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

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate this opportunity to discuss reforming the regulation of our financial system.

Recent turmoil in the financial markets, the unprecedented distress and failure of large financial firms, the mortgage and foreclosure crises, and growing numbers of problem banks – large and small – have prompted calls to reexamine and revamp the nation’s financial regulatory system. The crisis raises legitimate questions about whether our existing complex system has both redundancies and gaps that significantly compromise its effectiveness. At the same time, any restructuring effort that goes forward should be carefully designed to avoid changes that undermine the parts of our current regulatory system that work best.

To examine this very important set of issues, the Committee will consider many aspects of financial regulation that extend beyond bank regulation, including the regulation of government-sponsored enterprises, insurance companies, and the intersection of securities and commodities markets. Accordingly, my testimony today focuses on key areas where I believe the perspective of the OCC – with the benefit of hindsight from the turmoil of the last two years – can most usefully contribute to the Committee’s deliberations. Specifically, I will discuss the need to –

- improve the oversight of systemic risk, especially with respect to systemically important financial institutions that are not banks;
- establish a better process for stabilizing, resolving or winding down such firms;
- reduce the number of bank regulators, while preserving a dedicated prudential supervisor;
- enhance mortgage regulation; and

- improve consumer protection regulation while maintaining its fundamental connection to prudential supervision.

Improving Systemic Risk Oversight

The unprecedented events of the past year have brought into sharp focus the issue of systemic risk, especially in connection with the failures or near failures of large financial institutions. Such institutions are so large and so intertwined with financial markets and other major financial institutions that the failure of one could cause a cascade of serious problems throughout the financial system – the very essence of systemic risk.

Years ago, systemically significant firms were generally large banks, and our regime of extensive, consolidated supervision of banks and bank holding companies – combined with the market expertise provided by the Federal Reserve through its role as central bank – provided a means to address the systemic risk presented by these institutions. More recently, however, large nonbank financial institutions like AIG, Fannie Mae and Freddie Mac, Bear Stearns, and Lehman began to present similar risks to the system as large banks. Yet these nonbank firms were subject to varying degrees and different kinds of government oversight. In addition, no one regulator had access to risk information from these nonbank firms in the same way that the Federal Reserve has with respect to bank holding companies. The result, I believe, was that the risk these firms presented to the financial system as a whole could not be managed or controlled until their problems reached crisis proportions.

One suggested way to address this problem going forward would be to assign one agency the oversight of systemic risk throughout the financial system. This approach

would fix accountability, centralize data collection, and facilitate a unified approach to identifying and addressing large risks across the system. Such a regulator could also be assigned responsibility for identifying as systemically significant those institutions whose financial soundness and role in financial intermediation is important to the stability of U.S. and global markets.

But the single systemic regulator approach would also face challenges due to the diverse nature of the firms that could be labeled systemically significant. Key issues would include the type of authority that should be provided to the regulator; the types of financial firms that should be subject to its jurisdiction; and the nature of the new regulator's interaction with existing prudential supervisors. It would be important, for example, for the systemic regulatory function to build on existing prudential supervisory schemes, adding a systemic point of view, rather than replacing or duplicating regulation and supervisory oversight that already exists. How this would be done would need to be evaluated in light of other restructuring goals, including providing clear expectations for financial institutions and clear responsibilities and accountability for regulators; avoiding new regulatory inefficiencies; and considering the consequences of an undue concentration of responsibilities in a single regulator.

It has been suggested that the Federal Reserve Board should serve as the single agency responsible for systemic risk oversight. This makes sense given the comparable role that the Board already plays with respect to our largest banking companies; its extensive involvement with capital markets and payments systems; and its frequent interaction with central banks and supervisors from other countries.

If Congress decides to take this approach, however, it would be necessary to define carefully the scope of the Board's authority over institutions other than the bank holding companies and state-chartered member banks that it already supervises. Moreover, the Board has many other critical responsibilities, including monetary policy, discount window lending, payments system regulation, and consumer protection rule-writing. Adding the broad role of systemic risk overseer raises the very real concerns of the Board taking on too many functions to do all of them well, while at the same time concentrating too much authority in a single government agency. The significance of these concerns would depend very much on both the scope of the new responsibilities as systemic risk regulator, and any other significant changes that might be made to its existing role as the consolidated bank holding company supervisor.

Let me add that the contours of new systemic authority may need to vary depending on the nature of the systemically significant entity. For example, prudential regulation of banks involves extensive requirements with respect to risk reporting, capital, activities limits, risk management, and enforcement. The systemic supervisor might not need to impose all such requirements on all types of systemically important firms. The ability to obtain risk information would be critical for all such firms, but it might not be necessary, for example, to impose the full array of prudential standards, such as capital requirements or activities limits on all types of systemically important firms, *e.g.*, hedge funds (assuming they were subject to the new regulator's jurisdiction). Conversely, firms like banks that are already subject to extensive prudential supervision would not need the same level of oversight as firms that are not – and if the systemic overseer were the Federal Reserve Board, very little new authority would be required

with respect to banking companies, given the Board's current authority over bank holding companies.

It also may be appropriate to allocate different levels of authority to the systemic risk overseer at different points in time depending on whether financial markets are functioning normally, or are instead experiencing unusual stress or disruption. For example, in a stable economic environment, the systemic risk regulator might focus most on obtaining and analyzing information about risks. Such additional information and analysis would be valuable not only for the systemic risk regulator, but also for prudential supervisors in terms of their understanding of firms' exposure to risks occurring in other parts of the financial services system to which they have no direct access. And it could facilitate the implementation of supervisory strategies to address and contain such risk before it increased to unmanageable levels.

On the other hand, in times of stress or disruption it may be appropriate to authorize the systemic regulator to take actions ordinarily reserved for prudential supervisors, such as imposing specific conditions or requirements on operations of a firm. Such authority would need to be crafted to ensure flexibility, but the triggering circumstances and process for activating the authority should be clear. Mechanisms for accountability also should be established so that policymakers, regulated entities, and taxpayers can understand and evaluate appropriate use of the authority.

Let me make one final point about the systemic risk regulator. Our financial system's "plumbing" – the major systems we have for clearing payments and settling transactions – are not now subject to any clear, overarching regulatory system because of the variety in their organizational form. Some systems are clearinghouses or banking

associations subject to the Bank Service Company Act. Some are securities clearing agencies or agency organizations pursuant to the securities or commodities laws. Others are chartered under the corporate laws of states.¹

Certain of these payment and settlement systems are systemically significant for the liquidity and stability of our financial markets, and I believe these systems should be subjected to overarching federal supervision to reduce systemic risk. One approach to doing so was suggested in the 2008 Treasury Blueprint, which recommended establishing a new federal charter for systemically significant payment and settlement systems and authorizing the Federal Reserve Board to supervise them. I believe this approach is appropriate given the Board's extensive experience with payment system regulation.

Resolving Systemically Significant Firms

Events of the past year also have highlighted the lack of a suitable process for resolving systemically significant financial firms that are not banks. U.S. law has long provided a unique and well developed framework for resolving distressed and failing banks that is distinct from the federal bankruptcy regime. Since 1991, this unique framework, administered by the Federal Deposit Insurance Corporation, has also provided a mechanism to address the problems that can arise with the potential failure of a systemically significant bank – including, if necessary to protect financial stability, the ability to use the bank deposit insurance fund to prevent uninsured depositors, creditors, and other stakeholders of the bank from sustaining loss.

Unfortunately, no comparable framework exists for resolving most systemically significant financial firms that are not banks, including systemically significant holding

¹ For a description of the significance of payment and settlement systems and the various forms under which they are organized in the United States, see U.S. DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 100-103 (MARCH 2008) (2008 TREASURY BLUEPRINT).

companies of banks. Such firms must therefore use the normal bankruptcy process unless they can obtain some form of extraordinary government assistance to avoid the systemic risk that might ensue from failure or the lack of a timely and orderly resolution. While the bankruptcy process may be appropriate for resolution of certain types of firms, it may take too long to provide certainty in the resolution of a systemically significant firm, and it provides no source of funding for those situations where substantial resources are needed to accomplish an orderly solution. As a result, in the last year as a number of large nonbank financial institutions faced potential failure, government agencies have had to improvise with various other governmental tools to address systemic risk issues at nonbanks, sometimes with solutions that were less than ideal.

This gap needs to be addressed with an explicit statutory regime for facilitating the resolution of systemically important nonbank companies as well as banks. This new statutory regime should provide tools that are similar to those the FDIC currently has for resolving banks, including the ability to require certain actions to stabilize a firm; access to a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury; the ability to wind down a firm if necessary, and the flexibility to guarantee liabilities and provide open institution assistance if necessary to avoid serious risk to the financial system. In addition, there should be clear criteria for determining which institutions would be subject to this resolution regime, and how to handle the foreign operations of such institutions.

One possible approach to a statutory change would be to simply extend the FDIC's current authority to nonbanks. That approach would not appear to be appropriate given the bank-centric nature of the FDIC's mission and resources. The deposit

insurance fund is paid for by assessments on insured banks, with a special assessment mechanism available for certain losses caused by systemically important banks. It would not be fair to assess only banks for problems at nonbanks. In addition, institutional conflicts may arise when the insurer must fulfill the dual mission of protecting the insurance fund and advancing the broader U.S. Government interests at stake when systemically significant institutions require resolution. Indeed, important changes have recently been proposed to improve the FDIC's systemic risk assessment process to provide greater equity when the FDIC's protective actions extend beyond the insured depository institution to affiliated entities that are not banks.

A better approach may be to provide the new authority to the new systemic risk regulator, in combination with the Treasury Department, given the likely need for a substantial source of government funds. The new systemic risk regulator would by definition have systemic risk responsibility, and the Treasury has direct accountability to taxpayers. If the systemic risk regulator were the Federal Reserve, then the access to discount window funding would also provide a critical resource to help address significant liquidity problems. It is worth noting that, in most other countries, it has been the Treasury Department or its equivalent that has provided extraordinary assistance to systemically important financial firms during this crisis, whether in the form of capital injections, government guarantees, or more significant government ownership.

Reducing the Number of Bank Regulators

It is clear that the United States has too many bank regulators. We have four federal regulators, 12 Federal Reserve Banks, and 50 state regulators, nearly all of which have some type of overlapping supervising responsibilities. This system is largely the

product of historical evolution, with different agencies created for different legitimate purposes reflecting a much more segmented banking system from the past. No one would design such a system from scratch, and it is fair to say that, at times, it has not been the most efficient way to establish banking policy or supervise banks.

Nevertheless, the banking agencies have worked hard over the years to make the system function appropriately despite its complexities. On many occasions, the diversity in perspectives and specialization of roles has provided real value. And from the perspective of the OCC, I do not believe that our sharing of responsibilities with other agencies has been a primary driver of recent problems in the banking system.

That said, I recognize the considerable interest in reducing the number of bank regulators. The impulse to simplify is understandable, and it may well be appropriate to streamline our current system. But we ought not approach the task by prejudging the appropriate number of boxes on the organization chart. The better approach is to determine what would be achieved if the number of regulators were reduced. What went wrong in the current crisis that changes in regulatory structure (rather than regulatory standards) will fix? Will accountability be enhanced? Will the change result in greater efficiency and consistency of regulation? Will gaps be closed so that opportunities for regulatory arbitrage in the current system are eliminated? Will overall market regulation be improved?

In this context, while there is arguably an agreement on the need to reduce the number of bank regulators, there is no such consensus on what the right number is or what their roles should be. Some have argued that we should have just one regulator responsible for bank supervision, and that it ought to be a new agency such as the

Financial Services Agency in the U.K., or that all such responsibilities should be consolidated in our central bank, the Federal Reserve Board. Let me explain why I don't think either of these ideas is the right one for our banking system.

The fundamental problem with consolidating all supervision in a new, single independent agency is that it would take bank supervisory functions away from the Federal Reserve Board. In terms of the normal turf wars among agencies, it may sound strange for the OCC to take this position. But as the central bank and closest agency we have to a systemic risk regulator, I believe the Board needs the window it has into banking organizations that it derives from its role as bank holding company supervisor. More important, given its substantial role and direct experience with respect to capital markets, payments systems, the discount window, and international supervision, the Board provides unique resources and perspective to bank holding company supervision.

Conversely, I believe it also would be a mistake to move all direct banking supervision to the Board, or even all such supervision for the most systemically important banks. The Board has many other critical responsibilities, including monetary policy, discount window lending, payments system regulation, and consumer protection rule-writing. Consolidating all banking supervision there as well would raise a serious concern about the Board taking on too many functions to do all of them well. There would also be a very real concern about concentrating too much authority in a single government agency. And both these concerns would be amplified substantially if the Board were also designated the new systemic risk regulator and took on supervisory responsibilities for systemically significant payment and clearing systems.

Most important, moving all supervision to the Board would lose the very real benefit of having an agency whose sole mission is bank supervision. That is, of course, the sole mission of the OCC, and I realize that, coming from the Comptroller, support for preserving a dedicated prudential banking supervisor may be portrayed by some as merely protecting turf. That would be unfortunate, because I strongly believe that the benefits of dedicated supervision are real. Where it occurs, 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 part of the organization, 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 the case of the OCC, I would add that our role as the front-line, on-the-ground prudential supervisor is complementary to the current role of the Federal Reserve Board as the consolidated holding company regulator. This model has allowed the Board to use and rely on our work to perform its role as supervisor for complex banking organizations that are often involved in many businesses other than banking. Such a model would also work well with respect to any new authority provided to a systemic risk regulator, whether or not the Board is assigned that role.

In short, there are a number of options for reducing the number of bank regulators, and many detailed issues involved with each. It is not my intent to address these issues in detail in this testimony, but instead to make two fundamental and related points about changes to the banking agency regulatory structure. While it is important to preserve the Federal Reserve Board's role as a holding company supervisor, it is equally

if not more important to preserve the role of a dedicated, front-line prudential supervisor for our nation's banks.

Enhanced Mortgage Regulation

The current financial crisis began and continues with problems arising from poorly underwritten residential mortgages, especially subprime mortgages. While these lending practices have been brought under control, and federal regulators have taken actions to prevent the worst abuses, more needs to be done. As part of any regulatory reform to address the crisis, Congress should establish a mortgage regulatory regime that ensures that the mortgage crisis is never repeated.

A fundamental reason for poorly underwritten mortgages was the lack of consistent regulation for mortgage providers. Depository institution mortgage providers – whether state or federally chartered – were the most extensively regulated, by state and federal banking supervisors. Mortgage providers affiliated with depository institutions were less regulated, primarily by federal holding company supervisors, but also by state mortgage regulators. Mortgage providers not affiliated with depository institutions – including mortgage brokers and lenders – were the least regulated by far, with no direct supervision at the federal level, and limited ongoing supervision at the state level.

The results have been predictable. As the 2007 Report of the Majority Staff of the Joint Economic Committee recognized, “[s]ince brokers and mortgage companies are only weakly regulated, another outcome [of the increase in subprime lending] was a marked increase in abusive and predatory lending.”² Non-depository institution

² MAJORITY STAFF OF THE JOINT ECONOMIC COMMITTEE, 110TH CONG., REPORT AND RECOMMENDATIONS ON THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 17 (OCTOBER 2007).

mortgage providers originated the overwhelming preponderance of subprime and “Alt-A” mortgages during the crucial 2005-2007 period, and the loans they originated account for a disproportionate percentage of defaults and foreclosures nationwide, with glaring examples in the metropolitan areas hardest hit by the foreclosure crisis. For example, a recent analysis of mortgage loan data prepared by OCC staff, from a well-known source of mortgage loan data, identified the 10 mortgage originators with the highest number of subprime and Alt-A mortgage foreclosures – in the 10 metropolitan statistical areas (MSAs) experiencing the highest foreclosure rates in the period 2005-2007. While each type of mortgage originator has experienced elevated levels of delinquencies and defaults in recent years, of the 21 firms comprising the “worst 10” in those “worst 10” MSAs, the majority – accounting for nearly 60 percent of non-prime mortgage loans and foreclosures – were exclusively supervised by the states.³

In view of this experience, Congress should take at least two actions in connection with regulatory reform. First, it should establish national mortgage standards that would apply consistently regardless of originator, similar to the mortgage legislation that passed the House of Representatives last year. In taking this extraordinary step, Congress should provide flexibility to regulators to implement the statutory standards through regulations that protect consumers and balance the need for conservative underwriting with the equally important need for access to affordable credit.

Second, Congress should also ensure that the new standards are applied and enforced in a comparable manner, again, regardless of originator. This objective can be accomplished relatively easily for mortgages provided by depository institutions or their

³ Letter from Comptroller of the Currency John Dugan to Elizabeth Warren, Chair, Congressional Oversight Panel, February 12, 2009 at http://www.occ.treas.gov/ftp/occ_copresponse_021209.pdf.

affiliates: federal banking regulators have ample authority to ensure compliance through ongoing examination and supervision reinforced by broad enforcement powers. The objective is not so easily achieved with nonbank mortgage providers regulated exclusively by the states, however. The state regime for regulating mortgage brokers and lenders typically focuses on licensing, rather than ongoing examination and supervision, and enforcement by state agencies typically targets problems after they have become severe, not before. That difference between the federal and state regimes can result in materially different levels of compliance, even with a common federal standard. As a result, it will be important to develop a mechanism to facilitate a level of compliance at the state level that is comparable to compliance of depository institutions subject to federal standards. The goal should be robust national standards that are applied consistently to all mortgage providers.

Enhanced Consumer Protection Regulation

Effective protection for consumers of financial products and services is a vital part of financial services regulation. In the OCC's experience, and as the mortgage crisis illustrates, safe and sound lending practices are integral to consumer protection. Indeed, contrary to several recent proposals, we believe that the best way to implement consumer protection regulation of banks – the best way to protect consumers – is to do so through prudential supervision. Let me explain why.

First, prudential supervisors' continual presence in banks through the examination process puts them in the very best position to ensure compliance with consumer protection requirements established by statute and regulation. Examiners are trained to detect weaknesses in banks' policies, systems, and procedures for implementing

consumer protection mandates, and they gather information both on-site and off-site to assess bank compliance. Their regular communication with the bank occurs through examinations at least once every 18 months for smaller institutions, supplemented by quarterly calls with management, and for the very largest banks consumer compliance examiners are on site every day. We believe this continual supervisory presence creates especially effective incentives for consumer protection compliance, as well as allowing examiners to detect compliance failures much earlier than would otherwise be the case.

Second, prudential supervisors have strong enforcement powers and exceptional leverage over bank management to achieve corrective action. Banks are among the most extensively supervised firms in any type of industry, and bankers understand very well the range of negative consequences that can ensue from defying their regulator. As a result, when examiners detect consumer compliance weaknesses or failures, they have a broad range of tools to achieve corrective action, from informal comments to formal enforcement action – and banks have strong incentives to move back into compliance as expeditiously as possible.

Indeed, behind the scenes and without public fanfare, bank supervision results in significant reforms to bank practices and remedies for their customers – and it can do so much more quickly than litigation, formal enforcement actions, or other publicized events. For example, as part of the supervisory process, bank examiners identify weaknesses in areas pertaining both to compliance and safety and soundness by citing MRAs – “matters requiring attention” – in the written report of examination. An MRA describes a problem, indicates its cause, and requires the bank to implement a remedy before the matter can be closed. In the period between 2004 and 2007, OCC examiners

cited 123 mortgage-related MRAs. By the end of 2008, satisfactory corrective action had been taken with respect to 109 of those MRAs, without requiring formal enforcement actions. Corrective actions were achieved for issues involving mortgage underwriting, appraisal quality, monitoring of mortgage brokers, and other consumer-related issues. We believe this type of extensive supervision and early warning oversight is a key reason why the worst form of subprime lending practices did not become widespread in the national banking system.

Third, because examiners are continually exposed to the practical effects of implementing consumer protection rules for bank customers, the prudential supervisory agency is in the best position to formulate and refine consumer protection regulations for banks. Indeed, while most such rule-writing authority is currently housed in the Federal Reserve Board, we believe that the rule-writing process would benefit by requiring more formal consultation with other banking supervisors that have substantial supervisory responsibilities in this area.

Recently, alternative models for financial product consumer protection regulation have been suggested. One is to remove all consumer protection regulation and supervision from prudential supervisors, instead consolidating such authority in a new federal agency. This model would be premised on an SEC-style regime of registration and licensing for all types of consumer credit providers, with standards set and compliance achieved through enforcement actions by a new agency. The approach would rely on self-reporting by credit providers, backstopped by enforcement or judicial actions, rather than ongoing supervision and examination.

The attractiveness of this alternative model is that it would centralize authority and accountability in a single agency, which could write rules that would apply uniformly to financial services providers, whether or not they are depository institutions. Because the agency would focus exclusively on consumer protection, proponents also argue that such a model eliminates the concern sometimes expressed that prudential supervisors neglect consumer protection in favor of safety and soundness supervision.

But the downside of this approach is considerable. It would not have the benefits of onsite examination and supervision and the very real leverage that bank supervisors have over the banks they regulate. That means, we believe, that compliance is likely to be less effective. Nor would this approach draw on the practical expertise that examiners develop from continually assessing the real-world impact of particular consumer protection rules – an asset that is especially important for developing and adjusting such rules over time. More troubling, the ingredients of this approach – registration, licensing and reliance on enforcement actions to achieve compliance with standards – is the very model that has proved inadequate to protect consumers doing business with state-regulated mortgage lenders and brokers.

Finally, I do not agree that the banking agencies have failed to give adequate attention to the consumer protection laws that they have been charged with implementing. For example, predatory lending failed to gain a foothold in the banking industry precisely because of the close supervision commercial banks, both state and national, received. But if Congress believes that the consumer protection regime needs to be strengthened, the best answer is not to create a new agency that would have none of the benefits of a prudential supervisor. Instead, the better approach is a crisp

Congressional mandate to already-responsible agencies to toughen the applicable standards and close any gaps in regulatory coverage. The OCC and the other prudential bank supervisors will rigorously apply them. And because of the tools we have that I've already mentioned, banks will comply more readily and consumers will be better protected than would be the case with mandates applied by a new federal agency.

Conclusion

My testimony today reflects the OCC's views on several key aspects of regulatory reform. We would be happy provide more details or additional views on other issues at the Committee's request.