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**STATEMENT OF**  
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**COMPTROLLER OF THE CURRENCY**  
**before the**  
**FINANCIAL CRISIS INQUIRY COMMISSION**  
  
**APRIL 8, 2010**

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.

## **INTRODUCTION**

Chairman Angelides, Vice Chairman Thomas, and Commissioners, I appreciate the opportunity to appear today before the Financial Crisis Inquiry Commission (“Commission”). The Commission was created to examine the causes of both the financial crisis and the collapse of each major financial institution that failed or was likely to fail if not for the receipt of exceptional government assistance. In this context, the Commission’s letter of invitation asked me to address several specific areas: the roles played in the crisis by federal preemption of state mortgage lending laws and by the Community Reinvestment Act; the impact of the activities of national banks related to subprime lending, both directly and indirectly; changes in laws and regulations governing commercial banks’ authority to conduct asset-securitization activities; and aspects of supervision of Citibank and Citigroup, by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board, respectively. My statement addresses each topic, and is followed by separate appendices discussing each area in more detail, including additional relevant material. It concludes with my thoughts regarding several key lessons learned for the future.

## **CAUSES OF THE CRISIS**

To address the specific topics the Commission has identified, it is essential to place them in the context of key events that ignited the crisis. In particular, the Commission’s questions focus on the problems caused by deep and widespread losses on residential mortgages, especially subprime mortgages. That focus is appropriate given the record foreclosures, large financial institution losses and failures, and market seizures that trace back to problem mortgages.

While the lack of adequate consumer protection contributed to the record levels of mortgage losses, I believe there was a more fundamental problem: poor underwriting practices that made credit too easy. Among the worst of these practices were the failure to verify borrower

representations about income and financial assets; the failure to require meaningful borrower equity in homes in the form of real down payments; the offering of “payment option” loans where borrowers actually increased the amount of their principal owed with each monthly payment; and the explicit or implicit reliance on future house price appreciation as the primary source of loan repayment, either through refinancing or sale.

In short, at the beginning of the 21<sup>st</sup> century, the U.S. system for mortgage finance failed fundamentally. The consequences were disastrous not just for borrowers and financial institutions in the United States, but also for investors all over the world due to the transmission mechanism of securitization.

I believe there are a number of reasons why this happened. One is that, for many years, home ownership has been a policy priority. As a result, when times are good, we as a nation have an unfortunate tendency to tolerate looser loan underwriting practices – sometimes even turning a blind eye to them – if they make it easier for more people to buy their own homes. Against that backdrop, an unhappy confluence of factors and market trends led to even greater problems.

Around the world, low interest rates and excess liquidity spurred investors to chase yields, and U.S. mortgage-backed securities offered higher yields on historically safe investments. Hungry investors tolerated increased risk in order to obtain those higher yields, especially from securities backed by subprime mortgages, where yields were highest. The resulting strong investor demand for mortgages translated into weak underwriting standards to increase supply.

Structured mortgage-backed securities, especially complex collateralized debt obligations, were poorly understood. They gave credit rating agencies and investors a false sense of security that, no matter how poor the underwriting of the underlying mortgages, the risk could

be adequately mitigated through geographic and product diversification, sufficient credit tranching, and other financial engineering.

Cheap credit and easy underwriting helped qualify more consumers for mortgages, which increased demand for houses, which increased house prices. That in turn made it easier for lenders and investors to rely more on house price appreciation and less on consumer creditworthiness as the ultimate source of repayment for the underlying loans – so long as house prices kept rising.

In addition, many mortgage brokers and originators sold mortgages directly to securitizers. They therefore had no economic risk when considering the loan applications of even very risky borrowers. Without any “skin in the game,” brokers and originators had every incentive to apply the weakest underwriting standards that would produce the most mortgages that could be sold. And unlike banks, most mortgage brokers in the United States were virtually unregulated, so there was no regulatory or supervisory check on imprudent underwriting practices.

The rapid increase in market share by these unregulated brokers and originators put pressure on regulated banks to lower their underwriting standards, which they did, though not to the same extent as was true for unregulated mortgage lenders. Indeed, the OCC took a number of steps to keep the national banks we supervise from engaging in the same risky underwriting practices as their nonbank competitors. That made a difference, but not enough for the whole mortgage system.

The combination of all the factors I have just described produced, on a nationwide scale, the worst underwritten mortgages in our history. When house prices finally stopped rising, borrowers could not refinance their way out of financial difficulty. And not long after, we began to see the record levels of delinquency, default, foreclosures, and declining house prices that

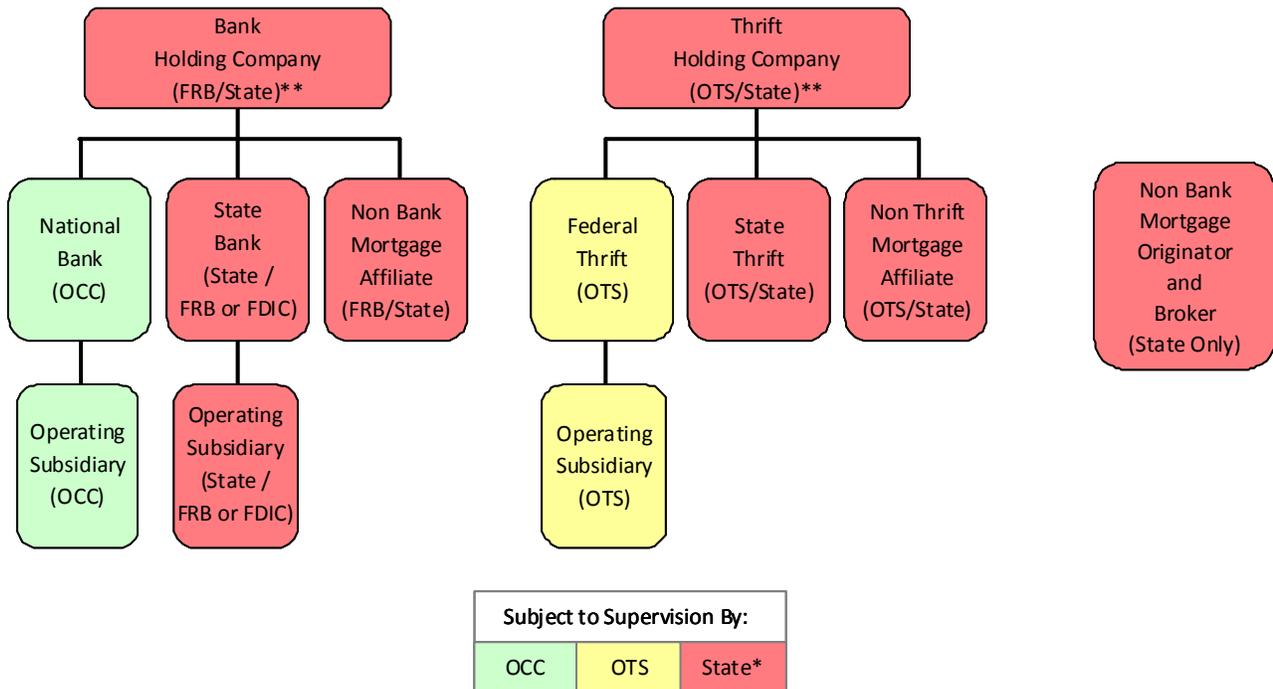
have plagued the United States for the last two years – both directly and through the spillover effects to financial institutions, financial markets, and the real economy.

### **Regulatory Framework for Mortgage Originators**

With that context, let me also briefly describe the regulatory framework governing the different types of institutions that originate residential mortgages, which is important for addressing the Commission’s questions relating to both subprime lending and the role played by federal preemption.

Chart 1 shows a regulated bank holding company, a regulated thrift holding company, and the entities within those holding companies that originate mortgages. It also shows mortgage originators that are not affiliated with a bank or thrift. In addition, the chart indicates the federal regulatory agency and/or the state that has supervisory responsibility for each mortgage originator. The OCC supervises national banks and their operating subsidiaries (the green boxes); these are the only entities over which the OCC exercises supervisory authority. Only the national banks and their operating subsidiaries, and the federal thrifts and their operating subsidiaries (the yellow boxes) are subject to exclusive federal supervision and federal preemption. The red boxes indicate entities that are subject to state supervision, either solely by the state, or jointly by the state and federal agencies; these entities are not subject to federal preemption. That is, state-chartered banks and thrifts and non-bank affiliates of bank and thrift holding companies are subject to both federal and state supervision, while mortgage lenders that are not affiliated with banks or thrifts are subject only to state supervision.

**CHART 1: Regulators of Mortgage Originators**



\* As noted, some mortgage originators are regulated by both state and federal regulators.

\*\* Some (mostly smaller) banks and thrifts are not part of holding companies and are not represented separately here.

**FEDERAL PREEMPTION OF STATE LAW AND THE CAUSES OF THE CRISIS**

As discussed above, the root cause of the mortgage crisis was exceptionally weak underwriting standards. But these weak standards were not caused by federal preemption of state mortgage lending laws.

Basic elements of national bank preemption are described in Appendix A. These principles apply to national banks and their subsidiaries. Preemption is not applicable to state regulated mortgage originators, whether they are state-chartered banks or thrifts, holding company affiliates of banks or thrifts, or lenders or brokers that are unaffiliated with depository institutions (the red boxes in Chart 1). As a result, preemption has done nothing to impede the ability of states to establish and enforce sound mortgage underwriting standards for these

mortgage originators, which, as described below, were collectively the source of the overwhelming majority of subprime loans that are now performing so badly.

Indeed, if it were true that federal preemption caused the subprime mortgage crisis by preventing states from applying more rigorous lending standards to national banks, one would expect that most subprime lending would have migrated from state regulated lenders to national banks. One would also expect that all bank holding companies engaging in these activities that owned national banks would carry out the business through their national bank subsidiaries subject to federal preemption, rather than their nonbank subsidiaries that were subject to state law. But, as described below, neither of these conjectures is accurate: the overwhelming majority of subprime lending was done outside of national banks in entities that were subject to state law, and several large bank holding companies conducted all or most of their subprime mortgage lending in nonbank subsidiaries rather than their national bank subsidiaries.

The essence of federal preemption as applied to national banks is that their banking activities are governed by uniform federal standards, and a federal supervisor, the OCC, regulates national banks to ensure their compliance with these federal standards. Conversely, by express Congressional design, national banks' banking activities are not subject to multiple sets of state banking standards and multiple state regulators. The fundamental concept is that a uniform set of banking standards should apply to national banks wherever they operate in the country.

National banks are subject, however, to various state laws that govern their day-to-day operations and do not restrict their federally authorized banking powers, such as laws governing fraud, contracts, torts, etc. Notably, state anti-discrimination laws and state laws governing the foreclosure process are not preempted.

The lending activities of national banks and their subsidiaries are subject to extensive federal standards and supervision by the OCC. This has been true, for example, in the area of predatory lending, or the set of unscrupulous, unfair, and deceptive lending practices by which lenders exploit borrowers. In the mortgage area, these include such practices as loan flipping, equity stripping, and lending based solely on the liquidation value of the houses underlying the mortgages. Such predatory lending is usually a subset of subprime lending, but it is different from the type of subprime lending that was lawful but involved exceptionally weak underwriting standards.

The OCC has been clear that predatory lending – unfair, deceptive, and abusive lending practices – has no place in the national banking system. We have taken enforcement actions to address such unacceptable credit practices; alone among the federal banking agencies issued detailed guidance to national banks on avoidance of abusive mortgage lending practices; and alone among the federal banking agencies issued enforceable guidelines on abusive, predatory, unfair or deceptive residential mortgage lending practices. Predatory lending practices of the type targeted by many state mortgage lending laws simply did not take root in the national banking system.

More broadly, OCC-supervised national banks have not been especially receptive to even the lawful type of subprime mortgage lending where underwriting standards declined so significantly in the last ten years. This may have been the result of more rigorous credit supervision and reserving practices required in national banks (and indeed, all banks), as evidenced by the fact that a number of large bank holding companies owning national banks often used nonbanks for their subprime lending. For example, HSBC, Citigroup, Wells Fargo, and Countrywide (when it owned a national bank) conducted most of their subprime mortgage lending in holding company affiliates of national banks that were not subject to OCC supervision, but were subject to Federal Reserve and state supervision. It may also have been the

result of the lead the OCC took on an interagency basis to promulgate standards for sound underwriting and consumer protection for nontraditional mortgage products, particularly negatively amortizing “payment option” mortgages, which were rarely provided by national banks.

Whatever the reasons, the result was that national banks and their operating subsidiaries accounted for a disproportionately small share of the subprime mortgage market during the period when the worst subprime mortgages were provided to consumers. The same was true for the market for so-called Alt-A mortgages, the credit quality of which was better than subprime mortgages but worse than prime mortgages. In both cases, overwhelmingly, these non-prime mortgage loans were originated by nonbank lenders that were unaffected by preemption.

More specifically, as described in detail in Appendix B, national banks and their operating subsidiaries accounted for only a small portion of non-prime loans originated in the key years 2005-2007, the peak years for non-prime lending: national banks originated 10.6 percent of subprime loans, and 12.1 percent of non-prime loans overall. Moreover, this figure overstates the portion of non-prime loans originated by national banks where preemption of state law could even have been an issue. The non-prime figure includes originations of both home purchase mortgages and refinance mortgages. Yet many state mortgage lending laws only covered home refinance mortgages and not home purchase mortgages; therefore, preemption could not have been a factor for a significant share of mortgage originations – the home purchase mortgages – in those states.

As discussed in detail in Appendix B, the vast majority of non-prime loans originated during this period were made by entities clearly subject to the jurisdiction of state authorities – lenders for which preemption was not an issue. During the crucial period 2005-2007, for example, analysis of non-prime loan data and HMDA data indicates that 72 percent of non-prime loans were made by lenders subject to state authority (the red boxes in Chart 1).

Moreover, the non-prime loans originated by national banks and their subsidiaries generally have performed better than non-prime lending as a whole: 22 percent of the loans originated by national banks and their subsidiaries subsequently entered the foreclosure process at some time after origination, compared to the market average of 25.7 percent of loans. Apart from credit unions, which were not significant originators, that percentage was the lowest of any other federal regulator and was below the percentage of non-prime loans originated by entities subject to state jurisdiction. The lower foreclosure rates generally indicate that the non-prime loans originated by national banks were of relatively higher credit quality. Analysis of delinquency rates on non-prime mortgage loans also supports that conclusion.

The relatively smaller share of non-prime mortgage originations made by national banks and their subsidiaries, and the relatively better performance of these loans, are hard facts that belie the argument that national banks' federal preemption caused the mortgage crisis. Objective analysis of the data reveals that the overwhelming majority of subprime and Alt-A loans, and the worst of these loans, were made outside the national banking system.

This is not to suggest that national banks had no involvement in the subprime lending crisis. Some national banks did originate poor quality non-prime mortgage loans and have suffered substantial losses as those loans defaulted. Some national banks, like other investors, acquired securitized interests in poorly underwritten subprime mortgages, unduly relying on the investment grade ratings accorded those investments. And some national banks, as discussed below, ended up holding mortgage-related risks that they had not anticipated. Nevertheless, the relatively smaller role that national banks played in originating and purchasing these mortgages is direct evidence that federal preemption was not a principal cause of the subprime mortgage crisis.

### **OTHER ACTIVITIES OF NATIONAL BANKS RELATED TO SUBPRIME LENDING**

The Commission's letter of invitation also asked me to address the nature and scope of the activities of national banks and their operating subsidiaries to indirectly support subprime mortgage lending. This could include activities such as providing warehouse lines of credit to subprime originators and purchasing subprime loans and interests in residential mortgage-backed securities or other structured products. Using the best information available, as discussed in Appendix B, Parts II-IV, it is clear that national banks played a relatively limited role in indirectly supporting independent subprime lenders.

Many of the state supervised subprime mortgage originators that sold mortgages directly to securitizers relied on warehouse lines of credit to finance their lending operations. Warehouse lines of credit are used to finance loans held for sale from origination to delivery into the secondary market. Relative to the overall size of the warehousing market, the warehouse lines of credit provided by national banks to subprime lenders were small. For example, as described in Appendix B, Part III, as of the fourth quarter 2006, large national banks provided approximately \$33 billion of warehouse lines to 60 subprime lenders, compared with a total warehousing market in excess of over \$200 billion in 2006. By the third quarter of 2007, the volume of such facilities at large national banks decreased to \$14.6 billion, compared to a total warehousing market of over \$200 billion in 2007.

Once originated, many of these subprime loans were bundled into residential mortgage-backed securities ("RMBS"), and these RMBS were sold to a broad range of investors, including national banks. As detailed in Appendix B, Part IV, national banks held more than \$700 billion in RMBS during 2005 - 2007, but much of this consisted of securities issued by the government-sponsored enterprises ("GSEs"). National bank holdings of private-label RMBS peaked at \$193 billion in 2007, representing less than 9 percent of the private-label market. But even that percentage is overstated as it relates to nonprime RMBS, because about one fourth of

outstanding private-label RMBS were backed by prime mortgages rather than subprime or Alt-A mortgages.

Another form of national bank involvement with subprime loans is through mortgage servicing. National banks service a sizeable volume of subprime mortgages. The OCC and the Office of Thrift Supervision collect data on first-lien residential mortgages serviced by most of the industry's largest mortgage servicers, the loans of which make up approximately 65 percent of all mortgages outstanding in the United States. At year-end 2009, the largest national bank servicers combined to service approximately \$378 billion in subprime first mortgage loans, yet this represented only approximately 8 percent of the total servicing portfolio. Moreover, servicing of loans does not drive the origination of loans, and the servicing function is distinct from the activities and funding associated with making the loan. Once a loan is originated, it must be serviced, regardless of whether the loan was prime or subprime.

**DATA DOES NOT SUPPORT ASSERTIONS THAT CRA WAS A CAUSE OF THE CRISIS**

Questions also have been raised about whether the Community Reinvestment Act ("CRA") was a cause of the subprime mortgage crisis. As described in more detail in Appendix C, available data does not support that claim. The federal banking agencies have considered this question and, based on available studies, all have concluded that the mortgage crisis cannot be traced to the CRA responsibilities of insured depository institutions. Moreover, based on independent studies of comprehensive home lending data sets, the volume of subprime originations in CRA assessment areas was simply too small relative to the overall mortgage market to be a cause of the crisis.

Of course, not all single-family CRA mortgages performed well, because these loans have experienced the same stresses as most other types of consumer credit. But CRA-related loans appear to perform comparably to or better than other types of subprime loans. For

example, a study by the Federal Reserve Bank of San Francisco concluded that loans made by a CRA-covered lender within its assessment area were markedly less likely to enter foreclosure than loans made in the same area by lenders not subject to CRA. A second Federal Reserve study concluded that single-family CRA-related mortgages originated and held in portfolio under the affordable lending programs operated across the country by partners of NeighborWorks (the Congressionally chartered organization dedicated to neighborhood reinvestment and rehabilitation) have, by any measure of delinquency or foreclosure, performed better than subprime and FHA-insured loans, and they have had a lower foreclosure rate than prime loans.

#### **CHANGES IN REGULATION AND LAWS RELATING TO ASSET-SECURITIZATION ACTIVITIES**

The Commission's letter of invitation also asked about the impact of changes in regulations and laws over the last 25 years that have allowed commercial banking organizations to engage in the issuance and sale of asset-backed and structured investments.

Actually, national banks (and bank holding company affiliates) have long been permitted to sell evidences of debt, including mortgages, to third parties, and no significant change in law or regulation was necessary for them to use asset securitizations as a means of selling interests in pools of mortgage loans (although there were important legal interpretations that clarified this authority). National banks engaged in the first securitization of residential mortgage loans in the 1970s pursuant to statutory language unaltered since the enactment of the National Bank Act in 1864. The same statutes permit national banks to securitize their assets today.

Appendix D provides a detailed summary of the evolution of securitization activities of national banks and companies affiliated with banks. This evolution has been gradual and has taken place against the backdrop of the maturing secondary market for mortgage assets. Over the years, as securitization practices have evolved, Congress and the courts have recognized the authority of national banks to engage directly in these activities. For example, the courts have

upheld, as part of the business of banking, national banks' authority to issue and sell interests in a pool of mortgages as a mechanism for selling loans. Congress, in provisions enacted in the Gramm-Leach-Bliley Act ("GLBA"), expressly recognized and preserved this authority for national banks to engage directly in asset-backed securitization activities. GLBA also repealed key provisions of the Glass-Steagall Act to allow banks to affiliate with full service investment banks that engage extensively in, among other securities activities, asset securitizations.

The result of this evolution in law, regulation, and legal interpretation is that banking organizations, especially larger ones, have become full participants in securitization activities and securitization markets. In practice, most securitizations and structured credit activities have been conducted outside of banking subsidiaries in holding company affiliates registered as broker-dealers and regulated by the SEC and the Federal Reserve. National banks have continued to participate in these activities, however, in various ways, including through credit and liquidity support facilities, as well as through derivatives activities that are often conducted in the bank.

It is plainly true that problems in securitization markets played a key role in the crisis, including, as described above, the negative effect that the "originate to distribute" model had on loan underwriting practices; the severe liquidity problems caused by the seizure in securitizations; and the spread of severe and unanticipated losses to investors around the world. It is also true that banking organizations, as full participants in securitization markets, participated in these securitization problems. And it is certainly true, as described below, that securitization activities caused very substantial losses for some banking organizations, including for some national banks.

Nevertheless, I do not think that the increasing participation by banking organizations in securitization markets over time was a singular cause of the securitization problems described

above. These problems were not unique to bank participants, and indeed appear to have been more severe for the investment banking organizations that were unaffiliated with banks, *e.g.*, Merrill Lynch, Lehman Brothers, and Bear Stearns. The same was true of the incidence of large securitization losses.

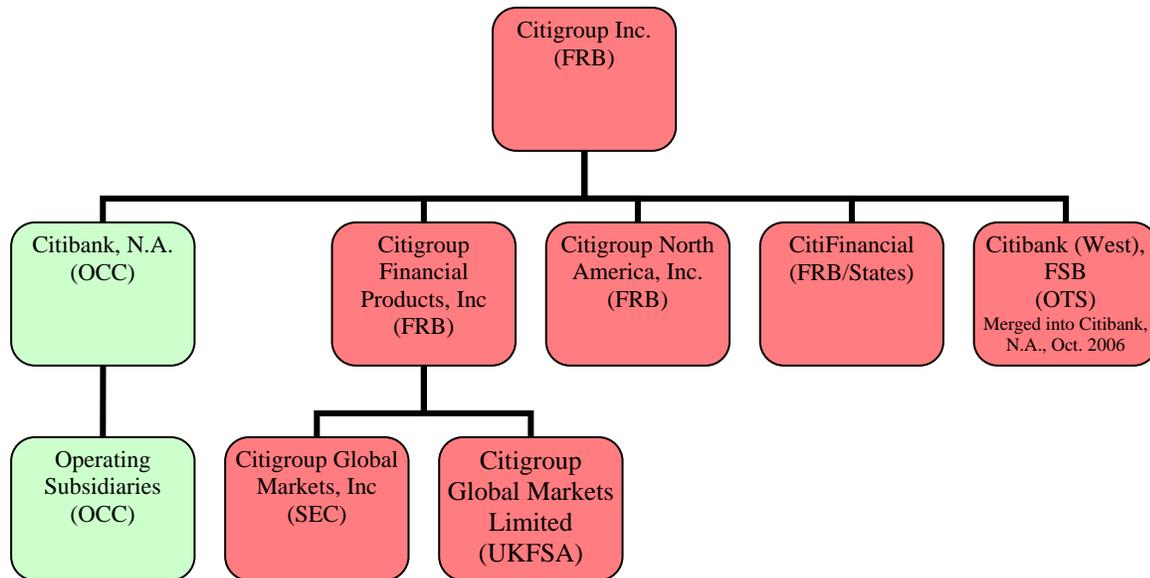
Moreover, I do not believe that restricting or curtailing bank participation in securitization activities or bank affiliation with securities companies is the right policy or regulatory response to securitization problems. Indeed, had GLBA not repealed key provisions of the Glass-Steagall Act to allow such affiliations, it would have been impossible to handle the market confidence problems associated with Bear Stearns and Merrill Lynch, where mergers with banks restored confidence and stability, and Morgan Stanley and Goldman Sachs, where conversions to regulated bank holding companies did the same.

Instead, I believe that other measures have been and continue to be necessary to address abuses in securitization markets, while preserving their benefits. These include accounting and regulatory capital changes, which have already been implemented, to address the problem of off-balance sheet assets and vehicles presenting the same risks as on-balance sheet assets. They also include changes to credit rating agency rating methodology and required disclosures to investors. And they include changes to the incentives to weaken loan underwriting, which I have argued should be addressed in the case of mortgages by the government establishing across-the-board minimum mortgage underwriting standards.

#### **SUPERVISION OF CITIBANK AND CITIGROUP BY THE OCC AND THE FEDERAL RESERVE**

Finally, the Commission asked about aspects of the supervision of Citibank and Citigroup by the OCC and the Federal Reserve. As an initial matter, it is important to be clear, as the chart below depicts, that the OCC's jurisdiction extends only to the national banks within Citigroup, and the subsidiaries of those national banks (the green boxes). The remainder of the company – including

the holding company affiliates in the chart that are referenced in the discussion below – is subject to the jurisdiction of the Federal Reserve, various other federal functional regulators, and state regulators.



As described in detail in Appendix E, some of Citigroup’s exposures to subprime mortgages and securities backed by subprime mortgages arose from the bank’s direct activities. However, a significant part of that exposure resulted from activities of holding company affiliates that, due to extraordinary market events, caused losses in the bank.

For example, through its broker-dealer affiliate, Citigroup warehoused and packaged subprime mortgage loans purchased from third parties (not the national bank) into collateralized debt obligations (CDOs) that were funded through off-balance sheet special purpose vehicles (SPVs). The national bank provided a liquidity backstop for a segment of this business by means of a “liquidity put.” If a liquidity event caused investors in short-term commercial paper issued by the CDO/SPV to refuse to renew their investments at maturity, and no replacement investors could be found, the liquidity put required the bank to step in with replacement funding. Management viewed the likelihood of such an event as extremely remote. However, long before

credit deterioration in the CDOs was officially evidenced through credit rating agency downgrades, the subprime mortgage market meltdown triggered just such a liquidity event as commercial paper investors chose not to roll commercial paper funding. As a result of the liquidity put, and as explained in Appendix E, the bank ultimately assumed a significant amount of “super-senior” credit exposure to CDOs backed ultimately by subprime mortgages. Even though such exposures had received the very highest credit agency ratings, they were subsequently downgraded and produced very large mark-to-market losses.

Citibank also assumed synthetic subprime CDO exposure through its London office. This synthetic exposure was created using credit derivatives on either asset-backed securities or related indices that were based on RMBS. When a structured synthetic CDO was packaged, the highest risk tranches were sold, and the bank retained the super senior position. As with the super-senior exposure to cash CDOs from the liquidity puts, the super senior exposures from the the synthetic CDOs ultimately produced substantial losses.

Additional subprime mortgage losses resulted from a major corporate restructuring completed in October 2006. In this action, Citigroup reduced the number of insured depository institutions from twelve to five as it consolidated approximately \$200 billion of assets into Citibank. Approximately 10 percent of this total consisted of subprime mortgages originated primarily by Citigroup's consumer finance company, CitiFinancial. Many of these mortgages were originated in 2005 and 2006 vintages, when underwriting standards were weakest, and Citibank has taken large losses and made substantial loan loss provisions as a result. Subprime mortgages subsequently issued by Citibank in 2007 have also produced losses.

Despite these losses, and other significant losses arising from other lending activities, Citibank and the other national banks owned by Citigroup have repeatedly performed as well or better than the remainder of the corporate family, as indicated in the chart below.

Net Income \$B	2006	2007	2008	2009
National Banks	\$13.1	\$5.1	- \$6.3	-\$3.0
Non-Banks	\$8.5	-\$1.5	-\$21.4	\$1.4

The national banks reported a net income of \$5.1 billion in 2007, and a loss of \$6.3 billion in 2008, compared to losses of \$1.5 billion in 2007 and \$21.4 billion in 2008 for Citigroup, excluding its national bank subsidiaries. As a result of its performance, as well as its better funding base, Citibank has consistently maintained a stronger position than Citigroup as a whole.

#### **LESSONS FOR THE FUTURE**

There are many lessons to be learned from the crisis to prevent a recurrence of similar events in the future. Financial reform legislation and changes to regulation and supervisory practices, both here and in countries around the world, are intended to do just that, with many sweeping changes proposed in such areas as capital and liquidity requirements, consumer protection, derivatives regulation, resolution regimes for systemically important companies, systemic risk regulation, loan loss provisioning practices, and many others. I have previously testified on these issues in the context of U.S. financial reform, and strongly support moving forward with legislative and regulatory changes.

In the context of the particular questions raised by the Commission for this hearing on mortgage lending, securitization, and the problems at Citigroup, let me close with several thoughts on lessons learned and proposed changes to address them.

First, we need to do more to ensure strong minimum underwriting standards for residential mortgages that are applied across the board to all mortgage originators. I support the

current proposals to empower a federal agency to write strong consumer protection rules that apply uniformly to all providers of financial products and services. But these proposals do not address minimum mortgage underwriting standards, which is a core safety and soundness function for prudential regulators (although it certainly has a bearing on consumer protection as well). I believe the bank regulators, the regulator of government sponsored enterprises, and the Federal Housing Administration should coordinate the adoption of minimum, common sense rules in such areas as required income and financial asset verification, real cash down payments and limits on home equity extraction, and the qualification of borrowers for “teaser rate” loans. In so doing, it is critical that the new rules apply effectively to all mortgage originators and purchasers of mortgages, not just those subject to federal regulation.

Second, steps need to be taken to address differential regulation both among banking regulators and, critically, between regulated sectors and the “shadow financial system” of unregulated sectors. In the area of mortgages, for example, it should not be the case that regulation should differ substantially depending on whether activities are conducted in a bank, where they are most regulated today; in a holding company affiliate, where they are less regulated; or in a mortgage lender or broker unaffiliated with a bank, where they are virtually unregulated. Current proposals to consolidate bank and thrift regulation would help, as would the proposal in the current Senate legislation to ensure unified regulation and supervision of banking activities in a bank holding company, regardless of whether the activities are conducted in the bank or a holding company affiliate of the bank. But we have still not solved the problem of effectively extending comparable standards and supervision to such shadow banking entities as nonbank mortgage lenders and brokers. These unregulated originators simply cannot be allowed to “end run” federal standards to put pressure on regulated lenders to follow suit, which was the very dynamic that caused so much damage during the crisis.

Third, important steps have been taken and need to be taken in the area of securitization. Accounting and regulatory capital standards have already been changed to address the problem off-balance sheet securitization vehicles that never should have been treated as off-balance sheet. Consensus proposals are moving forward, worldwide, to increase required capital for securitized assets, especially re-securitized assets such as CDOs, and to prevent banking organizations from over-relying on credit rating agency ratings in managing the risk of these exposures. The Securities and Exchange Commission will soon propose enhanced disclosure rules for asset-backed securities that will allow investors to do more due diligence on the credit quality of underlying assets, instead of relying exclusively on credit ratings. Other proposals are also moving forward on mandatory risk retention for securitizers, often referred to as “skin in the game” requirements, to improve the incentives for purchasers of loans to insist that the loans are well underwritten. While I support the goal of these skin-in-the-game proposals, which is to improve underwriting quality, there are legitimate concerns with unintended accounting consequences that could make it considerably more difficult to securitize assets subject to such rules. If these concerns cannot be addressed, then I have argued that, at least in the area of mortgages, a better approach to improving underwriting quality would be for the government to directly establish minimum underwriting standards, as discussed above.

Fourth, banking and financial organizations need to substantially improve their ability to aggregate and manage similar risk exposures that take different forms in different parts of their businesses. The crisis showed that risk concentrations can accumulate across product, business lines, and legal entities within a firm, and that complex products containing the same types of risks under different labels can obfuscate aggregate exposures. It also revealed weaknesses in banking companies’ risk identification systems, which failed to capture and aggregate these risks, and in their risk measurement models, which relied on historical correlations that did not

adequately address the risks presented by new forms of structured securities. Banking companies, and their regulators, also failed to appreciate the ramifications of different lending standards and risk tolerances in different segments of large companies, and how banks could end up bearing risks that they would not otherwise directly accept. For example, the losses on subprime CDOs proved in several cases to be a surprise to management that had consciously reduced exposure to direct subprime lending risk. In light of this issue, the OCC, working with other federal regulators, has directed bank management to take a number of steps to significantly upgrade reporting systems and risk management to address this risk aggregation issue.

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I appreciate this opportunity to appear before the Commission, and would be pleased to answer questions.

## **LIST OF APPENDICES**

**APPENDIX A:** Federal Preemption of State and Local Fair Lending and Mortgage Lending Laws

**APPENDIX B:** Activities of National Banks Related to Subprime Lending

**APPENDIX C:** Impact of the Community Reinvestment Act on Losses Incurred by National Banks

**APPENDIX D:** Changes in Laws and Regulations Impacting National Banks Engaging in the Issuance and Sale of Asset-Backed and Structured Investments

**APPENDIX E:** OCC Supervision of Citibank, N.A.