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**TESTIMONY OF**

**JOHN D. HAWKE, JR.**

**COMPTROLLER OF THE CURRENCY**

**Before the**

**COMMITTEE ON FINANCIAL SERVICES**

**Of the**

**U.S. HOUSE OF REPRESENTATIVES**

**April 1, 2004**

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

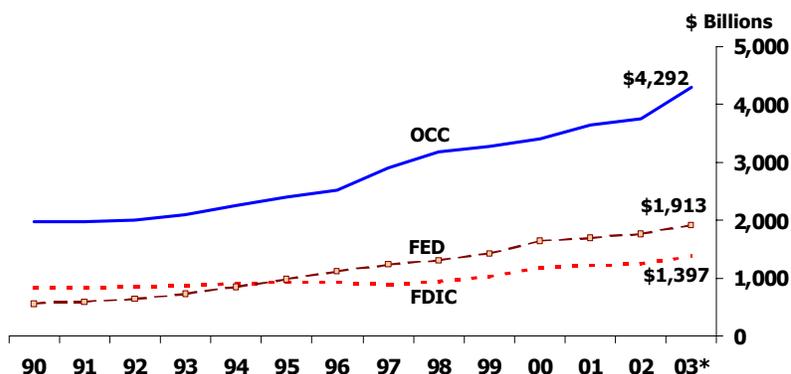
Mr. Chairman, Ranking Member Frank, and members of the Committee, I appreciate this opportunity to review the condition of the national banking system and the state of the Office of the Comptroller of the Currency (OCC). My written statement covers three principal areas. First, I will report to you on the current state of the national banking system, which is sound. Second, I will describe how the OCC strives to manage our financial resources efficiently and deploy our human resources effectively to ensure that the national banking system maintains its sound condition and its vital role in our country's economy.

The third section of my statement highlights three areas of our work that are of central significance to the way national banks will conduct business in this new century. There, I will describe our risk-focused approach to supervising the national banking system. I will also provide an update on the progress of the ongoing international and domestic deliberations about prospective revisions to the Basel risk-based capital framework. Finally, I will highlight the importance of an attribute that is key to the national bank charter – the ability of national banks to operate under uniform, nationwide standards, consistent with Federal law – and I will try to correct what I believe are some fundamental misunderstandings on several points concerning the regulations we have recently issued on applicability of State law to national banks and their operating subsidiaries. I also want to reiterate our willingness to work cooperatively with State officials on referrals and resolution of customer complaints, and identification and timely response to any inappropriate practices by the institutions we respectively supervise.

## II. THE CONDITION OF THE NATIONAL BANKING SYSTEM

The OCC supervises federally chartered national banks and federally licensed branches of foreign banks. As of year-end 2003, the national banking system consisted of approximately 2100 banks (26 percent of all commercial banks). Of these, approximately 2000 were FDIC-insured banks, holding total assets of \$4.3 trillion (56 percent of all commercial banking assets). The rest were uninsured bank and trust companies. The OCC also supervises 53 Federal branches of foreign banks. While the number of national banks has declined for nearly two decades, the national bank share of total system assets has remained roughly constant. The national banking system includes many

**Assets by Federal bank supervisor**



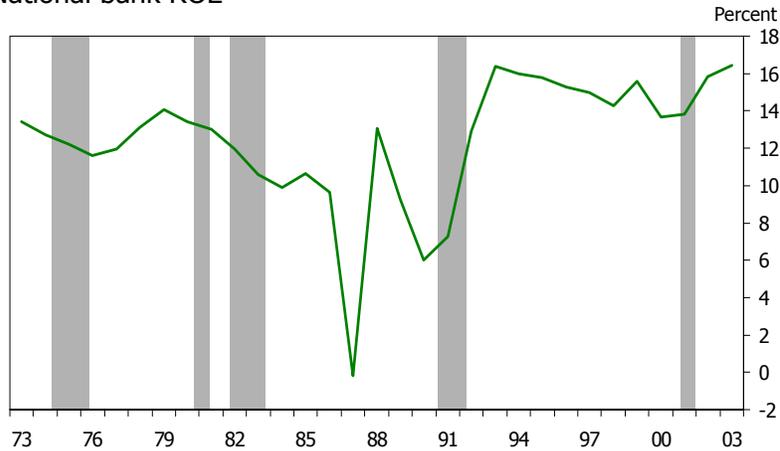
Source: Integrated Banking Information System (OCC). \*Data as of December 31, 2003

of the largest banks by asset size, but community national banks are by far the most numerous in the system.

The financial performance and condition of the banking system is strong. Bank earnings have remained at historically high levels for a decade. Until 2002, aggregate net income for national banks had never exceeded \$12.5 billion in a quarter, and the industry's average return on assets

## National bank ROE at record high

National bank ROE



Source: Integrated Banking Information System (OCC)

Data as of year-end. Shaded areas represent periods of recession.

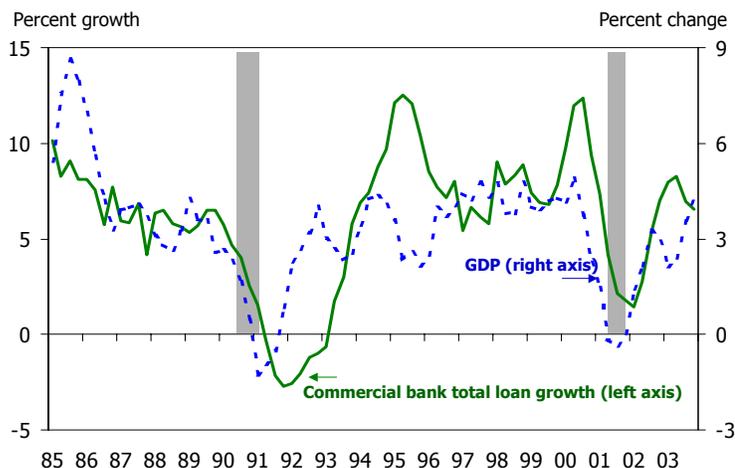
had never exceeded 1.5 percent, at least not since the quarterly reporting began in 1984. But since the beginning of 2002, national banks have exceeded both earnings milestones in every quarter but one. In 2003, national banks set new records for both return on equity and return on assets. Although the slow economy led to weakness in some areas, including business lending, the contractions in these areas were more than offset by growth elsewhere.

Total loans held by banks continued to expand throughout the recent economic cycle, growing by 7.8 percent in 2002 and 7.6 percent in 2003. In contrast, starting with the recession of 1990-91, total loans held by national banks fell for 10 consecutive quarters. Where the earlier recession affected all sectors of the economy, the recent recession was concentrated more extensively in the business sector, in part due to the fallout from the tech/telecomm bubble in the late 1990s. This caused a sharp fall in the demand for business loans, particularly at large banks.

The reduction in corporate lending by banks also was due to the competitive influence of the low rates on corporate bonds. Many large and even medium-size firms have been able to access the bond market at very low rates throughout this economic slowdown, which has further reduced the demand for larger commercial loans. This has affected especially the lending activity at the largest banks, because they tend to have potential business customers who have greater access to other financial options. Community banks, however, taking advantage of their knowledge of local markets and business needs, have maintained their business lending throughout this cycle, with increases reported in their commercial and industrial (C&I) and commercial real estate loan books.

The mortgage and consumer sectors have been a strong source of loan growth for national banks. Residential real estate loans held by national banks rose at an annual rate of about 20 percent in both 2002 and 2003. Within this broad category, home equity lending has grown particularly fast, rising by 21 percent in 2001, 38 percent in 2002, and 37 percent in 2003. Throughout this cycle, consumers have taken advantage of the declining mortgage rates to extract funds from the increased value of their homes. Some of these funds from the refinancing and home equity loan activity have been used, however, to pay off higher interest credit card and installment debt.

## Loan growth continued throughout this recession



Source: Integrated Banking Information System (OCC); BEA/Haver Analytics

Quarterly data through Q2-2003. Shaded areas represent periods of recession.

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The low interest rate environment has been a plus and a minus for banks. Smaller banks with their greater reliance on retail funding have seen steady erosion in their net interest margins. By contrast, the largest banks, which rely more on wholesale funding, until recently experienced relatively high net interest margins. As of December 2003, the net interest margin for banks in all asset size groups has fallen below their historic averages. Despite the decline in margins, banks have reported continued growth in net interest income due to the strong expansion in household lending. As long as margins remain compressed, however, this growth in income is vulnerable if volume of activity in the consumer markets falls.

The low interest rate environment also raises concerns about the extent to which banks may be taking on interest rate risk in an effort to maintain their interest income. Effective management of this risk will be important for banks in all asset size groups as the economy recovers, which is often accompanied by an increase in interest rates. We have alerted national banks to our concerns on this score and provided advice on approaches on how best to address this "low rate set-up."<sup>1</sup>

Deposits have continued to flow into banks, especially large banks, as might be expected when low interest rates hold down returns on alternative money market instruments. Deposits at national banks grew at 6.0 percent in 2001, 7.6 percent in 2002, and 8.6 percent (year-over-year) in 2003. The increase in deposits has fueled growth in bank assets. The assets of national banks grew 9.8 percent in 2003 (year-over-year), as compared to a 0.1 percent decline reported at this point of the recovery from the last recession. Nevertheless, we believe banks must be vigilant in their assessment of the potential sensitivity of their sources of funds to changes in the economic

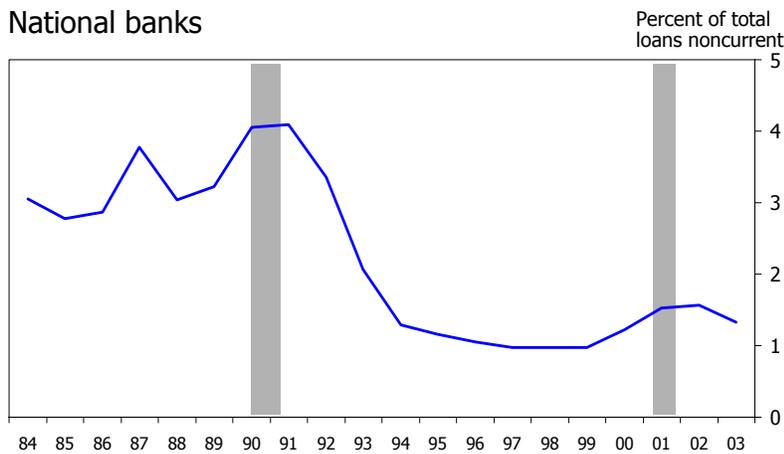
<sup>1</sup> OCC Bulletin 2002-19, "Supplemental Guidance on Unsafe and Unsound Investment Portfolio Practices," May 22, 2002.

environment or, in some cases, the bank’s own performance. The high level of liquidity in the banking system could be reduced rapidly if the relative yield on alternative investments increased sharply or if banks failed to maintain certain performance levels required to retain some sources of funds.

While credit quality deterioration is typically an issue during recessions, the most recent experience for national banks was much better than during the previous recession. This may well reflect national banks' response to cautions issued by the OCC to bankers in the late 1990s to be vigilant about their underwriting standards. The noncurrent loan ratio for national banks (loans at least 90-days past due plus nonaccruals) reached a peak of 4.4 percent in 1991Q2; in contrast, at the peak in this economic cycle, reported in 2002Q2, the noncurrent ratio was 1.6 percent. For large banks (over \$1 billion in assets), the noncurrent loan ratio has now declined to 1.3 percent, near pre-recession levels. Smaller banks (under \$1 billion in assets) were not as affected by the stresses in the nonfinancial corporate markets and thus experienced only a modest decline in credit quality during the recession. While credit quality appears to be improving for the banking industry, the OCC continues

### Noncurrent loans remained well below level of early 90s

National banks



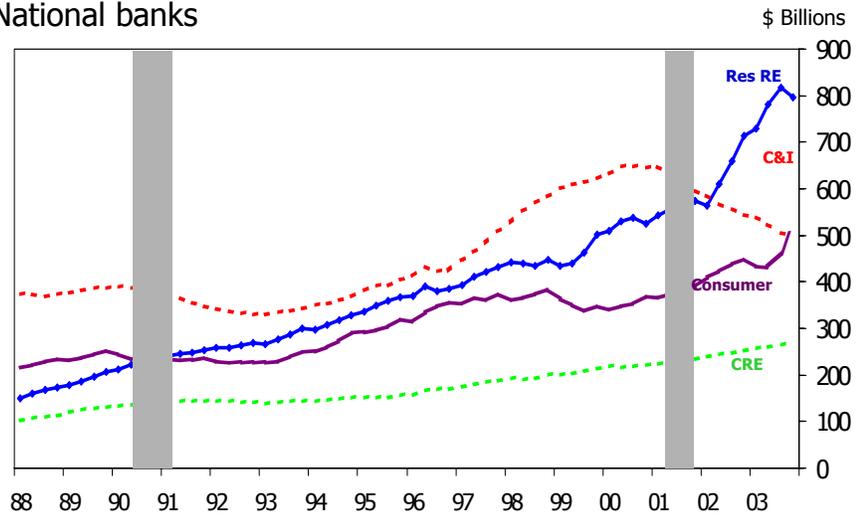
Source: Integrated Banking Information System (OCC) Data as of year-end. Shaded areas represent periods of recession.

to watch developments in areas that remain vulnerable, such as small business lending and certain real estate markets and property types.

The data on failure and new entrants to the commercial banking system also reflects a very dynamic and healthy banking system. In 2003, two banks failed – one national and one State bank. By contrast, 100 commercial banks – including 33 national banks and 67 state banks – failed in 1992, the first year of recovery after the 1990-91 recession. The commercial banking system also had 111 new entrants in 2003; this compares to 40 new banks in 1992.

Banks' business strategies have continued to evolve in response to demographic shifts, changes in technology, and improvements in risk management. Larger banks have moved increasingly into retail lending during a period of strong growth in demand from the household sector. Large banks have benefited from their geographic diversification, and have captured economies of scale by moving to automated processing of standardized products like home mortgages. Small national banks have seen more modest growth in retail lending. Economies of scale are reflected in the continued improvement in the efficiency ratio for large banks (noninterest expense to net operating revenue), a factor that also has contributed significantly to overall bank performance in recent years. In contrast, small banks have expanded their business lending, where many continue to find profitable niches offering customized products in local markets.

## Residential real estate lending has driven loan growth National banks



Source: Integrated Banking Information System (OCC). Data as of year-end.

While the national banking system has displayed strong performance, even during the recent recession, history teaches that we cannot know for certain what lies ahead, and banks' capital provides important protection against that uncertainty. National banks remain well capitalized and rest on a much firmer capital base than they did a decade ago. In 1990, for example, 6.3 percent of banks had risk-based capital ratios below 8 percent, which we would now consider undercapitalized, and 18.3 percent were below 10 percent. Today, all national banks, with the exception of a few small banks under special supervision, have risk-based capital ratios above 8 percent, and more than 90 percent of national banks have risk-based capital ratios above 10 percent.

### III. THE STATE OF THE OCC

The OCC's mission is accomplished through three major programs: supervise (including risk analysis), charter, and regulate. The OCC is headquartered in Washington, D.C., operates the Ombudsman's office in Houston, and maintains district offices in Chicago, Dallas, Denver, and New York. The agency has 48 field offices and 23 satellite locations in cities throughout the U.S., has stationed resident examiner teams in the 24 largest banking companies supervised, and maintains an examining office overseas in London. The agency has approximately 2,800 employees, the vast majority of which are bank examiners. To accomplish our mission in FY

2003, we used 2,761 Full-Time Equivalents (FTEs), down slightly from 2,792 in 2002, and 2,837 in 2001. Total examiner FTEs were 1,837 in 2003, 1,853 in 2002, and 1,888 in 2001.

The OCC receives no appropriated funds. Our funding is derived from assessments and fees and we set our budget each year based on agency practices and our estimation of available revenue for the upcoming year. Our budget has been balanced during all the years that I have served as Comptroller, and we have the resources available, as needed, to assure that we fulfill all dimensions of our responsibilities as supervisor and regulator of the national banking system. We guard against potential disruption to our operations due to major, unpredictable events affecting our funding, for example, through a contingency reserve that is funded on an incremental basis as part of the budget process, each year.

Effective supervision of a dynamic national banking system in a changing financial services marketplace demands careful management of our financial resources and thoughtful deployment of the first-rate work force we have been able to attract. In recent years, the OCC has placed a heavy emphasis to improving the discipline with which we manage our financial resources and building enhanced accountability into the way we manage our human resources.

### **Improving Financial Performance**

For the past five years, the OCC's financial management initiatives have been strongly focused on improving the planning, budgeting and program evaluation processes; strengthening financial accountability and internal management controls; and modernizing our financial operating systems. The OCC maintained its "green" rating – the highest of three possible ratings – on the Financial Performance Initiative<sup>2</sup> and received from its external auditors, Gardiner, Kamyra, and Associates, an unqualified opinion on its FY 2003 financial statements with no material weaknesses. We have received an unqualified opinion on our financial statements for 39 consecutive years. We close our books within three days of month-end each month, and our independent auditors are able to issue their audit report by November 15<sup>th</sup> each year.

Our ongoing commitment is to ensure that timely, accurate, and relevant management information is conveniently available to OCC program managers. Over the past five years we have improved the OCC's planning, budgeting, and program evaluation process in major respects. Since the first quarter of FY 2002, we have employed quarterly budgeting and implemented a procedure that requires advance approval for significant reprogramming actions. During FY 2003, we developed a five-year variable projection model that uses revenue, budget, reserve target, and actual reserve projections to allow management to better understand the financial impact of their business decisions on the future operations of the OCC. For FY 2004 we have adopted a new activity-based accounting code structure that will assist OCC managers in making staffing decisions and ensuring that resources are used in alignment with the OCC's strategies.

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<sup>2</sup> The Financial Performance Initiative is one of the five initiatives in the President's Management Agenda. The Office of Management and Budget scores the progress of each agency toward accomplishing these initiatives using a green/yellow/red scoring system. The Department of the Treasury scores its own bureaus, including OCC, in a similar fashion.

We have in place a strong quality management program that employs regular reviews and special studies designed to foster continuous organizational improvement. The OCC's program analysis unit evaluates program efficiency and effectiveness, and assists management in ensuring that OCC programs are strategically aligned with our objectives. The combination of administrative funds control processes and a strong management control program help us ensure that we maintain integrity and accountability in all of the OCC's programs and operations.

We recently upgraded our financial management and acquisitions system (\$SMART) to web-based technology. \$SMART is a state-of-the-art system that is Joint Financial Management Improvement Program (JFMIP)- and U.S. standard general ledger-compliant. The system has allowed us to integrate the budget execution function with the core functions of accounts payable, accounts receivable, asset management, and general ledger. \$SMART provides users with on-line access to daily status of funds and financial performance reports, and it provides appropriate security over financial information. Utilizing the features in \$SMART and management information provided by our new activity-based accounting structure, we expect to continue making progress throughout FY 2004 in further integrating budgeting and performance management and program evaluation.

### **Responding to New Management Challenges**

The OCC supports the Department of Treasury's 2003-2008 strategic goals of promoting prosperous U.S. and world economies; preserving the integrity of financial systems; and ensuring professionalism, excellence, integrity, and accountability in the management and conduct of the Department of Treasury. The OCC has established four strategic goals to achieve its mission and contribute to the achievement of the Department of Treasury's strategic goals. The OCC's goals, as defined in our 2003-2008 strategic plan, are a safe and sound national banking system; a flexible legal and regulatory framework that enables the national banking system to provide a full competitive array of financial services; fair access to financial services and fair treatment of bank customers; and an expert, highly motivated and diverse workforce that makes effective use of OCC resources. Described below are initiatives we have undertaken in two key areas that present cutting-edge management challenges.

#### ***Expanded e-Government and IT Security***

The OCC developed a three-year plan to fully implement the Clinger-Cohen Act and capital planning best practices. The plan was implemented in FY 2003, and significant progress was made during the FY 2004 budget cycle. The FY 2004 capital planning process significantly increased the involvement of all OCC business units, and training was provided on the capital planning program, e-Government initiatives, and the OMB's business case development.

We have recently implemented web-based interaction with national banks, including optional electronic filing of an increasing number of applications and electronic notification to banks of consumer complaints received by the OCC Ombudsman. The OCC also has recently deployed phase one of the automated learning information center for OCC employees, a state of the art learning management and delivery system. We are now initiating phase two, which includes the

development of operational, management, and integrated reporting capability. The learning management system is becoming a model for other agencies.

In the area of IT security, the OCC created a computer security incident response center to monitor, respond, and report to Treasury regarding virus attacks, intrusion attempts, and other security incidents. We have integrated security considerations into capital planning and system development processes, and inventoried all information-processing systems and grouped them for certification and accreditation. The OCC has also improved our continuity of operations by implementing an IT recovery strategy that is commensurate with the threats and risks of the post-9/11 era.

### ***Emergency Preparedness***

Immediately following the terrible events of 9-11, we established a Contingency Planning Oversight Committee to conduct a comprehensive review of the OCC's emergency management program and contingency plans. The committee was tasked with analyzing the existing program and plans to determine what changes were needed to address new and emerging threats. The result of the committee's work was the development and implementation of a Continuity of Operations Plan that ensures the OCC can respond to any emergency impacting our operations and can continue to perform essential functions necessary to support the mission of the OCC and the banking and finance sector of the nation's critical infrastructure. We recently re-organized our critical infrastructure protection and security functions into a new business unit to continue focusing on this work and allow the OCC to begin performing an even greater role in the planning and coordination activities of the banking and finance sector.

During the past two years the OCC completed a comprehensive physical risk assessment of our headquarters facility and implemented new security procedures and security systems at our key facilities. We also developed, implemented and tested new Information Technology disaster recovery strategies for those key information systems and applications necessary to support the OCC's essential functions. In addition to our physical and information assets, we also focused on the protection and safety of our most important asset, our employees. The OCC was one of the first Federal agencies to issue survival kits to all employees and one of the first to develop, implement and successfully test shelter-in-place procedures. We have also developed a testing, training and exercise plan that allows us to educate and prepare employees and which also enables us to identify and correct weaknesses in our contingency plans and emergency operations.

### ***Positioning our Workforce for the Future***

The most important asset the OCC has is its people. One of the challenges we face is to ensure that the structure and expertise of our workforce continues to evolve as the national banking industry changes. The OCC restructured its district offices last year by combining the existing six district offices into four offices to better realign our workforce with the location of the banks we supervise. We have managed these efforts carefully to maximize the choices available to employees affected by the restructuring and to minimize disruption to our ongoing operations and loss of critical expertise.

This past year, the OCC completely re-engineered its recruitment processes by hiring a professional recruiter as a permanent member of our staff and placing greater emphasis on a centralized approach to college recruitment. These changes have resulted in the hiring of a diverse cross-section of top quality candidates. To ensure that these candidates will be able to carry on the OCC's tradition of excellence for years to come, we have improved our training for pre-commission examiners and renewed our emphasis on employee retention. Retention efforts are particularly focused on new hires, who are especially susceptible to turnover during their first four years with the OCC.

For more than twenty years, the OCC has operated as a performance-based organization with a strong emphasis placed on aligning individual performance expectations with organizational priorities. Annual pay increases granted to employees are based on the extent to which their performance objectives are met rather than on cost of living changes or longevity. We offer compensation and benefit programs that are tailored to achieving several goals, including matching the diverse needs of our workforce, supporting the several components of our mission, and controlling costs so that we can continue to operate within a balanced budget.

Because our ability to fulfill our mission depends on the skill, dedication and good judgment of our people, we strive to maintain an environment that promotes creative and thoughtful contributions and encourages diversity of viewpoints. It is a measure of our success that the OCC was recently recognized as one of the "Best Places to Work in the Federal Government" in a report released by the Institute for Study of Public Policy Implementation.

#### **IV. KEEPING PACE WITH CHANGE IN THE NATIONAL BANKING SYSTEM**

Change is a consistent theme in the operation – and the supervision – of the national banking system today. National banks must evolve their businesses if they are to remain competitive in today's financial services markets. At the same time, the OCC must adjust its supervisory and regulatory approaches in order to ensure that national banks can avail themselves of all of the attributes of their charter safely and soundly. Among the most important strategies we have developed to maximize the effectiveness of our examination and supervisory program is our risk-focused approach to supervision.

##### **The OCC's Risk-Focused Approach to National Bank Supervision**

OCC's supervision by risk approach dates back more than 10 years and involves supervisory policies and processes that tailor our oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's tolerance for risk. This process provides an effective means for the OCC to allocate our supervisory resources and to better communicate to senior bank management the areas where they may need to correct problems before they become entrenched.

Risk-based supervision begins with an assessment of a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance,

strategic, and reputation. Based on that assessment, the OCC examiner-in-charge or portfolio manager will develop and implement a detailed, supervisory strategy for the bank, based on its risk profile and the complexity of its lines of businesses. Examiners identify areas of highest risk, understand exactly what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. In performing this evaluation, OCC examiners consider not only the activities of the bank and its operating subsidiaries, but also how the bank's risk profile is affected by the activities of other subsidiaries and affiliates.

Our assessment of the integrity and effectiveness of a bank's risk management systems includes appropriate validation through transaction testing. If this produces concerns, we will "drill down" to test additional transactions. If this reveals problems, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement. The examination procedures implementing OCC's supervision by risk program are documented in the Comptroller's Handbook.

Supervision by risk provides an effective way to supervise banks in the current rapidly changing environment. It also allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks and bank activities. Because the design of this approach requires that we customize an examination based on a bank's underlying risk characteristics, it allows us to more effectively direct OCC resources to the banks or activities within banks exhibiting the greatest risk.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we have divided our day-to-day supervisory operations into two lines of businesses – our Community and Mid-size Bank program and our Large Bank program.

Our Community/Mid-size Bank line of business oversees over 2,000 national banks and Federal branches and agencies through our network of district, field and satellite offices. When examining this population of banks, examiners use a core set of examination procedures to draw conclusions about the magnitude of risk and the adequacy of the risk management system for each of the nine areas of risk. Even in low-risk banks, we sample, verify, and test the bank's policies, procedures, and systems. When risks are elevated; when activities, products and services are more complex or present greater financial or compliance risks; or when issues or problems emerge, examiners will expand the scope of their supervisory activities using more detailed guidance found in topical booklets of the Comptroller's Handbook series. Periodic monitoring of community banks, another key element of the supervisory process, is also designed to identify changes in the bank's condition and risk profile, including new products or services, and to assess bank corrective action on outstanding supervisory concerns between formal onsite examinations. This quarterly monitoring process allows examiners to identify significant changes in the risk profile of the banks they supervise on a timely basis.

Our Large Bank program focuses on the 24 largest national banks. The supervision of each large bank, overseen out of our headquarters office, is staffed by a resident examiner-in-charge and a team of examiners and specialists in areas such as commercial and retail credit, capital markets,

bank technology, asset management, and compliance. These examiners and specialists track the quantity and quality of risk management in real time so that our assessments are forward-looking as well as historical. This program allows the OCC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the years, we have also developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex, and globally positioned banks. We are confident that this approach will be effective to supervise the "mega-banks," those will assets of a trillion dollars or more, that are forming as a result of recent acquisition activity in the industry.

Today's national banking system operates not just nationally, but globally. Our large banks all have operations or a presence overseas. Our London office provides us with examiner expertise to interact with foreign supervisors and provides a platform to examine national bank branches overseas. Our London examiner staff provides a critical network to deal with home/host country issues, information sharing issues, and outsourcing issues. We also participate in the Foreign Banking Organization program (along with the Federal Reserve Board) to examine and supervise Federal branches and agencies in the United States.

We also are deeply involved in the development of international bank supervision policy through our participation in the Basel Committee on Banking Supervision and in the Joint Forum, which is an international group of banking, securities, and insurance supervisors; through our regular dialogue with foreign banking regulators; and through our international and technical assistance programs that provide training and internship opportunities to bank supervisors. In fact, not long ago we detailed to the Treasury Department four experienced examiners who are now working in Iraq.

To help meet the challenges of an ever more complex banking industry, our resident and field examiners and specialists are supported by a team of policy specialists, analysts, accountants, and economists in our headquarters office who monitor industry, market and economic trends, provide technical expertise, and develop analytical tools and models to support our examination functions. For example, our Canary monitoring system monitors and identifies banks that may have high or increasing levels of credit, liquidity, or interest rate risks. Our credit risk and economics staffs have developed various analytical tools that assist examiners to identify portfolio or industry concentrations where risk may be increasing for more in-depth investigation. Our Risk Analysis unit – staffed by Ph.D. economists – provides on-site technical assistance to our resident staff in evaluating banks' quantitative risk models and measurement systems. Our National Risk Committee serves as a coordinating body to gather and disseminate information from throughout the OCC and the financial markets on emerging risk issues and advises me and the OCC's Executive Committee on quarterly basis of emerging issues and potential policy and supervisory responses.

Our combination of continuous on-site supervision, with the "ground level" intelligence it provides on each individual bank's activities and strategies, coupled with our broader, systemic risk analyses, allows us quickly to adjust our supervisory strategies to emerging risks and issues that may arise at individual institutions, within business segments or across the industry as a

whole. It also allows us to leverage the diverse skill sets that are needed to supervise our most complex institutions effectively.

### ***Regulatory Coordination***

We also work closely with other Federal regulators in carrying out our supervisory responsibilities through a variety of formal and informal mechanisms. Primarily through the Federal Financial Institutions Examination Council (FFIEC), the OCC works with the other Federal financial regulators (Board of Governors of the Federal Reserve System, FDIC, Office of Thrift Supervision, and National Credit Union Administration) to coordinate supervisory policies, regulations and regulatory reporting requirements, and examiner training on issues that cut across the banking system. Indeed, such coordination is the norm, not the exception among the Federal banking agencies. This coordination reduces regulatory burden by promoting greater uniformity, consistency, and efficiency in the supervision of insured depository institutions.

For example, during the past year the OCC worked together with the other Federal banking agencies on a variety of policy initiatives in areas such as bank technology, identity theft and consumer privacy and disclosure issues, and implementation of the USA PATRIOT Act.

In the area of bank technology, the banking agencies are undertaking a complete revision and update of the 1996 FFIEC Information Systems Examination handbook. A series of twelve, topical booklets addressing issues such as business continuity planning, information security, outsourcing (including off-shore outsourcing), and electronic banking will replace the 1996 handbook. The OCC also continues to coordinate with the Treasury Department's Financial and Banking Information Infrastructure Committee (FBIIC) and other agencies on issues related to improving the reliability and security of the U.S. financial system. These efforts have included sponsoring critical financial institutions' access to the Telecommunications Service Priority Program that provides priority treatment for the restoration or provisioning of telecommunications services in emergencies, and joint publication by the OCC, FRB and SEC, of an Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System. The paper identifies sound practices and steps necessary to protect the U.S. financial systems from the systemic effects of a wide-scale disruption.

We also are working closely with other regulators in the important areas of identity theft and consumer privacy. Last August, we and the other Federal banking agencies issued for comment proposed guidance that would require financial institutions to develop programs to respond to incidents of unauthorized access to customer information, including procedures for notifying customers under certain circumstances. The proposed guidance interprets the agencies' customer information security guidelines that require financial institutions to implement information security programs designed to protect their customers' information. We also are working closely with the Federal Reserve, the Federal Trade Commission and other agencies on implementation of the various provisions of the FACT Act.

Recognizing the importance of informing consumers about financial institutions' privacy policies and how consumers may affect information-sharing practices, the OCC, the other Federal banking agencies and the FTC issued in December, 2003, an advance notice of proposed

rulemaking to seek public comment on how to simplify privacy notices required under GLBA. With the other regulators, we have been meeting with consumer groups, as well as the Internal Revenue Service and Food and Drug Administration to get insights on how the banking agencies could use consumer testing to enhance the effectiveness of privacy notices.

To help alert consumers to potential pitfalls associated with certain high-cost mortgage and home equity loans, the agencies in conjunction with the Department of Housing and Urban Development, the Department of Justice, the Federal Housing Finance Board, the Federal Trade Commission, the National Credit Union Administration, and the Office of Federal Housing Enterprise Oversight, issued in October, 2003, a consumer brochure on predatory lending. The brochure, *Putting Your Home on the Loan Line is Risky Business*, cautions consumers about various predatory lending practices and advises consumers on steps they can take to protect themselves against such practices.

The OCC also works closely with law enforcement, the Treasury Department, and other Federal agencies, to disseminate information and take appropriate actions to help facilitate the prevention, detection, and prosecution of international money laundering and terrorist financing. For example, in May 2003, the FFIEC agencies, in cooperation with Treasury, the SEC and the CFTC, issued implementing regulations for the Customer Identification Program requirements of Section 326 of the USA PATRIOT Act. These and other USA PATRIOT Act requirements will be subject to examination reviews conducted in accordance with standards coordinated among the FFIEC agencies.

In addition to coordinating efforts on broad policy issues, we work closely with other regulators in our on-going bank examination programs. To the extent possible, we and the other banking agencies build upon each other's supervisory reviews and databases to minimize regulatory burden. We routinely share reports of examination, inspection reports, and other agency-institution communications and provide each other with access to our organizations' structure, financial, and supervisory information. To help facilitate and coordinate our supervision of large, complex institutions, we share information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those activities in such a way as to minimize or eliminate any overlap or duplication. When appropriate, we hold joint meetings with institutions involving matters of mutual interest and may conduct coordinated reviews or examinations where a business activity is conducted across legal entities. For example, the OCC worked closely with the Federal Reserve throughout 2003 to investigate and respond to questions about potential illegal tying activities at large, insured depository institutions. Similarly, the Federal Reserve, the OCC, and the SEC worked together closely throughout 2002 and 2003 to examine and respond to questions relating to structured finance transactions of the Enron Corporation. The OCC participates annually on an interagency basis in the Shared National Credit Program established to provide a periodic credit risk assessment of supervised institutions' largest and most complex credit facilities.

Our information sharing and coordination efforts extend beyond the other Federal banking agencies and include State insurance departments and foreign bank regulators. For example, consistent with GLBA, the OCC has entered into information-sharing agreements with 49 State insurance departments and we meet regularly with the National Association of Insurance

Commissioners to discuss topics of mutual interest. We have also entered into 11 information-sharing agreements with foreign bank regulators to promote more efficient supervision of institutions with foreign operations.<sup>3</sup>

## **Basel II Developments**

Because national banks have international as well as domestic operations, the OCC must – and we do – become involved in the development of approaches to bank supervision at the international level. Currently, the most significant of these approaches is the ongoing effort to revise the 1988 Basel Capital Accord. Let me briefly provide you a status report on this effort.

There have been a number of articles in the press in recent weeks about positions that U.S. regulators, and the OCC in particular, may be taking that I believe warrant some clarification and amplification.

First, let me stress that my U.S. colleagues and I share the overarching goal that Chairman Oxley expressed in his opening statement at this Committee's March 4, 2003 Oversight Hearing: that Basel II be implemented in a manner that is entirely consistent with the safety and soundness and continued competitive strength of the U.S. banking system.

As I have said, banks' current financial and capital positions are strong, but as the industry continues to evolve, so does its risk profile. Recognizing and adapting to changing risk profiles and changing risk management practices is critical to maintaining those strengths. These observations inform our approach to negotiations in the Basel Committee on Banking Supervision regarding Basel II. However, while we recognize that we can and should improve capital regulation to take into account changes in banking and risk management, a basic tenet in our negotiations over reform of the international capital standards is to *do no harm*. U.S. banks are world leaders in many aspects of banking – credit cards and securitizations, for example – and we must assure that these important markets are not disrupted or impaired in the name of achieving international conformity in capital rules. In view of the fundamental strength and resilience of the U.S. financial system, we believe that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective fashion.

Thus we are fully committed to three things: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on the capital of our banks prior to its adoption; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism. In this regard, I welcome the questions and issues that members of this Committee and its staff have raised about this important project

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<sup>3</sup> The U.S. Federal banking supervisors have concluded memoranda of understanding or statements of cooperation with supervisors in the following jurisdictions: the European Union, Argentina, Brazil, Canada, Chile, Germany, Hong Kong, Mexico, the Netherlands, Panama, and the United Kingdom. A number of others are in process. The OCC also has entered into some less formal information sharing arrangements with several other countries, including the Republic of China.

and I have repeatedly stressed to the Basel Committee the important role that Congressional oversight plays in our deliberative process.

The U.S. agencies' insistence on a thorough and rigorous deliberative process already has resulted in important modifications to the Basel II proposals. One of the most significant of these issues – and one that U.S. banks were virtually unanimous in criticizing in response to the Basel Committee's third consultative paper (CP-3) – involved the fundamental question of what losses capital requirements should be designed to cover. CP-3 would have calibrated capital to ensure coverage of both expected losses (EL) plus unexpected losses (UL). However, banks in the U.S. today generally measure and manage their internal economic capital allocations by reference to UL only, and most banks consider EL to be covered by a combination of reserves and credit pricing. As we examined this issue, we became convinced not only that the banks were conceptually correct in their arguments, but that retaining the EL plus UL calibration would have severe ramifications – not the least of which might be to seriously jeopardize the industry's acceptance of Basel II framework as being a conceptually sound framework. While many on the Basel Committee resisted this initially, the Committee ultimately put forth a new proposal in October to modify the calibration of Basel II to UL only. This modification was strongly endorsed by industry participants and has now been agreed to by the Committee.

The Committee announced several other important modifications to CP-3 in January that are responsive to numerous comments we received on CP-3 and the U.S. agencies' advanced notice of proposed rulemaking (ANPR) that was issued last August. These modifications include simplifying the proposed treatment for securitizations and aligning it more closely to industry practice and an agreement to find a prudentially sound solution that better recognizes credit mitigation techniques used by the industry. Other issues are still under discussion by the Committee's various technical working groups and are scheduled to be considered by the Committee at its meeting in May.

Probably the most difficult policy issue remaining involves the appropriate risk-based capital treatment of certain retail credit products – unused credit card lines in particular. This issue is critically important for national banks and for the cost and availability of consumer credit. It is also an area in which consensus has been hard to come by, not least because of the extent to which American credit card products are marketed and administered differently than in other parts of the world. Given the prominence of this issue for U.S. banks, and for national banks in particular, there is little room for substantive compromise, and the OCC will not accept provisions that are likely to unduly disrupt or disadvantage established, well-functioning business practices for the sake of global conformity.

Notwithstanding the difficulty of these issues, the Committee's goal is to be in a position by mid-year to release a text that will provide the basis for each country's national implementation process. Let me reiterate that point: the release of the next round of Basel II proposal does not represent a final agreement or accord; rather, it is the platform from which we will launch our more in-depth domestic deliberative process. In the U.S., that process will have several key steps.

First, the U.S. agencies will conduct a fourth quantitative impact study (QIS 4) in the third and fourth quarters of this year. This study will be based on the Committee's mid-year release and will differ in some important aspects from the Basel Committee's earlier quantitative studies. QIS-4 will not only be conducted against the background of a more fully articulated proposal, but will include a more prominent supervisory role to ensure greater reliability and consistency in survey results than has occurred in the past. We continue to believe that we cannot responsibly adopt final rules implementing Basel II until we have both determined with a high degree of reliability what the impact will be on the capital of our banks, and we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the U.S. We believe the results of QIS 4 will be more useful than any data we currently have in determining the magnitude of Basel II on bank capital and potential competitive inequities, as well as determining ultimately what to do about them.

Second, in another effort to increase our practical understanding of the effects of Basel, the U.S. agencies have commenced an operational risk benchmarking review at a number of institutions. Information obtained through this effort will enhance agency understanding of current qualitative and quantitative operational risk practices and will assist agency efforts to develop additional supervisory guidance and training materials for banks and examiners on the operational risk component of Basel II. Throughout this period we will continue our dialogue with banks and other interested stakeholders on various issues that Basel II may raise.

These projects and discussions will help us in the third key step in Basel implementation, developing a joint notice of proposed rulemaking (NPR) that will set forth the proposed regulatory text for Basel II in the U.S. Currently we anticipate that such an NPR will be released for public comment in late 2005 or early 2006. At the OCC, we have made a preliminary determination that this rulemaking will be a "significant regulatory action" for purposes of Executive Order 12866. Consequently, we will prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes:

- a description of the need for the rules and an explanation of how they will meet the need;
- an assessment of the benefits anticipated from the rules together with, to the extent feasible, a quantification of those benefits;
- an assessment of the costs anticipated from the rules together with, to the extent feasible, a quantification of those costs; and
- an assessment of potentially effective and reasonably feasible alternatives to the planned regulation and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

We have begun discussions with the OMB's OIRA regarding the how these analyses will be designed and conducted. Our analysis will be published as part of our notice and comment process.

Finally, as the rulemaking process for the domestic implementation of Basel II moves forward, we and the other U.S. agencies are exploring the implications that Basel II may have on non-

mandatory banks and what, if any changes we should make to our capital regulations for those banks. Any such changes will, of course, be subject to public notice and comment.

As my testimony conveys, while we have made important strides in trying to develop a more risk-sensitive capital framework for internationally active banks, there is still a long way to go before Basel II is completed and adopted. As I have repeatedly stated before Congress and in the Basel Committee, a new accord cannot be completely finalized until national implementation procedures have been completed and I am committed to a notice and comment process that is open and fair and responsive to public comments. The OCC and other U.S. agencies have recognized the possibility that, even in the late stages, public comments might reveal flaws in the proposal that will need to be addressed before we can issue final implementing regulations. The OCC's ultimate willingness to sign onto Basel II is going to depend on whether we are satisfied with the final product.

### **The Applicability of State Law to National Banks**

National banks today compete in a financial services marketplace that is profoundly different from the one they confronted 20, even 10, years ago. Legal barriers to banks' geographic expansion have been eroded by market developments and, in some cases, eliminated by Congress. At the same time, technology has enabled ways of doing business that have vastly expanded their markets. Consumers can comparison shop for financial products and services online and can initiate financial transactions over the Internet. Banks use technology to make available a wider array of products and services and to deliver those products and services more quickly. Credit decisions – like approving a mortgage loan – that used to take weeks can now be made in a matter of hours, for a customer located across the desk or across the country. In our highly mobile society, consumers expect that, when they move, they can take with them the financial relationships they have worked to establish with their banks. All these factors have combined to produce a market for credit, deposits, and many other financial products and services that is now national, and for some banks, international, in scope. In other words, through advances in data analysis and communications and changes in customer demographics, banking markets have expanded beyond the locality in which a given customer may be resident.

These developments highlight the significance of being able to conduct a banking business pursuant to consistent, national standards, regardless of the location of a customer when he or she first becomes a bank customer or the location to which the customer may move *after* becoming a bank customer. Yet the trend at the State – and sometimes the local – level has been the enactment of an increasingly diverse and potentially conflicting assortment of laws that localize bank regulation and threaten the ability of national banks to operate under the powers granted by their Federal charter, pursuant to uniform national standards, and subject to Federal oversight and supervision. In addition to conflicting with Federal authorities, these State and local laws have resulted in greater uncertainty about the standards applicable to national banks' operations, costly litigation to resolve that uncertainty, and in some respects, constriction of the availability of legitimate credit.

In January of this year, the OCC issued two final rules – our preemption rule and amendments to our existing visitorial powers rule – intended to provide national banks with the guidance they

need to operate under uniform, predictable Federal standards – plus rigorous standards of consumer protection. In the latter respect, our second and equally important goal was to ensure that the Federal standards under which national banks operate directly address and prevent abusive or predatory lending practices.

The preemption rule adds provisions to our regulations expressly addressing the applicability of certain types of State laws to national banks' lending and deposit-taking activities. The rule is not a dramatic expansion of preemption. The regulation only preempts the types of laws that are listed in the regulation. The listed types of laws are ones that already are preempted under longstanding, preexisting OCC regulations, have been found to be preempted in OCC preemption opinions, have been found to be preempted by the courts, or have been determined to be preempted for Federal thrifts by the OTS. Thus, they are types of laws for which substantial precedent exists recognizing the interference they pose to the ability of Federally-chartered institutions to operate under uniform Federal standards. We will continue to evaluate other types of laws, not listed in the regulations, under the pre-existing, judicially established standards for Federal preemption that are encapsulated by the "obstruct, impair, or condition" phrasing contained in the rule. It is important to stress that this phrase does not itself preempt any State law; rather it distills the standard that we believe the courts would apply in deciding questions of preemption for the types of laws not listed in the regulation.

Our second action involved amendments to our existing regulation concerning the OCC's exclusive "visitorial powers" with respect to national banks.<sup>4</sup> Existing, longstanding OCC regulations implement the visitorial powers statute by providing that State officials are not authorized to inspect, examine, or regulate national banks, except where another Federal law authorizes them to do so. One amendment to our visitorial powers rule clarified that the scope of the OCC's exclusive visitorial authority applies to the content and conduct of national bank activities authorized under Federal law. In other words, the OCC is exclusive supervisor of a national bank's banking activities. Another amendment clarifies that the *preservation* of visitorial powers "vested in the courts of justice" does not *grant* State regulatory or law enforcement officials *new* authority, in addition to whatever they may otherwise have, to exercise visitorial powers over national banks. State Attorneys General do not dispute that Federal law prohibits them from examining or taking actions directly against national banks, such as through cease and desist proceedings.<sup>5</sup> What we have said is simply that they may not use the courts to accomplish indirectly what they acknowledge Federal law clearly prohibits them from accomplishing directly.

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<sup>4</sup> "Visitorial powers" is a term used to refer to the authority to examine, supervise, and regulate the affairs of a corporate entity. Under Federal law, the OCC has exclusive visitorial powers over national banks – except where Federal law provides otherwise. Specifically, 12 U.S.C. § 484 provides that "no national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice" or exercised by Congress or a committee of Congress. This provision, originally enacted in 1863, is integral to the overall design of the system and the ability of national banks to conduct the business of banking subject to uniform, consistent standards and supervision, wherever in the nation they operate.

<sup>5</sup> See Footnote 28 in Brief of Amici Curiae of 41 State Attorneys General in support of Defendant, in Wachovia Bank, N.A. v. Watters, Civil Action No. 5:03CV0105, U.S. District Court for the Western District of Michigan, January 29, 2004.

These rules were the subject of thorough examination by this Committee's Subcommittee on Oversight and Investigations at a hearing held earlier this year. The written statement we submitted for that hearing contains a comprehensive description of the rules, the legal principles that support them, and our reasons for adopting them, and I would refer the members of the Committee to that earlier statement for detailed discussion of those matters.<sup>6</sup>

Today, I want to correct the record on three points that have been the subject of a great deal of confusion, misunderstanding, and mischaracterization in recent weeks:

- The OCC's preemption and visitorial powers rules do not leave consumers vulnerable to predatory or abusive lending practices.
- The OCC employs a comprehensive, integrated approach to compliance supervision, staffed with resources ample to ensure that national bank consumers are protected.
- The OCC welcomes new opportunities to cooperate with State authorities on issues of mutual concern pertaining to consumer protection.

***1. The OCC's rules do not leave consumers vulnerable to abusive lending practices.***

It is simply not the case that national bank customers are left exposed to abusive practices as a result of our rules. First, national banks and their operating subsidiaries are not where predatory and abusive lending practices are festering. Second, national banks and their operating subsidiaries are governed by strong Federal standards designed to prevent these practices. Finally, the OCC has a strong track record of taking vigorous enforcement action to remedy any such practices that do occur and require restitution to customers.

Clearly, there is a real problem with abusive lending practices in this country, but national banks are not the breeding ground.<sup>7</sup> Whatever our differences of opinion with the State Attorneys

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<sup>6</sup> See "Testimony of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, Before the Subcommittee on Oversight and Investigations of the Committee on Financial Services of the U.S. House of Representatives," January 28, 2004 (Williams Testimony).

<sup>7</sup> This conclusion is borne out not only by our own supervisory experience, but also by an extensive study of predatory lending conducted by the Department of Housing and Urban Development (HUD) and the Treasury Department. A Treasury-HUD joint report issued in 2000 found that predatory lending practices in the subprime market are less likely to occur in lending by –

banks, thrifts, and credit unions that are subject to extensive oversight and regulation . . . . The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts – who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Departments of Housing and Urban Development and the Treasury, "Curbing Predatory Home Mortgage Lending: A Joint Report" 17-18 (June 2000), [available at](http://www.treas.gov/press/releases/report3076.htm) <http://www.treas.gov/press/releases/report3076.htm>.

General, they have stated unambiguously in various filings that there is scant evidence that national banks, or their operating subsidiaries, are engaged in abusive lending practices.<sup>8</sup> Indeed, these State officials have recognized the extent to which banks (and thrifts) are highly regulated and closely supervised, and have credited that regulatory presence for the scarcity of evidence of abusive or predatory practices.

Our preemption rule contains two new provisions that expressly prohibit abusive or predatory lending practices by national banks or their operating subsidiaries. First, the rule prohibits national banks from making any consumer loan based predominantly on the foreclosure or liquidation value of a borrower's collateral, rather than on the borrower's ability to repay the loan according to its terms. This anti-predatory lending standard applies uniformly to all consumer lending activities of national banks and their operating subsidiaries, regardless of the location from which those activities are conducted or where customers reside. This standard strikes at the heart of predatory lending, namely lending practices that effectively swindle a homeowner out of his or her property.<sup>9</sup>

Second, our preemption rule provides that, in connection with *any* type of lending, national banks and their operating subsidiaries shall not engage in unfair and deceptive practices within the meaning of Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits "unfair or deceptive acts or practices" in interstate commerce. Although we do not have the statutory authority to define particular acts or practices as "unfair" or "deceptive" under the FTC Act, we added an express reference to Section 5 to our rule in response to commenters who urged us to affirm that the principles of the Act apply to national banks. We viewed this addition as particularly appropriate in light of the fact that the OCC pioneered the use of Section 5 as a basis for enforcement actions against banks that have engaged in such conduct, and have obtained substantial restitution for customers as a result.

These new standards are comprehensive and they apply nationwide, to all national banks and their operating subsidiaries. They apply strong protections for national bank customers in every State – including the many states that do not have their own anti-predatory lending standards.

The addition of these provisions to our lending rules reinforces the obligation of national banks and their operating subsidiaries to treat their customers fairly and operate pursuant to high standards of integrity. The provisions supplement prior OCC predatory lending guidance<sup>10</sup> and a

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In addition, the report found that a significant source of abusive lending practices is non-regulated mortgage brokers and similar intermediaries who, because they "do not actually take on the credit risk of making the loan, . . . may be less concerned about the loan's ultimate repayment, and more concerned with the fee income they earn from the transaction." *Id.* at 40.

<sup>8</sup> Brief for Amicus Curiae State Attorneys General, *Nat'l Home Equity Mortgage Ass'n v. OTS*, Civil Action No. 02-2506 (GK) (D.D.C.) at 10-11 (emphasis added). See also National Association of Attorneys General, Comment Letter Re: Docket No. 03-16 (dated Oct. 6, 2003) at 10.

<sup>9</sup> See also OCC Advisory Letter 2002-3, "[Guidance on Unfair or Deceptive Acts or Practices](#)," March 22, 2002.

<sup>10</sup> The OCC was the first Federal banking agency to issue anti-predatory lending guidance. Two advisory letters issued a year ago provide comprehensive supervisory guidance directed at ensuring that national banks and their operating subsidiaries do not become involved in abusive or predatory mortgage lending practices. See OCC

host of Federal consumer protection laws that apply to national banks and their operating subsidiaries.<sup>11</sup>

If, as a result of our examination or supervisory processes, or upon investigation of referrals or complaints, we find abusive practices in a particular institution, our track record compellingly shows that we take action to stop them. Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to require compliance with any "law, rule, or regulation." This includes the ability to issue cease and desist orders when the OCC determines that a national bank or its operating subsidiary has violated any applicable Federal law or regulation or any applicable State law or regulation.<sup>12</sup> In an appropriate case, the cease and desist order may include restitution or a requirement for such other affirmative action as the OCC determines is appropriate.<sup>13</sup> Our record shows that we have been willing and able to use these remedies to protect customers and to address unfair, deceptive, or abusive practices when such situations occur.<sup>14</sup>

## 2. *The OCC has ample resources to ensure that national bank customers are protected.*

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Advisory Letter 2003-2, "[Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices](#)," February 18, 2003; OCC Advisory Letter 2003-3, "[Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans](#)," February 18, 2003.

<sup>11</sup> Federal consumer protection laws and regulations that apply to national banks and to national bank operating subsidiaries include: the Federal Trade Commission Act; Truth in Lending Act; Home Ownership and Equity Protection Act; Fair Housing Act; Equal Credit Opportunity Act; Real Estate Settlement Procedures Act; Community Reinvestment Act; Truth in Savings Act; Electronic Fund Transfer Act; Expedited Funds Availability Act; Flood Disaster Protection Act; Home Mortgage Disclosure Act; Fair Housing Home Loan Data System; Credit Practices Rule; Fair Credit Reporting Act; Federal Privacy Laws; Fair Debt Collection Practices Act; the new OCC anti-predatory lending rules in 12 C.F.R. Parts 7 and 34; OCC rules imposing consumer protections in connection with the sales of debt cancellation and suspension agreements; OCC standards on unfair and deceptive practices (<http://www.occ.treas.gov/ftp/advisory/2002-3.doc>); and OCC standards on preventing predatory and abusive practices in direct lending and brokered and purchased loan transactions (<http://www.occ.treas.gov/ftp/advisory/2003-2.doc> and <http://www.occ.treas.gov/ftp/advisory/2003-3.doc>).

<sup>12</sup> 12 U.S.C. § 1818(b)(1). See National State Bank of Elizabeth, N.J. v. Long, 630 F.2d 981, 988-89 (3d Cir. 1980) (confirming the OCC's authority under 12 U.S.C. § 484 to enforce an applicable State redlining statute).

<sup>13</sup> 12 U.S.C. § 1818(b)(6).

<sup>14</sup> See the following actions taken by the OCC under the FTC Act to address unfair or deceptive practices: In the Matter of Clear Lake National Bank, San Antonio, Texas, Enforcement Action 2003-135 (required restitution of fees and interest for home equity loans); In the Matter of First Consumers National Bank, Beaverton, Oregon, Enforcement Action 2003-100 (required restitution of annual fees and overlimit fees for credit cards); In the Matter of Household Bank (SB), N.A., Las Vegas, Nevada, Enforcement Action 2003-17 (required restitution regarding private label credit cards); In the Matter of First National Bank in Brookings, Brookings, South Dakota, Enforcement Action 2003-1 (required restitution regarding credit cards); In the Matter of First National Bank of Marin, Las Vegas, Nevada, Enforcement Action 2001-97 (restitution regarding credit cards); and In the Matter of Direct Merchants Credit Card Bank, N.A., Scottsdale, Arizona, Enforcement Action 2001-24 (restitution regarding credit cards). See also the following actions taken by the OCC regarding payday lending activities of national banks: In the Matter of Peoples National Bank, Paris, Texas, Enforcement Action 2003-2; In the Matter of First National Bank in Brookings, Brookings, South Dakota, Enforcement Action 2003-1; In the Matter of Goleta National Bank, Goleta, California, Enforcement Action 2002-93; and In the Matter of Eagle National Bank, Upper Darby, Pennsylvania, Enforcement Action 2001-104. These orders can be found on the OCC's website within the "Popular FOIA Requests" section at <http://www.occ.treas.gov/foia/foiadocs.htm>.

The central feature of the OCC's consumer compliance supervision is our on-site presence in the institutions we supervise. National banks and national bank operating subsidiaries are subject to comprehensive, regular – in the case of large banks, continuous – program of supervision that is, as I have described, risk-focused and rigorous.

Federal law requires that the OCC examine national banks at least once every 12 or 18 months, depending on the size of the bank.<sup>15</sup> However, the largest national banks have on-site examination teams conducting continuous examinations of all aspects of the bank's operations. In addition, the OCC may at any time conduct targeted safety and soundness and compliance examinations.

Our system of supervision applies to national banks and their operating subsidiaries. The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries. The book figures of a parent national bank and its operating subsidiaries are combined for purposes of applying statutory or regulatory limits, such as lending limits or dividend restrictions. The OCC reviews the institution's policies and procedures in an effort to assess whether they adequately identify and address the risks the institution may face, given the nature and scope of its business. Finally, the OCC evaluates the adequacy of all elements of the institution's business, including capital, earnings, assets, management, liquidity, sensitivity to market risk, and information systems.

Through our safety and soundness and compliance examinations, the OCC reviews the adequacy of the bank's policies, systems and controls, relative to the character and complexity of the bank's business and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners typically sample transactions to assess the adequacy of the bank's systems and controls. For example, as part of an asset quality review, the sample of loans will be reviewed to determine the quality of the loans, the adequacy and completeness of the information concerning the loan and the borrower, and whether the lending function is being carried out in compliance with applicable laws.

Depending on the bank's risk profile and other supervisory information, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the bank is engaging in significant new or expanded mortgage lending activities through an operating subsidiary, examiners normally would select a sample of those loans for review. Similarly, as part of our compliance reviews, examiners may select a sample of consumer loan or deposit products to verify that the bank's systems and controls are adequate and that the bank is complying with applicable consumer protection laws and regulations. If the sampling process indicates potential issues, we will expand our reviews. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis. Through this process, we are

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<sup>15</sup> 12 U.S.C. § 1820(d)(1). The general rule requires examinations every 12 months. However, if a bank has less than \$250 million in assets and is in good condition, the OCC need only examine it at least once every 18 months. *Id.* § 1820(d)(4).

able to examine national banks and their operating subsidiaries for potentially abusive lending practices as well as compliance with the host of specific Federal consumer protection requirements to which they are subject. Our compliance supervision is an integral part of our comprehensive, ongoing oversight of the national banking system.

Today, the OCC supervises approximately 2100 national banks, together with their operating subsidiaries. Compliance and enforcement at the OCC are carried out through our corps of bank examiners and attorneys. We have nearly 1700 examiners in the field, hundreds of whom are involved in both safety and soundness and compliance supervision. Over 100 examiners throughout the country work exclusively on compliance supervision. We have over 300 examiners on site at our largest national banks, engaged in continuous supervision of all aspects of their operations. These resources are supplemented by dozens of attorneys in our district offices and Washington D.C. who work on compliance matters.

The employees in our Customer Assistance Group (CAG) located in Houston, Texas, further supplement these functions. The CAG provides direct assistance to customers of national banks and their subsidiaries to resolve individual complaints. It also collates and disseminates complaint data that help point our examiners toward banks, activities, and products that require further investigation or transaction testing through product sampling. While the CAG is an important supplement to our compliance supervision functions, it is by no means all there is to it.

It is important to note, by way of comparison, based on data published by the Conference of State Bank Supervisors, State banking departments collectively supervise approximately 113,000 entities, of which approximately 6,000 are commercial banks.<sup>16</sup> For all these entities, the States report that they have 2,308 examiners.<sup>17</sup> Thus, if one were to look only at commercial banks and assume all State examiners were dedicated to commercial bank supervision, OCC's resources exceed those of the States on a per-supervised bank basis. But, in fact, State banking departments are responsible for many entities in addition to commercial banks. These include, depending on the State, savings banks, thrifts, credit unions, bank holding companies, mortgage bankers and brokers, industrial loan companies, non-bank trust companies, money transmitters, consumer finance companies, other licensed lenders, payday lenders, title lenders, check cashers, pawnshops, bankers' banks, securities brokers and dealers, and funeral parlors. Thus, on a per-supervised entity basis, the OCC has significantly more resources than do the States.<sup>18</sup> This is exactly the opposite of what some critics of our regulations have suggested. These suggestions – that our resources are inadequate to enable the OCC to supervise compliance effectively or to fulfill the consumer protection aspect of our mission – are simply without foundation.

**3. *The OCC welcomes opportunities to cooperate with States on issues pertaining to consumer protection.***

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<sup>16</sup> A Profile of State Chartered Banking, Nineteenth Edition, 2002-2003, Conference of State Bank Supervisors.

<sup>17</sup> Id.

<sup>18</sup> See attached chart.

The OCC and the States have a long history of coordination and cooperation, which we wish to continue. Neither the preemption rule nor the revised visitorial powers rule results in the OCC taking over a vast domain of supervisory and enforcement activity currently being conducted by State authorities with respect to national banks. The rules do not effect the ability of States to engage in those activities, where authorized by Federal law, e.g., securities, insurance, telemarketing, nor do the rules prevent State officials from applying and enforcing generally applicable State laws that do not attempt to control the content or conduct of national banks' banking activities. Our jurisdiction over national banks and their subsidiaries does not deprive State regulators of a role in protecting consumers in their States. We welcome the opportunity to work cooperatively with them to further that goal. We have invited State authorities to refer consumer complaints concerning national banks to the OCC, and to bring to our attention concerns that any national bank is engaged in unfair, deceptive, abusive or predatory practices. We have set up special procedures to handle and track referrals from State authorities. Unfortunately, we have received very little response to the overtures.

The OCC and the states already cooperate extensively in many respects, referring consumer complaints to the appropriate regulator of the entity generating the complaint, and we welcome additional opportunities to collaborate. Recently, the OCC issued a new advisory letter to national banks clarifying our expectations about how they should handle customer complaints that are forwarded to them from State agencies and departments.<sup>19</sup> We took that opportunity to emphasize the importance of resolving consumer complaints fairly and expeditiously, regardless of the source of the complaint, and to remind banks that their complaint resolution processes are subject to review as part of our regular supervision of their compliance management programs.

There may ultimately be some areas where we will have to agree to disagree, but I am confident that there are many more where we can agree that there are improvements that all of us can make in how consumer concerns are identified and resolved. We welcome the opportunity to have further dialogue to achieve those goals.

## V. CONCLUSION

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change – by refining our own management practices, by improving the approaches we use to supervise the industry, and by striving to ensure that national banks remain the safe, and sound, competitive, and high integrity engines of our economy that they were designed to be. We look forward to working productively with you, with the members of this Committee, and with State officials as we pursue our efforts to achieve that goal.

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<sup>19</sup> OCC Advisory Letter 2004-2, "Consumer Complaints Referred to National Banks from State Officials," February 26, 2004.

# Comparison of OCC and State Examiner Resources

