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**TESTIMONY OF**  
**JOHN WALSH**  
**ACTING COMPTROLLER OF THE CURRENCY**  
**before the**  
**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**February 17, 2011**

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.

Chairman Johnson, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to describe the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony reports on the OCC's work to date to implement Dodd-Frank in the following key areas:

- The OCC's progress integrating the staff and functions of the Office of Thrift Supervision (OTS) into the OCC, and identifying employees for transfer to the Consumer Financial Protection Bureau (CFPB);
- Highlights of our work to date in implementing important policy and rulemaking initiatives required by Dodd-Frank, including the OCC's participation on the Financial Stability Oversight Council (FSOC or Council), and the challenges of ensuring that these initiatives are appropriately coordinated with other participating agencies and with international efforts to reform capital and liquidity standards for financial institutions; and the Council's achievements thus far; and
- Provides an update on a significant issue that was just emerging at the time of the Committee's last hearing on Dodd-Frank implementation by reporting on the steps that the OCC, working with our fellow regulators, has taken to identify and address irregularities in institutions' foreclosure processes and our efforts to foster development and implementation of comprehensive and nationally applicable mortgage servicing standards.

## **I. Implementation of Agency Restructuring**

### ***A. OTS/OCC Integration***

As the Committee is aware, the Dodd-Frank Act transfers from OTS to the OCC supervisory responsibilities for federal savings associations, as well as rulemaking authority relating to all savings associations. Under the statute, all OTS employees will be transferred to either the OCC or the Federal Deposit Insurance Corporation (FDIC) no later than 90 days after the "transfer date," which is one year after enactment unless extended for an additional six months by the Secretary of the Treasury. The allocation is to be based generally on the proportion of federal versus state savings associations regulated by the OTS.

When I testified before this Committee in September of last year,<sup>1</sup> I described the steps the OCC had begun to take to prepare for our expanded supervisory responsibilities and for the integration of OTS staff that is so essential to the success of that effort. Since then, we have continued to work closely with the OTS, the Board of Governors of the Federal Reserve System (FRB), and the FDIC to prepare for the smooth and effective transfer of OTS staff, authority and responsibilities, and property and other assets. Much remains to be done, but I am pleased to report that the agencies are on track to complete the transfer of functions and staff by the target date of July 21, 2011. The following summarizes key elements of this progress. A detailed description of all our activities is

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<sup>1</sup> Testimony of John Walsh, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, September 30, 2010.

set forth in the interagency Joint Implementation Plan (Plan) submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate, the Committee on Financial Services of the House of Representatives, and the Inspectors General of the Department of the Treasury, the FDIC, and the FRB on January 25, 2011.<sup>2</sup>

Because Dodd-Frank transfers the vast majority of OTS responsibilities to the OCC on the transfer date, most of the OTS's approximately 1,000 employees will transfer to the OCC.<sup>3</sup> The OCC recognizes that retaining the unique talent and experience of OTS staff is essential for the effective supervision of federal savings associations going forward. Our work in preparing for the full integration of the OTS staff is focused on: ensuring that the protections afforded by the legislation are fully and equitably implemented; building a sustainable organizational structure that will successfully accomplish supervision and regulation of both national banks and federal savings associations; fostering an environment that will maximize opportunities for staff; and promoting communication with all employees throughout the transition. Pursuant to section 314(b) of Dodd-Frank, on November 3, 2010, I designated Timothy T. Ward to be Deputy Comptroller for Thrift Supervision. Mr. Ward, who joined the OCC after 26 years at the OTS and its predecessor agency, reports to the Senior Deputy Comptroller for the OCC's Midsize/Community Bank Supervision (M/CBS) and is leading the planning process for integration of the OTS's examination and supervision functions and staff. He serves as a key senior management group member, and will coordinate the nationwide network of Senior Thrift Advisors and function as the key advisor to other Deputy Comptrollers on large and problem thrifts.

#### *Realignment of Staffing to Prepare for Expanded Supervisory Responsibilities*

The OCC will assign OTS employees, to the extent practicable, to OCC positions performing the same functions and duties that the OTS employees performed prior to the transfer. To assist in this effort, the OCC has reached out to OTS employees in a number of ways at the agency and business unit level. For example, because most OTS employees will transfer into the OCC's M/CBS organization, the Senior Deputy Comptroller for M/CBS has held four OTS-wide conference calls explaining its organizational structure and the decisions that are being made to accommodate the transfer of OTS staff. Similar conversations are occurring for other functional areas.

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<sup>2</sup> The Plan was submitted pursuant to section 327 of the Dodd-Frank Act. See Interagency Joint Implementation Plan at [www.occ.gov/publications/publications-by-type/other-publications/pub-other-joint-implementation-plan.pdf](http://www.occ.gov/publications/publications-by-type/other-publications/pub-other-joint-implementation-plan.pdf). The Plan provides additional detail about the agencies' progress in implementing the employee protections that Dodd-Frank provides to transferring OTS employees, including retirement benefits; health, dental, vision, and long-term care; and life insurance. The Plan also discusses the integration of OTS employees into the OCC's pay structure.

<sup>3</sup> The final number of staff who transfer to the OCC will include those personnel who do not transfer to the FDIC to support functions transferred to that agency, those personnel who do not transfer to the CFPB, and those personnel who do not choose to leave the agency for other reasons prior to the transfer date.

Approximately 670 federal savings associations will be transferred to the OCC on the transfer date. OCC's Community Bank Supervision staff will supervise the vast majority of them, while the Midsize and Large Bank Supervision programs will supervise federal savings associations with profiles that align with those units. The Special Supervision portfolio will also expand to include certain troubled federal savings associations. The OCC is working with the OTS to execute an orderly transfer of authority and responsibilities that will ensure the effective supervision of both national banks and federal savings associations.

To provide thrift supervision leadership continuity and facilitate the integration of the OTS into the OCC, five senior OTS managers responsible for thrift supervision already have accepted positions in OCC's M/CBS organization. Although they will not officially assume these positions until the transfer date, they are actively participating in the OCC's planning activities. Their extensive knowledge of the OTS organization, the staff, and federal savings associations is an invaluable resource as we prepare for the transition. The OCC is in the process of filling the remaining positions created by the OCC's structural changes through a competitive posting process open to both qualified OTS and OCC staff.

#### *Training and Certification of Employees*

Training will be critical to the combined success of the OCC and the OTS. Ultimately, the OCC's National Bank Examiner commission will expand to ensure that each commissioned examiner has the skill set and credentials to lead examinations of both national banks and federal savings associations. Initially, the agencies are reviewing each of their training and certification programs to identify where OCC and OTS training programs overlap and where gaps need to be addressed.

#### *Review and Continuation of OTS Regulations*

Dodd-Frank requires the OCC, the FDIC, and the FRB to identify those continued OTS regulations that each agency will enforce. The OCC and the FDIC must consult with each other in identifying these regulations, and the OCC, the FRB, and the FDIC must publish a list of these identified regulations in the *Federal Register* not later than the transfer date. The agencies have begun the task of identifying these OTS regulations and will publish the lists required by the legislation on or before the transfer date.

Working together with OTS staff, the OCC is considering how to integrate the OTS's regulations with the OCC's regulations. This process is expected to include certain changes that would be effective as of the July 21, 2011, transfer date and to continue in phases after that date. Any substantive changes proposed to either the OCC's or the OTS's regulations affecting savings associations will be published in the *Federal Register*.

### *Thrift Industry Outreach*

The OCC recognizes the importance of communicating regularly with the industry throughout this process to address concerns, clarify expectations, and promote effective supervision of federal savings associations. The communication process began with a personal letter that I sent to the chief executive officer of each federal savings association in September. Two additional letters have been sent since that time to share further information about the integration process. Senior OCC leaders have also accepted numerous invitations to participate in industry-sponsored events that provide an opportunity to speak directly with management representatives of federal savings associations. Additionally, the OCC has developed a day-long program for thrift executives to provide information and perspective on the agency's approach to supervision and regulation. The OCC District Deputy Comptrollers and OTS Regional Directors are co-hosting 17 of these sessions in locations around the country during the first quarter of 2011. More than 1,000 thrift industry representatives have registered to attend one of these sessions. The feedback received from attendees at the first seven sessions has been very positive.

### **B. *Transfers of Specified Functions to the CFPB***

OCC has continued to provide extensive assistance to Treasury and the CFPB to support the stand up of the CFPB. We have provided extensive information about our human resources policies and practices, compensation structure and OCC-unique benefits, and copies of all of our position descriptions. We have worked with Treasury and CFPB staff and our payroll provider, the National Finance Center, to enable the CFPB to replicate the OCC's NB pay plan and compensation system, accelerating its ability to hire employees under their own authorities and provide the compensation and benefits allowed for under the Dodd-Frank Act.

In the late fall, OCC established an Expression of Interest process for employees who may be interested in pursuing work with the CFPB, either on a temporary basis (detail) or permanently. Having a cadre of interested employees has allowed us to respond to requests for assistance with targeted OCC resources with unique skill sets.

The OCC has met with the CFPB implementation team several times over the past few months to discuss a mutually-agreeable transfer process for OCC employees who are interested in going to the CFPB and have the requisite skills and experience to perform the work. We are committed to following through on the development and execution of this process.

In addition to human resource related matters, the OCC has responded to numerous data requests, held informational meetings, and provided technical support to assist the CFPB as it develops processes to fulfill its consumer protection function. Informational meetings have been held to discuss OCC processes relating to the Equal Credit Opportunity Act (ECOA), the CARD Act, and general bank supervision as well as enforcement authorities and practices. Consumer compliance policies and training

materials have been provided. Extensive meetings have been held with the OCC's Customer Assistance Group and a team leader from this group was detailed to help the CFPB develop its consumer complaints function. Most recently in response to a request for information on the CARD Act, the OCC agreed to make a presentation at the CFPB's seminar on the effects of the CARD Act.

## **II. Implementation of Dodd-Frank Policy and Rulemaking Initiatives**

In my September 2010 testimony, I described the OCC's early post-enactment efforts to support the organization and operation of the FSOC and our participation in the important interagency rulemaking projects that were just then starting up. The OCC now is actively working on approximately 85 Dodd-Frank projects ranging in scope from our extensive efforts to prepare to integrate the OTS's staff and supervisory responsibilities to consultation on a variety of rulemakings being undertaken by other agencies. While significant progress has occurred on a number of these policy and rulemaking initiatives, the OCC continues to face substantial challenges in the implementation of some of Dodd-Frank's provisions. This portion of my testimony provides highlights the progress we have made thus far in implementing key Dodd-Frank initiatives and describes the most significant challenges to implementation that we have identified.

### ***A. Rulemaking and Policy Initiatives: Milestones Achieved***

#### *Financial Stability Oversight Council*

The OCC actively participates in the FSOC. The FSOC's mission is to identify risks to financial stability that could arise from the activities, material financial distress, or failure of large, interconnected financial companies; to recommend standards for implementation by the agencies in specified areas; to promote market discipline; and to respond to emerging threats to the stability of the U.S. financial system.

The FSOC already has undertaken a number of significant actions. At its first meeting in October 2010, the FSOC approved publication of an advance notice of proposed rulemaking (ANPR) seeking public comments regarding the criteria and analytical framework for designation of nonbank financial firms for enhanced supervision by the FRB pursuant to section 113 of the Dodd-Frank Act. Based on a review of comments received and consideration by the members of the FSOC, at its January 2011 meeting the FSOC approved a notice of proposed rulemaking relating to section 113. The proposed rule lays out the framework that the FSOC proposes to use to determine whether a nonbank financial company could pose a threat to the financial stability of the United States. It also implements the process that the FSOC would use when considering whether to subject a firm to supervision by the FRB and heightened prudential standards.

The FSOC has also taken steps to implement the provisions of the Dodd-Frank Act known as the "Volcker Rule," which prohibit banking entities from engaging in proprietary trading and from maintaining certain relationships with hedge funds and private equity funds. The Volcker Rule requires the FSOC to study and make

recommendations on implementing its restrictions. Under section 619, the OCC and other agencies must consider the recommendations of the FSOC study in developing and adopting regulations to implement the Volcker Rule. To assist the FSOC in conducting the study and formulating its recommendations, in October 2010 the FSOC issued a request for information through public comment. Based on a review of comments received and consideration by the members of the FSOC, the FSOC issued the Volcker Rule study and recommendations in January 2011. Informed by the study, the rulemaking agencies have begun the process of drafting regulations to implement the Volcker Rule. The statute sets a deadline of October 2011 for completion of that work.

#### *Establishment of the Office of Minority and Women Inclusion*

Pursuant to section 342 of the Dodd-Frank Act, the OCC has established an Office of Minority and Women Inclusion. On January 19, 2011, I named Joyce Cofield Director of this office. Ms. Cofield, who has 28 years of experience in human capital management, workforce diversity and business operations, will report to the Comptroller and provide executive direction, set policies, and oversee all matters of the OCC relating to diversity in management, employment, and business activities. The establishment of this office and the appointment of Ms. Cofield will ensure that the OCC will continue to be atop the list of “Best Places To Work” in the federal government for issues relating to the broadest definition of diversity.

#### *Incentive Compensation Rulemaking*

The OCC, FRB, FDIC, OTS, National Credit Union Administration (NCUA), Securities Exchange Commission (SEC), and Federal Housing Finance Agency (FHFA) (the Agencies) are in the process of issuing a proposal to implement the incentive-based compensation provisions in Section 956 of the Dodd-Frank Act. The proposed rule will require the reporting of certain incentive-based compensation arrangements by a covered financial institution<sup>4</sup> and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to a material financial loss.

The material financial loss provisions of the proposed rule establish general requirements applicable to all covered institutions and additional requirements applicable to larger covered financial institutions. The generally applicable requirements provide that an incentive-based compensation arrangement, or any feature of any such arrangement, established or maintained by any covered financial institution for one or more covered persons must balance risk and financial rewards and be compatible with effective controls and risk management and supported by strong corporate governance.

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<sup>4</sup> Section 956(e)(2) defines a “covered financial institution” to mean a depository institution or depository institution holding company; a registered broker-dealer; a credit union; an investment adviser; Fannie Mae; Freddie Mac; and “any other financial institution” that the regulators jointly determine, by rule, should be covered by section 956. Institutions with less than \$1 billion in assets are not subject to section 956.

The proposed rule includes two additional requirements for “larger financial institutions,” which for the federal banking agencies, NCUA, and the SEC means those covered financial institutions with total consolidated assets of \$50 billion or more. First, a larger financial institution must defer 50 percent of incentive-based compensation for its executive officers for a period of at least three years. Second, the board of directors (or committee thereof) of a larger financial institution also must identify, and approve the incentive-based compensation arrangements for, individuals (other than executive officers) who have the ability to expose the institution to possible losses that are substantial in relation to the institution’s size, capital, or overall risk tolerance. These individuals may include, for example, traders with large position limits relative to the institution’s overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.

### *Credit Risk Retention*

Section 941 of the Dodd-Frank Act requires the OCC, FRB, FDIC, and SEC to issue joint regulations requiring securitizers of asset-backed securities to retain an economic interest in a portion of the credit risk for assets that the securitizer packages into the securitization for sale to others. Where these regulations address the securitization of residential mortgage assets, the Department of Housing and Urban Development and the FHFA are also part of the joint rulemaking group. The Treasury Secretary, as Chairperson of FSOC, is directed to coordinate the joint rulemaking.

In order to correct adverse market incentive structures revealed by the crisis, section 941 requires the securitizer to retain a portion of the credit risk on assets it securitizes, unless those assets are originated in accordance with conservative underwriting standards established in regulation. This new regulatory regime will give securitizers direct financial disincentives against packaging loans that are underwritten poorly.

As the FRB has noted in its recent study of the securitization markets (also required by section 941), the securitization markets provide an important mechanism for making credit available for businesses, households, and governments.<sup>5</sup> In drafting the proposed rules mandated by section 941, the agencies are taking a number of priorities into account. These include incorporating appropriate incentives that encourage high-quality underwriting of loans included in securitizations; designing robust forms of risk retention that reflect the diversity of securitization structures used in the marketplace; and recognizing the diversity of asset classes commonly securitized. The statute requires the agencies not only to create low-risk underwriting standards for certain asset classes used in securitizations, but also to define the appropriate form and amount of risk retention interests, consider circumstances in which it might be appropriate to shift the retention obligation to the originator of the securitized assets, and create rules addressing complex securitizations backed by other asset-backed securities. Various exemptions from the risk retention requirements also must be implemented. In particular, the banking agencies, SEC, HUD and the FHFA are directed to define “qualified residential mortgages” with

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<sup>5</sup> Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, (October 2010).

underwriting and product features that historical loan performance data indicate result in a lower risk of default. Securitizations of QRMs are specifically exempted from the credit risk retention requirements.

Work on the notice of proposed rulemaking is nearing completion and the agencies hope to be able to publish a proposal in the next month.

## **B. *Implementation Challenges***

### *Capital and Liquidity: Coordination of Dodd-Frank Initiatives with International Reforms*

The Dodd-Frank Act focused considerable attention on enhancing the capital and liquidity standards of U.S. financial companies. The banking agencies and FSOC are called upon to develop and publish numerous studies and regulations that will materially affect the level and composition of capital and liquidity for both banks and certain non-bank financial companies. As I have indicated in previous testimony to this Committee<sup>6</sup> and reiterated in a recent speech,<sup>7</sup> one of the main challenges facing supervisors in this area is the need to coordinate Dodd-Frank implementation efforts with agency actions to adopt recent reforms announced by the Basel Committee on Banking Supervision (Basel Committee), the so-called Basel III reforms. While these two significant public policy initiatives are not identical in their design and standards, they share many common objectives and address many of the same underlying issues. It is incumbent on the agencies to consider these reforms in a coordinated, mutually reinforcing manner, so as to enhance the safety and soundness of the U.S. and global banking system, while not damaging competitive equity or restricting access to credit.

As noted above, various provisions of Dodd-Frank seek to enhance the capital and liquidity standards of U.S. financial companies. The U.S. agencies are making appropriate progress in drafting the required studies and regulations to effectuate Congressional intent in these areas. A summary of these efforts is provided below:

- Under sections 115(a) and 115(b) of Dodd-Frank, in order to prevent or mitigate risk to financial stability, the FSOC may make recommendations to the FRB<sup>8</sup> concerning the establishment of prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies. These prudential standards, which are to be more stringent than those applicable to other companies that do not pose similar risk to financial stability, are expected to address risk-based capital requirements, leverage limits, and liquidity requirements, among other provisions. The

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<sup>6</sup> See *supra* note 1.

<sup>7</sup> See John Walsh, Acting Comptroller of the Currency, Remarks at the Exchequer Club (January 19, 2011).

<sup>8</sup> Under section 165 of Dodd-Frank, the FRB, on its initiative or pursuant to recommendations by FSOC under Sections 115(a) and 115(b), shall establish prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies.

FSOC has commenced work on this project and expects to provide recommendations to the FRB shortly.

- Section 171(b) of Dodd-Frank requires the banking agencies to establish minimum risk-based capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the FRB. On December 30, 2011, the banking agencies published a notice of proposed rulemaking addressing the requirements of section 171(b). Agencies continue to encourage public comment on this proposal through February 28, 2011.
- Section 115(c) of Dodd-Frank requires the FSOC to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for certain nonbank financial companies and bank holding companies. FSOC has commenced work on this requirement earlier than initially projected in order to articulate a U.S. position on this important topic in advance of international deliberations at the Basel Committee, Financial Stability Board, and other organizations.
- Section 616(c) of Dodd-Frank amends the International Lending Supervision Act of 1983 by providing that each federal banking agency shall seek to make capital standards countercyclical, so that the amount of required capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness. Consistent with this provision, the agencies are actively considering the establishment of countercyclical capital requirements in proposed regulations implementing the Basel III reforms.

As noted in my testimony before this Committee on September 30 of last year, the Basel III reforms focus on many of the same issues and concerns that the Dodd-Frank Act sought to address. These reforms of the Basel Committee are designed to strengthen global capital and liquidity standards governing large, internationally active banks and promote a more resilient banking sector. Like Dodd-Frank, the Basel III reforms tighten the definition of what counts as regulatory capital by placing greater reliance on higher quality capital instruments; expand the types of risk captured within the capital framework; establish more stringent capital requirements; provide a more balanced consideration of financial stability and systemic risks in bank supervision practices and capital rules; and call for leverage ratio requirement and global minimum liquidity standards. Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by Dodd-Frank. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards.

## *Credit Ratings*

The OCC recognizes that issues surrounding credit ratings were a significant factor in market overconfidence that contributed to losses in the markets for mortgage-backed securities in 2008-2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the ratings agencies, greater SEC oversight of the ratings process, and loan-level disclosures to investors in asset-backed securities. In this context of enhanced regulation that Dodd-Frank provides, the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary. Moreover, it has become clear, as we have tried to implement this requirement, that the disadvantages of the prohibition are substantial.

Section 939A of Dodd-Frank requires each federal agency to review its regulations that refer to, or require the use of, credit ratings in connection with an assessment of the creditworthiness of a security or money market instrument. Each agency must then remove from its regulations any reference to or requirement for reliance on credit ratings and must develop alternative standards of creditworthiness to serve as a substitute for reliance on credit ratings.

In accordance with section 939A, the OCC reviewed its regulations and determined that credit ratings are referenced in two key areas – 1) regulations governing which investment securities banks may purchase and hold; and 2) regulations governing banking institutions' risk-based capital requirements. Together, these regulations prevent banks from making excessively speculative investments and help to assess the relative risk of securities holdings.

In an effort to modify its regulations pursuant to the requirements of section 939A, the OCC published an ANPR in August 2010 requesting comment on alternative creditworthiness measures for its investment securities regulations. Shortly thereafter, the OCC joined with the FDIC and FRB in publishing an ANPR requesting comment on alternatives for the agencies' risk-based capital regulations.

Additionally, the FRB, FDIC, and OCC hosted a forum on alternatives to credit ratings that included representatives from various sectors of the financial industry, including community, regional, and internationally active banking institutions, financial analysts and consultants, credit rating agencies, and insurance industry regulators, as well as members of academia.

The comments received in response to the ANPRs, as well as the discussion during the credit ratings forum, reinforced my concerns. Although the commenters generally concurred with the agencies' stated criteria for developing alternative creditworthiness standards, they failed to suggest practical alternatives that could be implemented across the banking industry.

In response to the OCC's requests for comment on how best to implement section 939A, regional and community banks noted that using internal risk assessment systems to measure credit worthiness for regulatory purposes would be costly and time consuming. These commenters noted that while cost and burden would be a factor for all banks, it is likely to be more pronounced for community and regional banks, and may therefore place

them at a disadvantage compared to larger institutions that have advanced analytical capabilities and whose in-house systems and management capabilities could be converted to apply new standards. A number of commenters stated that the costs could be so great as to shut out smaller institutions from being able to purchase certain types of high quality investment securities.

These concerns could be addressed if section 939A is amended in a targeted manner that allows institutions to make limited use of credit ratings. Precluding undue or exclusive reliance on credit ratings, rather than imposing an absolute bar to their use, would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery. With appropriate operational and due diligence requirements, credit ratings can be a valuable factor to consider when evaluating the creditworthiness of money market instruments and other securities.

Additionally, without amendment to allow the use of ratings as one of the factors taken into consideration in evaluating creditworthiness, the provision would prevent the federal banking agencies from implementing internationally agreed capital, liquidity, and other prudential standards – including the strong new Basel III framework that is now being finalized. The banking agencies already have had to propose a limited implementation of an internationally negotiated framework applicable to traded assets. Because of section 939A, the federal banking agencies’ proposal to amend the risk-based capital rules for market risk, published on January 11, 2011, did not include ratings-based provisions that would have significantly increased the amount of capital required to be held against traded assets. The continued inability of the banking agencies to implement important portions of the international standards will adversely affect our ability to negotiate strong new global standards designed to prevent a recurrence of the recent financial crisis.

#### *Inconsistent or Duplicative Supervisory Responsibilities*

Other implementation difficulties arise outside the rulemaking context. One example concerns the respective roles of the banking agencies and the CFPB in dealing with consumer complaints. Under the Dodd-Frank Act, the function of handling consumer complaints is not a function that transfers to the CFPB, but the CFPB has various responsibilities concerning consumer complaints. At the same time, other provisions of the Dodd-Frank Act envision that the prudential regulators will also have responsibilities handling consumer complaints, and those responsibilities are not confined to complaints concerning banks of \$10 billion or more in asset size. Absent clarification of the CFPB’s role, it is difficult for the prudential regulators to determine how to staff their consumer complaint operations, and if we downsize those operations to handle only complaints involving institutions of less than \$10 billion in size, it is not clear how complaints involving larger institutions will be handled.

Another area of concern is the confusing overlap of roles of the federal banking agencies and the CFPB for supervising and enforcing fair lending provisions for insured depository institutions with total assets greater than \$10 billion. The federal banking agencies currently oversee depository institutions’ compliance with the Fair Housing Act,

the ECOA, and the Federal Reserve Board's Regulation B, using interagency examination guidelines issued by the Federal Financial Institutions Examination Council. Under the Dodd-Frank Act, the banking agencies will continue to perform this function for institutions under our supervision with \$10 billion or less in total assets. For larger institutions, the legislation assigns exclusive supervisory responsibility for "federal consumer financial laws" to the CFPB. The definition of "federal consumer financial laws" includes the ECOA and Regulation B, but not the Fair Housing Act. Because conduct that violates the Fair Housing Act generally also violates the ECOA, the CFPB's examination for compliance with ECOA should suffice to address compliance with the Fair Housing Act.

However, if the intent of the legislation is for the CFPB to supervise larger institutions for compliance with the ECOA and Regulation B, but for the federal banking agencies to supervise such institutions' compliance with the Fair Housing Act, this result risks significant inefficiency and potential confusion regarding accountability in this area.

Another provision presenting potential concerns are the particular requirements for how the prudential supervisors and the CFPB conduct examinations of institutions with \$10 billion or more in size. We strongly favor efficient coordination of the activities of the prudential regulators and the CFPB, but the particular requirements set out in the Dodd-Frank Act would direct multi-step activities that are inefficient, overbroad, and sufficiently time-consuming that safety and soundness based remedial actions that institutions should be required to take immediately could be delayed.

While we plan to work with the CFPB to ensure appropriate oversight of these activities without creating duplicative and potentially inconsistent supervision, we also believe these areas would benefit from Congressional clarification.

### **III. Other Developments**

At the time of this Committee's Dodd-Frank implementation hearing in September, concerns about foreclosure processing at the largest mortgage servicers were just beginning to command wide attention. In the months since then, the OCC, together with the other federal banking regulators, has taken unprecedented steps to investigate the problem. This section provides an overview of that work, and the related initiative to develop comprehensive national mortgage servicing standards.

#### **A. *Foreclosure Processing Irregularities***

Following reports of irregularities in the foreclosure processes of several major mortgage servicers in the latter part of 2010, the OCC, together with the FRB, the FDIC, and the OTS, undertook an unprecedented project of coordinated horizontal examinations of

foreclosure processing at the 14<sup>9</sup> largest federally regulated mortgage servicers during fourth quarter 2010. In addition, the agencies conducted interagency examinations<sup>10</sup> of MERSCORP and its wholly owned subsidiary, Mortgage Electronic Registration Systems, Inc. (MERS), and Lender Processing Servicers (LPS), which provide significant services to support mortgage servicing and foreclosure processing across the industry. The primary objective of the examinations was to evaluate the adequacy of controls and governance over bank foreclosure processes, including compliance with applicable federal and state law. Examiners also evaluated bank self assessments and remedial actions as part of this process, assessed foreclosure operating procedures and controls, interviewed bank staff involved in the preparation of foreclosure documents, and reviewed approximately 2,800 borrower foreclosure cases<sup>11</sup> in various stages of foreclosure. Examiners focused on foreclosure policies and procedures, organizational structure and staffing, vendor management including use of third parties, including foreclosure attorneys, quality control and audits, accuracy and appropriateness of foreclosure filings, and loan document control, endorsement, and assignment. When reviewing individual foreclosure files, examiners checked for evidence that servicers were in contact with borrowers and had considered alternate loss mitigation efforts, including loan modifications, in addition to foreclosure.

To ensure consistency in the examinations, the agencies used standardized work programs to guide the assessment and document findings of each institution's corporate governance process and the individual case review. Specifically, work programs were categorized into the following areas:

- *Policies and Procedures*—Examiners determined if the policies and procedures in place ensured adequate controls over the foreclosure process and that affidavits, assignments, and other legal documents were properly executed and notarized in accordance with applicable laws, regulations, and contractual requirements.
- *Organizational Structure and Staffing*—Examiners reviewed the functional unit(s) responsible for foreclosure processes, including staffing levels, qualifications, and training programs.
- *Management of Third-Party Service Providers*—Examiners reviewed the financial institutions' governance of key third parties used throughout the foreclosure process.
- *Quality Control and Internal Audits*—Examiners assessed foreclosure quality control processes. Examiners also reviewed internal and external audit reports, including government-sponsored enterprise (GSE) and investor audits and reviews of

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<sup>9</sup> Agencies conducted foreclosure-processing examinations at Aurora Bank, Bank of America, Citibank, EverBank, GMAC/Ally Bank, HSBC, OneWest, JPMC, MetLife, PNC, Sovereign Bank, SunTrust, US Bank, and Wells Fargo.

<sup>10</sup> The interagency examination of MERS was led by the OCC with participation by the FHFA, FRB, FDIC, and OTS. The interagency examination of LPS was led by the FRB with participation by FDIC, OCC, and OTS.

<sup>11</sup> The foreclosure file sample was selected independently by examination teams based on pre-established criteria. Foreclosure files at each bank were selected from the population of in-process and completed foreclosures during 2010. In addition, the foreclosure file sample at each bank included foreclosures from both judicial states and non-judicial states.

foreclosure activities, and institutions' self-assessments to determine the adequacy of these compliance and risk management functions.

- *Compliance with Applicable Laws*—Examiners checked compliance with applicable state and local requirements as well as internal controls intended to ensure compliance.
- *Loss Mitigation*—Examiners determined if servicers were in direct communication with borrowers and whether loss mitigation actions, including loan modifications, were considered as alternatives to foreclosure.
- *Critical Documents*—Examiners determined whether servicers had control over the critical documents in the foreclosure process, including appropriately endorsed notes, assigned mortgages, and safeguarding of original loan documentation.
- *Risk Management*—Examiners determined whether institutions appropriately identified financial, reputation, and legal risks, and whether these risks were communicated to the board of directors and senior management.

In general, the examinations found critical deficiencies and shortcomings in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third party law firms and vendors. These deficiencies have resulted in violations of state and local foreclosure laws, regulations, or rules and have had an adverse affect on the functioning of the mortgage markets and the U.S. economy as a whole. By emphasizing timeliness and cost efficiency over quality and accuracy, examined institutions fostered an operational environment that is not consistent with conducting foreclosure processes in a safe and sound manner.

Despite these deficiencies, the examination of specific cases and a review of servicers' custodial activities found that loans were seriously delinquent, and that servicers maintained documentation of ownership and had a perfected interest in the mortgage to support their legal standing to foreclose. In addition, case reviews evidenced that servicers were in contact with troubled borrowers and had considered loss mitigation alternatives, including loan modifications. A small number of foreclosure sales should not have proceeded because of an intervening event or condition, such as the borrower: (a) being covered by the Servicemembers Civil Relief Act; (b) filing bankruptcy shortly before the foreclosure action; or (c) being approved for a trial period modification.

While all servicers exhibited some deficiencies, the nature of the deficiencies and the severity of issues varied by servicer. The OCC and the other federal banking agencies with relevant jurisdiction are in the process of finalizing actions that will incorporate appropriate remedial requirements and sanctions with respect to the servicers within their respective jurisdictions. We also continue to assess and monitor servicers' self-initiated corrective actions. We expect that our actions will comprehensively address servicers' identified deficiencies and will hold servicers to standards that require effective and proactive risk management of servicing operations, and appropriate remediation for customers who have been financially harmed by defects in servicers' standards and procedures.

We also intend to leverage our findings and lessons learned in this examination and enforcement process to contribute to the development of national mortgage servicing standards. This initiative is discussed in more detail below.

**B. *New National Mortgage Servicing Standards***

The interagency foreclosure processing examinations revealed significant weaknesses in mortgage servicing related to foreclosure oversight and operations. Outside the scope of the foreclosure review, however, we have also seen servicing-related problems arise for borrowers seeking mortgage relief.

Two practices in particular are generally recognized to have adversely affected borrowers seeking to avoid foreclosure. For example, I have questioned the practice of continuing foreclosure proceedings even when a trial modification had been negotiated and is in force – the so-called “dual track” issue. Indeed, the OCC has directed national bank servicers to suspend foreclosure proceedings for borrowers in successfully performing trial modifications when they have the legal ability under the servicing contract to do so. Another significant issue relates to the sufficiency of staffing. Frequently, troubled borrowers find that there is no one individual or team who takes responsibility for monitoring and acting on their loan modification requests. This can lead to lost time, lost documents, and lost homes. These borrowers need to have a single point of contact that they can go to in these situations. And servicers need to have appropriately trained and dedicated staff, reporting to management, with the authority and responsibility to address the borrower’s concerns so they cannot “fall through the cracks.”

But the problems with servicing are not limited to the practices affecting delinquent loans, and recent experience highlights the need for uniform standards for mortgage servicing that apply to all facets of servicing the loan, from loan closing to payoff. The OCC believes that mortgage servicing standards should apply uniformly to *all* mortgage servicers and provide the same safeguards for consumers, *regardless* of whether a mortgage has been securitized. To be meaningful and effective, these standards should be directly enforceable by federal and state agencies rather than rely on the actions of private parties to enforce the terms of servicing contracts affecting a limited class of mortgage loans. A key driver of servicing practices has been and continues to be secondary market requirements. We will not achieve improvements in mortgage servicing without corresponding changes in requirements imposed by the GSEs.

To further this effort and discussion, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and we are now participating in an interagency effort to develop a set of comprehensive and robust, nationally applicable mortgage servicing standards. Our objective is to develop uniform standards that govern processes for:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;

- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;
- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation;
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors;
- Not taking steps to foreclose on a property or conduct a foreclosure sale when the borrower is in a trial or permanent modification and is not in default on the modification agreement; and
- Ensuring appropriate levels of trained staff to meet current and projected workloads.

We are still at a relatively early stage in this process, but the fact that we share these common objectives will help ensure that the agencies can achieve significant reforms in mortgage servicing practices across the board for all types of mortgage servicing firms.

## **VI. Conclusion**

Let me close by assuring the Committee that, as we work to implement the initiatives required by the Dodd-Frank Act, the OCC remains fully engaged in its primary mission of ensuring the safety and soundness as well as the vibrancy of the national banking system.

We continue to closely monitor and evaluate developments in the system. The system is beginning to return to profitability -- though revenue generation and margins are low compared to historical experience. In the large banks, we see a return to balance sheet strength as capital, reserve, and liquidity levels have been re-built over the past three years. Although credit risk remains elevated, we see steady improvements contributing to an overall lower risk profile in the largest banks. Conditions are also stabilizing for community banks. While embedded losses continue to produce bank failures among community banks, the vast majority of community banks continue to play a vibrant role

in the nation's financial system. But, going forward, banks of all sizes will face a business landscape that is significantly changed by post-crisis market developments and by new rules implementing Dodd-Frank. These developments affect both the ability of banks to generate revenue and the costs and viability of particular activities or lines of business. Their efficiency may be affected in the shorter term and their business models in the long run. The OCC is committed to supervising the effects of these changes to ensure the continuing safety and soundness of the national banks we supervise.

I appreciate this opportunity to update the Committee on the work we are doing to implement Dodd-Frank and I am happy to answer your questions.