products are used by a variety of groups, including policymakers, international bodies such as the IMF, and supervisors.

Now, let me spend a few minutes describing some of the work of the Joint Forum. As I noted earlier, the Joint Forum has been at the forefront of issues that cut across the three sectors, and specifically on some of the topics of interest to the IAIS.

For example, the Joint Forum recently completed work on customer suitability. The paper titled *Customer suitability in the retail sale of financial products and services* was published in April. In it, we considered how supervisors and regulated firms across the insurance, securities, and banking sectors address risks posed by the sale of unsuitable retail financial products. We reviewed both the disclosure of information to retail investors and requirements on firms to determine whether recommended investment products are suitable for such investors. We were informed through surveying some 90 financial firms in ten countries.

Our review indicates that while suitability and the risks posed by mis-selling are increasingly on the minds of regulators and firms, there remains wide disparity in what is required of firms and in firms' internal policies and practices. A key report finding is that the notion of suitability is recognized in regulatory requirements across all sectors, but to a varying extent. There are some differences in its application by sector, and probably greater differences by country. The differences that do exist may stem, in part, from the fact that not all supervisors have consumer protection mandates.

I know that market conduct is an important issue to you and is the topic of the next panel. Our work on customer suitability is another example of the importance and relevance of the Joint Forum's work.

Let me cite another example of the Joint Forum's work that has assumed added significance and urgency in light of current market developments over the past year.

A Joint Forum paper titled *Credit Risk Transfer – Developments from 2005 to 2007* has contributed significantly to the understanding of the causes of the current market turmoil. The paper was developed in response to a request from the Financial Stability Forum in March 2007. The FSF asked the Joint Forum to consider the extent to which the Joint Forum's March 2005 paper *Credit Risk Transfer* required updating as a result of the continued growth and rapid innovation in credit risk transfer markets, such as ones involving credit derivatives and collateralized debt obligations or "CDOs." While development of the paper was underway well ahead of the market disruption that began in the summer of 2007, much of the technical work was done after the turmoil began.

The Joint Forum published the credit risk transfer report this past July, and I invite you to read it. Policymakers and practitioners alike consider this an extremely valuable, ground breaking analysis. While it covers technical material, you don't have to be a technician to understand it. We took great pains to make sure it was written in a clear and understandable manner. The report focused particularly on two financial instruments that have been used widely to transfer credit risk: collateralized debt obligations, especially those secured by tranches of sub-prime asset-backed securities, and collateralized loan obligations. The part of the paper that explains and analyzes CDOs backed by tranches of subprime mortgage-backed securities is especially relevant given the very substantial losses that major financial institutions sustained with respect to these instruments. While the losses from these securities was originally considered only a large bank and large securities dealer problem, as you know, insurance companies are now suffering the fallout from these structured products. Some, like AIG and monoline insurers, are suffering more directly than others.

I believe a combination of factors led to these enormous losses that have in turn brought us to where we are today, and the Joint Forum papers I mentioned previously provide excellent details. Since time does not permit me to provide much background, I refer you also to a speech Comptroller Dugan gave last February to the Global Association of Risk Professionals, which you can find on the OCC's website. Briefly though, a chain of events beginning with a systematic decline in subprime mortgage underwriting standards culminated in these enormous losses from subprime ABS CDOs – a majority of which resulted from holdings of so-called "super-senior" tranches of these instruments, because these supposedly low risk securities represented the vast majority of the CDO's capital structure.

I would like to highlight two reasons, outlined in the Joint Forum credit risk transfer paper, that explain why investors in CDOs have suffered such significant losses. The first reason is concentrations. We know that concentrations – whether they involve credit, revenue, liquidity or really any other risk factor -- are always dangerous. The firms that took the biggest losses on ABS CDOs were the ones that had very large positions – concentrations – relative to their earnings and capital. These firms continued to originate these deals, even when they knew that there was no investor demand for these low-yielding assets. Not only did this turn the originate-to-distribute model into a retention model, a fundamental change in business practice, but it also created serious risk management issues because these CDOs were extremely hard to value. Some of these firms took comfort that there was very little chance that securities rated triple A could ever suffer a loss. Although we now know there will be principal losses, these firms failed to understand that mark-to-market losses on these concentrated exposures can be very significant even if there were ultimately no principal losses.

The second reason investors have suffered such significant losses relates to the role of credit rating agencies and the over-reliance investors placed on them. Credit rating agencies gave these super-senior tranches triple-A ratings. The credit rating reflected the subordination beneath the super-senior tranches, but also a view that home prices in the U.S. would not fall. When dealers could no longer sell these tranches to investors, they purchased credit protection, through credit default swaps, from monoline financial guarantors, a classic case of wrong-way risk because those firms already had significant exposures to the same asset class.

Despite the complexity of these securities, the credit rating agencies believed they had enough information to rate all of the tranches of a typical ABS CDO. This included providing a triple A rating to a super-senior tranche. Our work in the Joint Forum focused on a critical characteristic of triple A-rated super-senior ABS CDO securities that may have led them to perform quite differently than other types of triple A-rated securities, such as individual corporate securities. This characteristic is the fact that the extremely broad range of subprime loans underlying a super-senior tranche of an ABS CDO effectively diversifies away the idiosyncratic risk, but the CDO pool remains very exposed to systematic or correlation risk. In other words, if an unexpected market event occurred, such as a decline in home prices, the underlying pool of exposures would become highly correlated and then would behave as if it were a large, single, exposure. Put another way, these securities can be expected to perform well under most conditions, but in times of severe systematic stress they may incur exceptionally large losses. In addition, the credit rating agencies did not recognize that the severe erosion of underwriting standards for subprime mortgages invalidated the historical assumptions they used for assessing the risk of these assets.

The credit rating agencies, I believe, did not do a good job of disclosing the distinctions between the likely performance of triple A-rated structured securities and triple A-rated corporate securities. In other words, a triple A means different things in different contexts. Triple A credit ratings provided to instruments such as these are a powerful green light for conservative investors all over the world. A point made explicitly in the Joint Forum's 2005 credit risk transfer report, well before the turmoil began was that neither investors nor regulators should rely exclusively on credit ratings when evaluating the credit risk in a highly rated tranche of an ABS CDO. This may seem obvious to everyone now, but exclusive reliance on ratings has been all too common a practice. Investment managers get paid to analyze and assess risk and reward. In far too many cases, professional investment managers ceded their responsibilities to the credit rating agencies, relying on, as we now know, their flawed assessment of ABS CDO risks.

To conclude my remarks on the work of the Joint Forum in the credit risk transfer area, while it is critical to understand the causes of the market turmoil and how to resolve the immediate crisis at hand, we policymakers must also consider actions to increase the resilience of markets and institutions going forward. To that end, our most recent credit risk transfer report provides a number of recommendations applicable to all market participants, including insurance firms and their supervisors. These recommendations enhance the earlier recommendations of the Joint Forum's 2005 paper. Indeed, had they been followed more closely several years ago, I believe these recommendations would have helped avoid the turmoil stemming from these types of products or reduced their impact. To support my point I only provide one example – the reliance on credit ratings.

Also, I want you to know that in 2009, the Joint Forum will survey market participants to assess the extent to which they have implemented the recommendations from the 2005 and 2008 credit risk transfer papers. I urge all significant participants in these markets to consider performing a self-assessment.

The Joint Forum’s work on credit risk transfer, along with customer suitability, are examples of the broad range of technical work we do.

Next, I want to tell you about the Joint Forum’s new initiatives. This summer, the Joint Forum initiated two new projects, which all three parent committees have approved and support.

Our first new initiative concerns the use of credit ratings in regulation and supervision. As I just described, credit rating agencies played a critical role in evaluating and disseminating information on the types of structured credit products that were key to the large losses incurred by commercial and investment banks. As you in the insurance business know, credit ratings play a major role in investment and risk management also. Like our credit risk transfer work that has stimulated so much discussion, I expect our work on the use of credit ratings will do so as well.

For this work, the Joint Forum is conducting a stocktaking of the uses of external credit ratings by its member supervisory authorities in the insurance, banking, and securities sectors. The idea behind this work is to collect, in one place, all of the ways that supervisors use or rely on credit ratings in regulation and guidance across the three sectors and in each of the 13 countries represented on the Joint Forum. This could then be used by policymakers or others – including the Joint Forum or IAIS - to consider further analyses and initiatives on, for example, the extent to which the use of credit ratings is appropriate or should be scaled back.

The main deliverable for this project will be a range-of-practices paper outlining the key findings of the stocktaking and addressing the use of credit ratings by Joint Forum member authorities across the sectors they supervise. This work is scheduled to be completed by the end of 2008. Additionally, I am sure Joint Forum members will be exchanging views during our upcoming meeting in November on whether the use of external credit ratings has had the unintended effect of implying an endorsement of such ratings and/or discouraging investors across the financial system from performing their own due diligence. I am confident Joint Forum members will bring these debates back to their respective supervisory bodies.

The second new initiative focuses on the uses, characteristics, and risks posed by off-balance sheet vehicles. Off-balance sheet vehicles are widely used by financial firms – from retail financing structures such as credit card and auto loan securitizations, to asset-backed commercial paper programs and structured investment vehicles. Such vehicles have been used for years by many financial firms as an effective risk management tool and as a source of liquidity and funding. However, recent events have demonstrated that these vehicles can also present significant risks in these same areas as well. For example, problems in asset-backed commercial paper conduits and structured investment vehicles represented an early chapter in the current market disruption, when the seizing up of the asset-backed commercial paper market back in the summer of 2007 exposed weaknesses in these vehicles. Many operated with significant liquidity and maturity mismatches, inadequate capital buffers, and asset compositions – especially the investments in super-senior tranches of CDOs – that were not well understood by their commercial paper investors. The performance of these and other off-balance sheet structures has raised questions about just how much risk is truly transferred to third parties and the degree to which these off-balance sheet exposures remain an obligation of, and pose risk to, the sponsoring entity.

The focus of this Joint Forum initiative will be to provide a better understanding of the types and characteristics of off-balance sheet vehicles, to address how and why they are used, and to provide insight into the degree of risk transfer achieved by such vehicles. We will be developing an informative, technical paper, much in the same vein as other work of the Joint Forum such as that on credit risk transfer. As is traditional for the Joint Forum, the group will reach out to industry representatives for their perspective. The review should be completed within one year.

I want to point out that we recognize that recently proposed changes to U.S. accounting rules could have a significant impact on the use of off-balance sheet vehicles by financial firms. In particular, the proposed accounting changes could result in many of the assets and liabilities held in off-balance sheet vehicles being brought on to firms' balance sheets, which could also have significant implications on regulatory capital requirements. We also recognize that the IASB is proposing changes to its consolidation standards in the same general direction as those proposed by FASB. While this Joint Forum work is not intended to pass judgment on accounting standards or regulatory capital, these potential changes and their effect on off-balance sheet vehicles could have major effects on how firms conduct certain businesses; therefore, accounting and regulatory capital elements need to be considered as they are motivating factors for how and why these off-balance sheet vehicles are structured and used.

Regardless of the outcome of discussions on accounting and capital treatment, off-balance sheet vehicles will continue to play an important role in financial markets. I expect that the insights developed through this initiative to have broad applicability and relevance. This work will serve to inform supervisors of the benefits and risks associated with financial institutions' use of off-balance sheet vehicles. The end product will collect in one place relevant, informative, technical analysis that provides an understanding of the risks posed by off-balance sheet vehicles. The work will serve as a foundation to stimulate debate, contribute to policy discussions, and to ensure policymakers have the right tools to make sound changes in response to the current turmoil.

I want to briefly mention a third work stream scheduled to begin early in the new year. It will focus on risk aggregation, diversification and modeling. More specifically, this work stream will investigate the extent to which supervisors incorporate firm-estimated correlations and diversification benefits into the new solvency frameworks (e.g., Basel II and Solvency II), as well as how supervisors across sectors assess and validate firms' risk models.

These new initiatives will allow the Joint Forum to continue to make meaningful contributions to international financial policy discussions and provide policy makers with substantive, needed analyses.

In closing, the market stresses we are experiencing today are not confined by national borders or within a specific financial sector. Effective supervision and regulation of the global financial system requires an international approach and cooperation among regulators. This is even more critical now, with larger and more complex financial conglomerates being formed just over the past month. Because of its composition and its mandate, the Joint Forum is uniquely positioned to contribute to some of the most important international financial policy discussions. I know that Comptroller Dugan appreciates the support and contributions of the IAIS members to Joint Forum work and that he encourages continued engagement. Recent events in global financial markets ensure that the remainder of his term as chairman will continue to be a challenging and an interesting time.

Thank you.