PWG Working Group on Supervision
Questionnaire
August 11, 2009

1. **Regulation and guidance**

- **Overview**

a. What weaknesses have we discovered in our regulations and guidance during the crisis? What changes have been made to address these weaknesses? What further changes to regulations or guidance in these areas should be considered?

As has been documented in a variety of studies and papers published by the President's Working Group (PWG), the Senior Supervisors Group (SSG), the Financial Stability Forum (FSF), and the Basel Committee on Banking Supervision (Basel Committee), lessons learned from the recent crisis have highlighted a number of areas where our supervision and firms' risk management practices need to be strengthened. Some key areas include:

Underwriting Standards:

- The recent crisis has underscored that underwriting standards matter, regardless of whether loans are held or sold. Regulators and firms must be more diligent in ensuring that underwriting standards are not compromised due to competitive pressures from unregulated or lightly regulated firms, by investors who may be willing to take on more risk for incremental yield, or by pressures from various sources to expand activities in targeted products or geographies.

- In this regard, we have emphasized to bankers through the federal banking agencies' Shared National Credit (SNC) reviews and through our on-going supervision, that underwriting standards should not be compromised by competitive pressures. Our most recent underwriting survey indicates that the majority of national banks covered by the survey now use generally the same underwriting standards regardless of the intent to hold or distribute. It also indicates that the majority of the national banks surveyed have strengthened their underwriting standards for both commercial and retail loans.

- The Office of the Comptroller of the Currency (OCC) also strongly endorses proposals that would promote more national, uniform standards for mortgage products that would apply consistently regardless of originator and that would ensure such standards are applied and enforced in a comparable manner, again, regardless of originator. As discussed below, the OCC also believes that it may be appropriate for the federal banking agencies to consider whether there is a need to establish minimum underwriting standards for certain credit products such as residential or commercial mortgages. Such an effort will require more thought and deliberation and may need to be held in abeyance until there is more clarity on whether and what types of standards for residential mortgage products may be proposed either legislatively or through the various regulatory initiatives currently under consideration.

- To improve our ability to monitor credit quality trends at the largest national banks and to identify potential trends that could pose systemic risks to the industry as a whole, during fiscal year (FY) 2009 the OCC awarded contracts to several data aggregators to collect, validate, and aggregate data on home equity, credit card and large corporate syndicated credits. These efforts build off of the highly successful Mortgage Metrics project that the OCC initiated in FY 2008.

Identification and Management of Risk Concentrations:

- The recent crisis highlighted that risk concentrations can accumulate across product, business lines, and legal entities within a firm. It also illustrated that complex product structures containing the same types of risks under different labels and in different booking units, such as certain types of collateralized debt obligations (CDOs) and various off-balance sheet funding structures, can obfuscate certain exposures and risks. The crisis revealed weaknesses in banks' use of risk measurement models where models of portfolio credit risk relied too heavily on historical correlations and therefore did not adequately address the risks from exposures to highly-rated senior CDOs and other structured securities.

- Similarly, banks' internal stress tests generally failed to fully capture the risks that could be posed from various "tail" events and from off-balance sheet structures that were legally separate from the firm but that the firm ultimately supported in order to maintain relationships with counterparties, funds providers, and investors. Many stress tests failed to fully estimate the potential severity and duration of stress events and/or focused on a single line of business.

- Various reports by the FSF, SSG and Basel Committee have identified steps that supervisors and firms need to take to improve their overall risk management practices. The OCC, along with FRB and other global regulators, is benchmarking major financial players against these risk management practices. In addition, the recent revisions to Pillar 2 requirements for banks operating under the Basel II capital framework will require enhanced firm-wide risk oversight, enhanced procedures to identify and manage risk concentrations and off-balance sheet exposures, sound stress testing practices, and sound compensation practices that incorporate the FSF's "Principles for Sound Compensation Practices." Within the largest national banks, we are directing banks to improve their stress testing capabilities and strengthen their enterprise-wide risk management. We would note that other changes that have recently been announced also may significantly affect banks' use of various securitization and off-balance sheet conduits. These include the Basel Committee's recently announced enhanced capital provisions for certain re-securitizations under Basel II and Financial Accounting Standard (FAS) 166/167 as discussed below.

Liquidity:

- The shutdown of various markets underscored the importance of maintaining a cushion of asset-based liquidity and the need for robust liquidity contingency plans. Many banks' liquidity plans assumed that there would be a continuously ready market for highly-rated assets and/or failed to fully anticipate the liquidity demands resulting from their "originate-to-distribute" loan pipelines.
- A number of actions have been taken or are underway to address some of these shortcomings. These include:
  - The Basel Committee's September 2008 guidance on "Principles for Sound Liquidity Risk Management and Supervision" and its on-going work to secure international

convergence on supervisory regulations governing the liquidity of internationally active banks.

- The federal banking agencies' recent request for comment on the proposed *Interagency Guidance on Funding and Liquidity Risk Management*. The agencies developed the guidance to provide consistent expectations on sound practices for managing funding liquidity risk and to strengthen liquidity risk management practices. This guidance, when appropriate, brings the agencies' liquidity risk principles into conformance with the international guidance recently issued by the Basel Committee.
- At the OCC, we conduct ongoing reviews of liquidity through standardized liquidity monitoring across all of the large national banks. As part of our liquidity monitoring, we developed and implemented a template for the monthly collection of information about balance sheet exposures, cash flow sources and uses, and financial market risk indicators. This information is used to produce a monthly report that summarizes the liquidity risk profile, based on levels of risk and quality of risk management, for the 15 largest national banking companies. We do a similar exercise for the mid-size banks on a quarterly basis.

Enhanced Capital Buffers:

- Although all large national banks met (and continue to meet) current regulatory capital minimums, the events of the past two years have highlighted areas where global capital standards need to be strengthened. Much of this work is being undertaken through the Basel Committee, and the OCC is an active participant in those efforts. As recently announced by the Basel Committee, these efforts include:
  - Higher capital requirements to capture the credit risk of complex trading activities, including a stressed value-at-risk requirement designed to dampen the cyclicality of the minimum regulatory capital framework; and
  - Higher capital requirements for re-securitizations to better reflect the risk inherent in these products, and for short-term liquidity facilities to off-balance sheet conduits.
  - Banks will also be required to conduct more rigorous credit analyses of externally rated securitization exposures and to comply with higher supervisory standards for firm-wide risk governance and risk management.

- These measures are part of the Basel Committee's broader program to strengthen capital by:
  - Promoting the build-up of capital buffers that can be drawn down in periods of stress;
  - Strengthening the quality of bank capital;
  - Introducing a leverage ratio backstop to Basel II for countries that currently do not have a leverage-based capital ratio; and
  - Revisiting the current market risk capital framework in recognition of the limitations of value-at-risk models given the increased complexity and degree of credit risk that is now found in many trading book assets.

- In addition to these efforts, as noted in Comptroller Dugan's recent testimony before Congress, the OCC also supports the concept of imposing more stringent prudential standards, such as requirements for higher capital and stronger liquidity, on systemically significant financial firms to address both their heightened risk to the system and the competitive advantage they could enjoy from being designated as systemically significant.

- Beyond regulatory capital minimums, the OCC expects national banks to maintain sufficient capital buffers to support the overall risks of their institution. It is clear that the previously noted shortcomings in banks' stress testing processes also adversely affected their ability to adequately plan for potential capital needs under extreme adverse market conditions. The OCC participated with the Federal Reserve Board (FRB) and Federal Deposit Insurance Corporation (FDIC) to conduct a comprehensive, forward looking assessment of the financial condition of the nation's 19 largest bank holding companies to determine if those companies had sufficient capital buffers to withstand losses and sustain lending during a severe, sustained economic downturn scenario. We are emphasizing to national banks our expectations that they maintain robust capital planning systems.

Overreliance on Ratings for Structured Products:

- While credit ratings provide useful information to bankers and regulators, it is clear that bankers, regulators, and the rating agencies themselves put too much reliance on the various credit enhancements that were designed to support various structured products such as asset-backed securities (ABS) CDO securitizations and thus failed to fully recognize the leverage and concentrated nature of the underlying credit exposures embedded in these securities. We are emphasizing to national banks that they need to conduct sufficient due diligence of any structured product that they may purchase and that they need to have an understanding of the underwriting characteristics and risks of the assets underlying these securities. We are also emphasizing that excessive holdings of similar complex structured financial instruments, even if rated AAA, is not sound concentration risk management. We support efforts being undertaken by the Securities and Exchange Commission (SEC) to reform and enhance the transparency of methodologies used by nationally recognized statistical rating organizations (NSROs) and to prohibit potential conflicts of interest.

Dampening Procyclicality:

- One of the problems that has impaired banks' ability to absorb increased credit losses while continuing to provide appropriate levels of credit is that their levels of loan loss reserves available to absorb such losses were not as high as they should have been entering the crisis. One reason for this is the current accounting regime for building loan loss reserves, which is based on the concept that loan loss provisions are permissible only when losses are "incurred." The OCC, under the Comptroller's leadership as co-chair of the FSF's Working Group on Provisioning, has led efforts to adopt a more forward looking "life of the loan" concept so that banks could build bigger loan loss reserves when times are good, which would then be available to absorb increased losses when times are bad.

This effort complements the Basel Committee's initiative to introduce standards that would promote the build up of capital buffers that can be drawn upon in periods of stress.

Accounting Standards:

- The recent crisis highlighted a number of issues with regard to certain accounting standards, including the application of fair value accounting in illiquid or inactive markets and the treatment of financial instruments deemed to be other-than-temporarily impaired. As noted in the OCC's May 2009 testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, the OCC has supported the efforts by the SEC and accounting standard setters to provide additional guidance on these two important issues.

- The recent adoption by Financial Accounting Standards Board (FASB) of two new accounting standards, Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140* (FAS 166) and Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167) are potentially more far-reaching in their application to various structures and practices that affected banks and the markets during the recent disruptions. These standards become effective for an entity's first fiscal year beginning after November 15, 2009, and will have a significant impact on many banking institutions. In particular, many securitization transactions will lose sales accounting treatment and thus securitized assets will need to be reflected on banks' balance sheets. These changes may have a material affect on how banks structure transactions, manage risk, and on the levels of loan loss reserves and regulatory capital they hold for certain assets.

- The OCC, along with the other federal banking agencies, will be issuing a notice of proposed rulemaking that will amend our capital rules to address these accounting changes. The proposed rule would eliminate the provision in the current rules that permits banks that are required to consolidate an asset-backed commercial paper (ABCP) program under U.S. generally accepted accounting principles (GAAP) to exclude the consolidated ABCP program assets from risk-weighted assets. More generally, the rule would also retain GAAP as the foundation for calculating risk-weighted and leverage capital requirements such that banks will be required to hold both risk-based and leverage capital against any exposures that will be required to be reflected on the balance sheet under these accounting standards.

- We are also closely monitoring and will be assessing the potential impact of the FASB's recently announced plans to propose that all loans be presented at fair value in the balance sheet. We understand that an Exposure Draft on this proposal may be released by year-end. Our initial concerns are that this would expand the use of fair value without addressing measurement issues that arose during the recent market disruption.

Regulatory Reform Proposals:

- In addition to the various items noted above, as the Comptroller recently testified before the House Financial Services Committee and the Senate Banking, Housing and Urban Affairs Committee, the OCC supports key features of the President's regulatory reform proposal that would further strengthen the regulatory framework and fill gaps that have been exposed, including:
  - Establishment of Financial Stability Oversight Council;
  - Enhanced authority to resolve systemically significant financial firms;
  - Designation of Federal Reserve as the consolidated supervisor of systemically significant financial firms; provided that the responsibilities and accountability of the prudential supervisor of any bank subsidiaries in such firms are not undermined and that nonbank affiliates in such firms receive supervision comparable to the supervision of a bank in the firm engaged in the same activities;
  - Enhanced consumer protection standards and enhanced supervision and application of those standards to currently unregulated and lightly regulated firms; and

- Stronger regulation of payments systems, hedge funds, and over-the-counter derivatives, such as credit default swaps.

- These proposals, coupled with the actions already underway as outlined above, will go a long way to address many of the weaknesses and gaps in the current system that the OCC and other supervisors have identified. There also are potentially additional steps that could be explored. These include:
  - More explicit minimum underwriting standards for certain loan products, such as residential and commercial mortgage loans, through stricter debt service capacity, down payment requirements and/or loan-to-value ratios; and
  - Explicit limits on the concentration that a bank could have to a particular industry or market segment, similar to the loan limits we currently have for loans to an individual borrower, or more aggressive capital charges when such concentrations exist.

The benefits of such actions would need to be carefully weighed, however, against the potential costs and unintended consequences that may result. For example, the imposition of explicit concentration limits could result in a de facto regulatory allocation of credit away from various industries or markets. Such limits could also have a disproportionate impact on smaller community banks whose portfolios by their vary nature tend to be concentrated in their local communities and, often, particular market segments, such as commercial real estate.

b. Do we need to reconsider the balance between guidance and rules?

The appropriate balance between guidance and rules will depend on the nature of the issue or activity being addressed. In general, we believe supervisory guidance, as opposed to explicit rules, is the most effective way to address many risk management issues. Guidance allows needed flexibility in the application of those principles to individual institutions whose size, scope, and complexity of operations vary considerably. Designing a "one-size fits all" regulation could be onerous for small, less complex banks, but be insufficient for large, complex banking organizations. In addition, prescribing specific risk management practices or systems via regulation could impede advances in risk management. On the other hand, we recognize that many of the individual items discussed above (revisions to current regulatory capital requirements, more formalized liquidity thresholds for large institutions, and uniform national standards for certain consumer products) will require rules rather than supervisory guidance. Similarly, if we elect to impose more explicit underwriting standards or concentration limits, we would likely need to issue rules, rather than guidance, to ensure consistent and enforceable application of those standards and limits.

c. Any other comments?

We believe it is important to implement a process that results in clear, consistent guidance for similar products that is consistently applied across all financial market participants.

2. Execution of supervision

- **Consolidated supervision of large, complex firms**

Critics have argued that supervisors failed to identify key risks developing at large, complex financial institutions. In some cases, they argue, where supervisors did identify key risk areas, they failed to react with timely and appropriate measures.

a. *What processes does your agency have in place to identify and continuously monitor emerging risks at major financial institutions?*

The foundation of the OCC's supervisory efforts at the major financial institutions we regulate is our continuous, on-site presence of examiners at each of our 15 largest banking companies. These 15 banking companies account for approximately 89% of the assets held in all of the national banks under our supervision. The resident examiner teams are supplemented by subject matter specialists in our Policy Division and PhD economists from our Risk Analysis Division trained in quantitative finance.

The OCC's Large Bank program is highly centralized and structured to promote consistent uniform coordination across institutions. The onsite teams at each of our 15 largest banks are led by an Examiner-In-Charge (EIC) who manages a staff of seasoned examiners, generally with experience across numerous banks and multiple business cycles. The EIC reports directly to the Deputy Comptrollers in our Large Bank Supervision Office in Washington, DC. The Large Bank Deputy Comptrollers (LBDCs) are in ongoing communication with the Large Bank EICs, in addition to holding monthly calls and quarterly face-to-face meetings with all Large Bank EICs. To enhance our ability to identify risks and share best practices across the Large Bank population, we have established a program of examiner network groups in Large Banks. There are eight main network groups (Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk and Compliance) and numerous subgroups. These groups facilitate sharing of information, concerns and policy application among examiners with specialized skills in these areas. The EICs and leadership teams of each of the network groups work closely with specialists in our Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to well-defined, as well as, emerging issues.

The Large Bank Supervision program enables the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors. This process enables our examiners to focus on those products and services posing the greatest risk to the bank through risk-based supervision. Resident examiners apply risk-based supervision to a broad array of risks, including credit, liquidity, market, compliance and operational risks. Supervisory activities are based upon supervisory strategies that are developed for each institution that are based on the dimensions of risk presented by that institution, and with appropriate focus on the more complex and risk sensitive banking activities. Although each strategy is tailored to the risk profile of the individual institution, our strategy development process is governed by supervisory objectives set forth annually in the OCC's bank supervision operating plan. Through this operating plan, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concerns. With the operating plan as a guide, EICs develop detailed strategies that will direct supervisory activities and resources for the coming year. Each strategy is reviewed by the appropriate Large Bank Deputy Comptroller. Our risk-based supervision is flexible, allowing strategies to be revised, as needed, to reflect the changing risk profile of the supervised institutions. We have a Quality Assurance group within our Large Bank program that selects strategies to review as part of a supervisory program review to ensure reasonableness and quality supervision.

Our supervisory goal is to ensure banks have sound risk governance processes commensurate with the nature of their risk-taking activities. Risk management systems must be sufficiently comprehensive to enable senior management to identify and effectively manage different types of risk throughout the firm. Therefore, examinations of our largest banks focus on the overall integrity and effectiveness of risk management systems. Our supervisory activities at individual banks are often supplemented with horizontal reviews of targeted areas across a group of banks. These horizontal reviews can help us to identify emerging risks that, while not posing a significant threat to any one institution could, if not corrected, pose more system-wide implications for the industry.

The first step in risk-based supervision is to identify the most significant risks and then to determine whether a bank has systems and controls to identify, measure, monitor and control those risks. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. This is accomplished through our supervisory process which involves a combination of ongoing monitoring and targeted examinations. The purpose of our targeted examinations is to validate that risk management systems and processes are functioning as expected and do not present any significant supervisory concerns. Our supervisory conclusions, including any risk management deficiencies, are communicated directly to bank senior management. Thus, not only is there ongoing evaluation, but there is also a process for timely and effective corrective action when needed. To the extent we identify concerns, we "drill down" to test additional transactions.

These concerns are then highlighted for management and the Board as "Matters Requiring Attention" (MRAs) in supervisory communications. As described in more detail in b., below, MRAs often are line of business specific, and can be corrected relatively easily in the normal course of business. However, a few MRAs address more global concerns such as enterprise risk management, compliance deficiencies, or company-wide information security. We also have a consolidated electronic system to monitor and report outstanding MRAs. Each MRA is assigned a due date and is followed-up by on-site staff at each bank. If these concerns are not appropriately addressed within a reasonable period, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

We have a staff of specialists who provide on-going technical assistance to our on-site examination teams. Our Risk Analysis Divisions include more than 40 PhD economists and mathematicians who have strong backgrounds in statistical analysis and risk modeling. These individuals frequently participate in our risk management examinations to help evaluate the integrity and empirical soundness of banks' risk models and the assumptions underlying those models. Our policy specialists assist by keeping abreast of emerging trends and issues within the industry and the supervisory community. Staffs from our Credit and Market Risk (CMR), Operational Risk, and Capital Policy units have been key participants and contributors to the ongoing work of the SSG, FSF, PWG and Basel Committee.

To summarize, our Large Bank program is organized with a national perspective and is structured to provide rigorous, expert, consistent and uniform supervision across the large national bank population. Large national banks supervised by the OCC are the financial anchor and typically the dominant firm within the holding company as a whole. Because of our supervisory approach, they are by far the most intensely regulated part of the largest bank holding companies, which has translated into generally lower levels of losses of banks within the holding company versus other companies owned by that holding company – including those large bank holding companies that have sustained the greatest losses. Indeed, some of the largest national banks have been the source of strength that enabled their holding companies to acquire significant problem thrift institutions and broker-dealer operations, thereby providing critical support to the financial system more generally.

We also are actively pursuing additional steps to strengthen our supervision of Large Banks. For example, as noted in our response to question 1, we are obtaining granular, loan level information on mortgage, home equity, credit card, and large corporate credits from the largest national banks. This information will help us identify underwriting and performance trends of individual banks as well as across the industry. No other agency has a comparable supervisory initiative. Also, in 2008, we established a Financial Markets Group within the agency and tasked them with the build-out of a market intelligence program. Their mission is to seek out early warning signs of emerging and/or systemic risk issues. This team is comprised of highly experienced bank examiners and subject matter specialists hired from the industry, and they spend considerable time meeting with bank investors, bank counterparties, bank competitors, bank analysts, and other relevant stakeholders. Their work is discussed with members of the OCC's senior management team on a regular basis and discussed in detail with the OCC's National Risk Committee (NRC) members, who represent all lines of bank supervision within the OCC, as well as our legal and economics teams.

b. *What processes does your agency have in place to make sure that risks and vulnerabilities at individual firms that have been identified are escalated within the supervisory function?*

Based on targeted examinations and ongoing supervision activities, the OCC's EIC assesses the risk exposure from 9 categories of risk (credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic, and reputation). For 7 of the 9 risks, the process identifies the quantity of risk, quality of risk management, aggregate risk, and direction of risk. For the 2 remaining risks, strategic and reputation, only aggregate risk and direction of risk are assessed. This Risk Assessment Summary (RAS) is performed at least quarterly but is updated more often if warranted. The RAS is communicated to the Large Bank Deputy Comptroller.

A completed RAS is the foundation for planning. Conclusions from the RAS are used to develop supervisory strategies, which outline planned supervisory activities and help ensure that sufficient resources are available to address bank risks and fulfill statutory requirements. Strategies are dynamic documents that are reviewed and updated frequently based on company, industry, economic, legislative, and regulatory developments. The strategy development process allows for another opportunity for bank risks and issues to be communicated between onsite examiners and OCC management.

Annually, the OCC provides the bank's board of directors a Report of Examination (ROE) that conveys the overall condition and risk profile of the bank, and summarizes examination activities and findings during the supervisory cycle. This ROE is created by the bank EIC and reviewed and signed by the Deputy Comptroller. The ROE communicates the composite and CAMELS ratings; however, these ratings are adjusted as necessary throughout the cycle.

OCC management receives a comprehensive quarterly report. The report contains an executive summary as well as detailed quantitative analysis covering supervisory areas such as capital, the allowance for loan and lease losses (ALLL), asset quality, earnings, liquidity, balance sheet summaries, sensitivity to market risks, and Basel II implementation.

Our supervisory process includes an escalation process for concerns identified during the examination cycle. Most often, concerns are highlighted for management and the board as MRAs in supervisory communications. MRAs include practices that deviate from sound governance, internal control, and risk management principles that may adversely affect the bank's earnings or capital, risk profile, or reputation if not addressed. In addition, MRAs include practices that result in substantive noncompliance with: laws and regulations; internal policies, controls, or processes; OCC supervisory guidance; or supervisory conditions imposed in interpretive letters or licensing approvals. Often these MRAs are line of business specific, and can be corrected relatively easily in the normal course of business. MRAs may also address more global concerns such as enterprise risk management or company-wide information security. For tracking purposes, we have a consolidated electronic system to monitor and report outstanding MRAs. Each MRA is assigned a due date and is followed-up by on-site staff at each bank. The most significant MRAs are typically highlighted in the ROE. If concerns are not appropriately addressed within a reasonable period, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

The OCC utilizes a Washington Supervision Review Committee (WSRC) to ensure bank supervision and enforcement policies are applied effectively and consistently, and to advise the Senior Deputy Comptroller, Mid-Size/Community Bank Supervision (M/CBS) and the Senior Deputy Comptroller, Large Bank Supervision (LBS) on bank supervision and enforcement cases and issues. The WSRC reviews enforcement actions and may also be asked to advise on certain cases. Membership consists of a core group representing the OCC's staff. In some cases, the group will include representatives of other divisions. Individuals with special expertise or knowledge may also be asked to attend when actions involving their area of expertise are under consideration. The WSRC serves as an advisory committee to the Senior Deputy Comptrollers for M/CBS and LBS, providing its recommendations on the proposed supervision and enforcement actions presented to it. The Senior Deputy Comptrollers for M/CBS and LBS make the final decision for their respective cases.

c. *What processes does your agency have in place to review examination reports and examiners?*

Examination findings, reported through ROEs or other supervisory letters, are reviewed and approved by the EIC before they are communicated with management. ROEs for banks in the

OCC's Large Bank program are reviewed and signed by a Large Bank Deputy Comptroller. Regulatory risk ratings and risk assessments also must be reviewed and approved by the by a Large Bank deputy comptroller. The supervisory office review ensures that the ROE fully supports the CAMELS ratings and risk assessments; appropriately conveys findings, conclusions, Matters Requiring Attention, and the overall message to bank management and the board; and is consistent with internal information systems.

Examination findings and other key supervisory information are maintained in the OCC's electronic supervisory databases. The OCC's Committee on Bank Supervision (CBS) members and their key staff, in addition to the relevant line supervisors, have access to these databases. Key members of the OCC senior management team, including the Comptroller and CBS members, receive periodic briefings on the condition of each of the largest national banks. In addition, the OCC's Large Bank Supervision program has an internal quality assurance processes to provide independent evaluation of compliance with established policies and procedures, to promote consistent application of those policies, to make recommendations for enhancements and to encourage dissemination of best practices. The OCC's Ombudsman's office will review examination products upon request in cases where banks believe the OCC's conclusions are in error.

Integral to the vigor and quality of our supervisory program is our commitment to enhance the skills, knowledge, and abilities of OCC employees. The OCC's Performance Management Program is designed to:

- Provide employees with a clear understanding of what is expected of them.
- Align employee performance objectives with organizational objectives and priorities.
- Provide managers with the mechanisms to recognize and reward excellent performers.
- Create a framework for managers and employees to have an ongoing dialogue about the employee's job performance and developmental needs.
- Improve and enhance employee performance and assist the OCC in developing resources needed for the future.
- Differentiate levels of performance to provide an equitable basis for personnel actions.

All OCC employees are evaluated annually. Performance measures and objectives are established each year to align with the OCC's Strategic Goals as well as set up individual performance measures. In addition to the annual evaluation, supervisors meet with each employee at the mid-point of the performance year to discuss their progress. New employees are evaluated at least 4 times during the probationary period.

d. *What were the strengths and weaknesses in the processes described above in 2a, 2b, and 2c? Did they identify key risks and result in timely and appropriate actions in the run-up to the current financial crisis – particularly with respect to risks posed by complex structured products, securitization, and nontraditional mortgage lending? Which important emerging risks were identified early but did not get appropriately addressed? Are there other examples where these processes worked well or broke down? What changes has your agency made or is it considering to these processes?*

We believe the supervision process described in 2a, 2b, and 2c is fundamentally strong and we were taking actions to address the build up of risks and the lax risk management practices that our examiners were seeing within the system. For example, we led the interagency efforts that resulted in the 2003 guidance on Credit Card Account Management and Loss Allowance practices, which addressed a number of inappropriate account management, risk management, and loss allowance practices. Although we faced considerable criticism by some that this guidance and actions could have negative repercussions on bank profitability, consumer spending, and the broader economy, we thought it was critical that the continuing decline that we were seeing in minimum payments be curtailed. We took steps to enforce this guidance across the national bank population notwithstanding complaints we heard that non-national bank credit card issuers were not being held to similar standards. In 2004 we alerted banks to credit card marketing and account management practices that we believed could entail unfair or deceptive acts or practices. We also took strong supervisory actions against national banks that were issuing secured credit cards and payday loans that we believed took advantage of subprime borrowers by essentially offering them minimal credit availability but charged the consumer excessively high fees. As a result of our actions, this business was essentially driven out of the national banking system, but because other operators were not subject to similar action, the product continued to be offered to consumers through other channels.

We took similar action in the residential mortgage arena. Early in this decade, the OCC became concerned about the growth of exotic mortgages that carried the potential for a big payment shock for consumers and we responded in an escalating fashion, both privately and publicly. Through various speeches and outreach events we began alerting the industry to our concerns. Early in 2004, we adopted regulations that addressed and prohibited various practices associated with predatory lending and prohibited national banks from making mortgage loans based predominantly on the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. We followed this new rule with more detailed Guidelines for Residential Mortgage Lending Practices in early 2005. And in 2005, even though home prices were still escalating, we instructed our examiners to more aggressively address the risks of these products within the national banks. As a result of our intervention, when compared to their strong overall presence in the mortgage market, national banks were far less significantly involved in either subprime or payment option ARM mortgages. Here again, however, the lack of uniform national standards that applied to *all* mortgage originators meant that much of this business was conducted in other entities that in turn resulted in competitive pressure on national banks.

However, even though national banks were not as significantly involved in originating subprime and payment option products, they were not immune from the problems caused by these products over time. For example, subprime-related exposures came back into the national banks through CDOs that had been arranged and structured by nonbank holding company affiliates. This failure to see and aggregate comparable risks arising in different parts of the entire banking organization is an issue that supervisors and firms must address. Going forward large, complex financial institutions should have management information systems capable of aggregating counterparty risk across all business lines, legal entities, and geographies. Similarly, while our supervisory posture on payment option mortgages kept them from becoming a dominant product in national banks, the acquisition by the holding companies of large national banks of other types of companies engaged in these activities – without any significant input from the OCC – resulted in a backwash of the risks of these activities into the national banking system, directly or indirectly (*e.g.*, the acquisition by the parent company of Wachovia national bank, of a thrift, Golden West, whose large payment option portfolio created enormous problems for the combined organization).

More generally, as discussed in other sections, we and the industry did not anticipate the historic downturn in U.S. home prices, the loss of confidence across U.S. and global capital markets and the severity and rapidity of the liquidity crisis and its subsequent impact on the banking system. In addition to the adverse macroeconomic environment, idiosyncratic issues such as unforeseen concentrations arising from failures in the originate-to-distribute model resulted in further downward pressure on earnings, capital and liquidity positions, at some companies. As discussed elsewhere in this questionnaire, we identified a number of lessons learned (better aggregation of risk concentrations; more robust stress testing, capital and liquidity planning; better cooperation with other functional regulators; and less reliance on rating agency ratings) and are changing our supervisory programs to more fully address these issues.

e. How does your agency identify large, complex firms? What factors are considered or should be considered in the future?

This designation is largely based on the bank's asset size and whether other special factors that affect its risk profile and complexity are present. For instance, a national bank may be included in the large-bank program if it exhibits a number of the following features:

- the bank is a mandatory Basel II institution;
- the bank and its affiliate national charters are part of a much larger banking organization (company) and proper supervision requires extensive coordination with other regulators;
- the company is a dominant player within its market;
- the company has large asset management operations;
- the company performs significant international activities;
- the company owns unique operating subsidiaries;
- the company offers high-risk products and services; or
- the company conducts sophisticated capital markets activities.

We continue to reassess and adjust these criteria as necessary.

f. What is your agency's process for setting and implementing supervisory priorities for individual institutions? What are your lessons learned from the current crisis? What changes has your agency made or is it considering?

Supervisory priorities are set forth in the annual operating plan of the OCC's Committee on Bank Supervision (CBS). Through this operating plan, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concerns. With the operating plan as a guide, staff responsible for individual banks (examiners-in-charge (EIC) for larger national banks and portfolio managers for community banks) develop detailed strategies for each national bank that direct supervisory activities and resources for the coming year. Each strategy is reviewed by the appropriate Large Bank Deputy Comptroller or M/CBS Assistant Deputy

Comptrollers or Deputy Comptrollers. The OCC's risk-based supervision is flexible, allowing strategies to be revised, as needed, to reflect changing risk profiles or industry and economic conditions.

The setting of priorities and creating supervisory strategies with sufficient flexibility to alter as conditions warrant have served us well, but we continually look for ways to make improvements. As noted earlier, the OCC is enhancing its loan-level data gathering to improve systemic data analysis. We have also established a Financial Markets Group to improve our ability to identify early warning signs among markets and financial players of emerging risk issues.

g. *How does your agency conduct supervision of non-depository subsidiaries of banks, bank holding companies, and financial holding companies? What are your lessons learned? What changes has your agency made or is it considering? Are sufficient resources available and allocated to this task?*

Bank operating subsidiaries are supervised as an integral part of the bank, and are subject to the same regulatory standards and supervisory oversight as their parent bank. The only exception are so-called "functionally-regulated" subsidiaries, e.g., SEC-regulated securities brokers and dealers, state-regulated insurance agencies and companies, where the OCC's ability to supervise such companies has been specifically limited by Congress. The holding company parents of banks and non-bank holding company subsidiaries of those parent companies are different and are supervised by the Federal Reserve and the states is some important respects. The OCC relies on the Federal Reserve to conduct supervision of these firms and share the conclusions, risks, or concerns to the extent they affect the national banks. As previously noted, a key lesson learned is the need to fully assess and understand how the activities and risks of the non-bank affiliates and subsidiaries may affect the bank. As we have seen, in times of stress, the entities outside of the national bank can severely affect the bank, whether through exposure and subsequent losses that come through the "back door" as we saw with certain CDOs; through heightened liquidity pressures on the bank arising from the need to shore up various off-balance sheet conduits; acquisitions by the holding company of significant nonbanks engaged in banking activities; etc. Examples that come to mind are risks in the broker/dealer positions, structured investment vehicles (SIVs) held in the holding company subsidiaries, finance companies, and non-traditional mortgage products held in thrifts.

Related to this concern is the critical need to ensure that similar products and activities are subject to consistent and uniform regulation, standards, and examination, regardless of where they are conducted. We believe our examination programs and resources are sufficient to apply and enforce these standards within national banks and their operating subsidiaries. We are concerned that, historically, non-bank subsidiaries of bank holding companies have not been subject to bank-like examination and supervision, even when they engage in the same activities as affiliated banks. This has resulted in different and less rigorous standards applied outside the bank than inside, and regulatory arbitrage in some cases, *e.g.*, in the area of subprime lending, where large bank holding companies that conducted these activities frequently conducted them in nonbank subsidiaries of holding companies, where they were lightly regulated, rather than in banking subsidiaries, where they were much more intensively regulated.

Similarly, many firms that provided mortgages and other banking products operate in the so-called "shadow banking" system and are subject to little, if any, rigorous supervisory oversight. For this reason, OCC has supported national underwriting standards for mortgages and has also urged that if a new Consumer Finance Protection Agency were to be established, its examination and oversight functions should be focused on nonbank financial providers, supporting the efforts of the states to supervise the state-regulated firms that played such a telling role in the subprime mortgage crisis.

h. How does your agency identify and evaluate the risks of new products to individual institutions? To what extent does your agency rely on examiner evaluations of banks' internal risk management processes for evaluating new products? What are your lessons learned, particularly with respect to complex structured products and nontraditional mortgages? What changes has your agency made or is it considering, to your approach to new products?

The OCC's expectations for new products are outlined in OCC Bulletin 2004-20, "Risk Management of New, Expanded, or Modified Bank Products and Services." In summary, we expect national banks to conduct full due diligence of the risks, including reputation risk; applicable legal, regulatory, and accounting standards; and required skill sets and risk management controls, before they enter into any new product. The OCC considers basic sound practices to include having a new product approval policy that requires review and approval by all operational areas affected by such transactions, and is evidenced by an audit trail of approvals before a new product is introduced. We also expect banks to maintain effective risk management systems, including applicable management information systems (MIS), and that those systems are adjusted as the product expands or changes. Finally, we expect banks to have effective performance monitoring systems and reports to ensure that the activity is meeting anticipated operational, profitability and strategic goals and that risks are within established thresholds.

OCC examiners verify that banks have policies and processes in place to ensure that management identifies and reviews all risks associated with new activities or products, and that the infrastructure and internal controls necessary to manage the related risks are in place.

The OCC expects the risk management process to reflect the size and the complexity of the product or service offered. Although the board may delegate performance of managerial duties to others, it has the ultimate responsibility for ensuring that the bank is run in a safe and sound manner. In fulfilling its responsibilities, the board or its designee must ensure that a new, expanded, or modified bank product or service is consistent with strategic goals.

A key lesson learned is that new products or practices, when viewed in isolation, may mask systemic risk when combined with other risk factors or practices. For example, risk layering in the mortgage market occurred with the origination of non-traditional mortgage products combined with low doc/no doc loans, and borrowers taking out simultaneous closed-end second lien loans (e.g., piggy back loans) or subsequently taking out second lien home equity loans without the knowledge of first lien lenders. In addition, borrower capacity to repay non-traditional mortgages was not adequately assessed due to over-reliance on behavioral scoring models that did not adequately capture risk layering, and lack of verification of borrower total debt and income sources. This risk layering in the mortgage market, coupled with rapid home price appreciation, masked borrower default risk, and exposed borrowers to payment shock when teaser rates re-set and to excessive leverage when home values declined. To address these risks the agencies issued guidance on non-traditional mortgages and the OCC conducted a horizontal review of large bank mortgage originators to assess compliance with this guidance.

OCC examiners generally conduct separate targeted examinations of the new activity/product approval process, and may verify approvals of specific activities and/or products during targeted examinations of specific business activities.

When a new product or activity requires explicit agency approval, such conditions are often imposed as part of the approval process and are enforceable conditions under 12 U.S.C. § 1818 and the OCC has implemented a formal process for evaluating new products that require legal or licensing review or approval. This process involves review by appropriate supervision, legal, and licensing staff and applies to requests for legal opinions (and licensing applications) that are "novel and/or complex." While there are no standards for determining which cases are "novel/complex," it is expected that the process will apply to requests that: 1) would address a novel legal issue such as permissibility of a new activity or 2) raise significant novel supervisory issues.

One of the first steps in this process is that the Law Department or Licensing identifies and involves the appropriate supervisory managers from Large Bank or Mid-Size Community Bank Program, as appropriate, and the relevant Supervision Policy unit or units (Supervision Managers) involved in the review of the bank's request. Law (with Licensing as appropriate) and Supervision Managers will consult to identify key issues presented by the request (including key risk issues), types of additional information needed, and any preliminary legal, supervisory or policy concerns. Where possible, they will develop a consensus recommendation about how the request should be handled and a plan for further analysis, additional information to be sought from the bank or other sources, and/or other steps they believe are appropriate to determine how, or if, the request will be answered. The Law and Supervision Managers also inform the Chief Counsel and the Senior Deputy Comptroller for their respective areas of the proposal.

One of the key issues discussed by the review team is what supervisory conditions and requirements should be placed on the approvals and what limitations on the new activities. Such conditions, requirements and limitations are one of the key devices the OCC uses to assure that there are adequate risk management systems implemented and maintained with respect to new activities. For example, for many new activities, OCC will require that before the bank may commence the new activities, it must receive the written non-objection from the bank's examiner in charge that the bank has satisfied the supervisory requirements and expectations stated in the approval letter, such as implementing specified risk management systems and processes.

The draft legal interpretation or licensing approval for a novel/complex case is subject to extensive internal review by senior OCC managers. Ultimately the Senior Deputy Comptrollers for Large Bank Supervision, Supervision Policy, and Mid-Size/Community Bank Supervision are asked to provide their comments and input. Novel and/or complex activities will not be permitted if the Senior Deputy Comptroller with supervisory responsibility for the bank objects to the bank in question conducting the activity.

i. *To what extent does the supervisory process incorporate an explicit focus on factors such as "tail risks," inherent limitations of quantitative risk management, and forecasting uncertainties? What specific "tail risks" are considered (e.g., credit, liquidity, asset prices) and how are co-movements in tail risk incorporated into the analysis? What recent changes has your agency made or is it considering?*

A key goal of our supervision is to assess tail risks and to try to answer the question: "how bad could it get?" In credit, we assess or conduct downside analysis on individual assets, on portfolios, and on various asset classes. We conduct ALLL sensitivity analysis. For liquidity, we assess contingency funding plans. And we review models and value-at-risk (VAR) limits for market-based exposures.

However, we and the industry underestimated the magnitude and effects of a global loss of confidence and subsequent liquidity crunch as well as the severity of the credit cycle that is still underway. Indeed, this crisis had the character of a 200-year flood, striking so unexpectedly and with such severity that no modeling exercise could be expected to predict its timing or impact. Needless to say, our downside calculations proved to be too benign. We put too much emphasis on simple VAR models that did not adequately measure tail risks. We were less than effective in our aggregation of risk concentrations across the entire enterprise. This includes aggregation of different, but correlated activities and products. We and the industry over-relied on quantitative models that were overly biased to recent history and did not sufficiently incorporate adjustments for changes in underwriting and risk characteristics of the assets being modeled.

Firm wide stress testing that incorporates co-movements of risk factors in a manner that creates tail risk is probably insufficient at most institutions. The OCC is considering ways to take the concepts used in the government stress tests, further develop them, and incorporate them into our supervision (not as a stand alone exercise, but as an explicit part of supervision by the on-site teams).

Specific actions we are taking:

- Directing banks to improve their risk concentration aggregation processes
- Requiring more robust model validations and stepping up our challenges of quantitative models and their key assumptions
- Requiring enhancement of pipeline and warehouse management practices to provide better measurement of the downside risks
- Calling for augmentation of liquidity contingency funding plans
- Working toward better cooperation with other functional regulators. Problems in our institutions often included risk concentrations that spanned multiple legal entities regulated by different functional regulators. To get unified view of the risk, better cooperation and coordination is necessary.
- Requiring better analysis of enterprise risk concentrations that were previously not readily apparent (e.g. indirect exposure to monolines)

- Increasing our focus on low probability high impact loss events such as COLI/BOLI wraps, stable value pension fund wraps, and other products that have similar tail risk characteristics.

j. *How does the supervisory process address the risk of prolonged periods of market illiquidity? How is such risk measured? What changes has your agency made or is it considering in its approach to such risk?*

As previously noted, the OCC has actively been involved in various work groups, such as the SSG, the FSF, the Joint Forum, and the Basel Committee. These groups have each issued reports and the OCC is taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations. One key area is liquidity risk management.

The sudden and complete shutdown in many traditional funding markets, in the U.S. and across the world, was not contemplated by most contingency funding plans. This period of market disruption has magnified the risks associated with underestimating liquidity risk exposures and improperly planning for periods of significant duress. The SSG report specifically noted that better performing firms carefully monitored their and on- and off-balance sheet risk exposures and actively managed their contingent liquidity needs. As previously noted, the OCC has developed a liquidity risk monitoring program to standardize liquidity monitoring information across our large bank population and provide more forward looking assessments. We developed a template for the monthly collection of information about balance sheet exposures, cash flow sources and uses, and financial market risk indicators. Our resident examiners complete this template each month and then work with our subject matter specialists in the Credit and Market Risk (CMR) division in Washington to produce a monthly report that summarizes the liquidity risk profile, based on levels of risk and quality of risk management, for 15 banking companies in our Large and Mid-size bank programs. These risk profiles include a forward looking assessment of liquidity maturity mismatches and capacity constraints, both of which are considered early warning signals of potential future problems.

In September 2008, the Basel Committee issued a report on, "Principles for Sound Liquidity Risk Management and Supervision." This report represents critical thinking that was done by supervisors in over 15 jurisdictions on the fundamental principles financial institutions and supervisors must adopt to provide appropriate governance of liquidity risk. OCC subject matter specialists in our CMR division were actively involved in the development of this important paper on risk management expectations, and are now contributing to the second phase of this work which is focused on identifying key liquidity metrics and benchmarks that may be valuable for enhancing transparency about liquidity risk at financial institutions. As noted earlier, the OCC and other U.S. federal banking agencies have incorporated these principles into the proposed *Interagency Guidance on Funding and Liquidity Risk Management* guidance that has been published for public comment.

The OCC reviews bank liquidity on an ongoing basis and we have incorporated these valuable lessons into our evaluations. Our strategic bank supervision operating plan for 2009 directs examiners at our largest national banks to focus on banks' firm-wide assessments of their liquidity risk and the adequacy of their liquidity cushions (short-term liquid assets and collateralized borrowing capacity) to meet short and medium term funding needs, as well as on the effectiveness of their liquidity risk management, including management information systems related to rollover risk and funding concentrations, and contingency funding plans.

k. How much of supervision is currently "audit" related (i.e., checking assertions of the firms themselves) vs. independent analysis? Is this the right balance?

During regular on-site examinations, the OCC completes a series of testing procedures to confirm banks' compliance with prudential regulations and other legal requirements. In addition, compliance with some rules is monitored on an ongoing basis through the collection and analysis of financial and structure reports that must be filed. The OCC confirms that banks also maintain policies and procedures designed to ensure their compliance with applicable laws and regulations. These internal compliance programs are evaluated by examiners during on-site examinations. The OCC has issued extensive supervisory guidance to evaluate compliance programs and specific areas including internal controls, audit, consumer protection, fair credit reporting, home mortgage disclosure, real estate settlement procedures, and anti-money-laundering, among others. We believe our current model provides for proper balance of monitoring with independent testing and analysis.

On-site examinations address all key areas of a bank's operations, including capital adequacy, asset quality, management strength and quality of oversight from the board of directors, compliance with laws and regulations, quality and sustainability of earnings, the adequacy of liquidity sources to support ongoing cash needs, and sensitivity of earnings and capital position to market risk. These reviews incorporate independent verification of the effectiveness of risk management, internal controls, management reporting, and overall corporate governance. In addition, examination procedures may be directed to validating the reliability and accuracy of financial data reported to the agencies. As previously noted, we also have MIS systems that facilitate monitoring compliance with MRAs.

l. What does your agency do to assure that supervisors continue to enforce strong risk management practices – for example, underwriting standards – during long periods of market stability and limited credit losses? What lessons has your agency learned?

The OCC assesses (1) how well management understands the risk involved in business activities; (2) the communication of risk appetite to management and the board; and (3) the adequacy of policies, procedures, and controls. Examiners review the quality of aggregated management information provided to management and the board to test whether these reports are comprehensive and timely and accurately reflect the level and nature of the risk. To assess management and board involvement in credit-risk oversight, OCC examiners will review minutes of board meetings and meetings of board committees, management committees, and other records, as needed. Examiners also determine whether the board approves and regularly reviews the adequacy of significant policies and procedures for identifying, measuring, monitoring, and controlling credit-risk activities. Finally, for each risk-taking activity, OCC examiners review compliance with supervisory guidance for risk management as well as compliance with internal risk management strategies and policies by conducting interviews, reviewing internal policies and procedures, and performing transaction testing. The OCC applies these processes consistently including during periods of stability.

The banking agencies' annual SNC reviews is an important mechanism for monitoring underwriting standards in the syndicated commercial loan market where loans are originated for distribution or sale. During the 2007, 2008 and 2009 SNC reviews OCC and Federal Reserve examiners collected underwriting data on a sample of newly originated syndicated commercial loans to identify structurally weak loans and their characteristics, and track risk rating migration of these loans. This syndicated loan underwriting data base is a new supervisory tool that will help to document changes in underwriting standards over the credit cycle and benchmark current underwriting standards to the weakest underwriting observed.

In addition to the SNC underwriting data base, the OCC collects loan-level data using standard data definitions on first lien residential mortgages, second lien residential mortgages and home equity loans, credit cards and large corporate commercial loans. This comprehensive loan-level credit data is a new supervisory tool that allows the OCC to conduct comparative analysis of credit risk across large banks in a more timely manner and identify potential systemic risk issues. In addition, these large comprehensive credit data sets provide the OCC with the ability to conduct more forward looking analysis to determine what could happen to credit quality under varying economic scenarios and assumptions. The OCC's loan-level data collection process also provides us with a window into the large bank credit MIS and quality of credit risk data. Periodic feedback is provided to large bank reporters on the quality of their data submissions and progress made to institutionalize these new regulatory reporting requirements.

Lessons learned include reinforcement that basic credit fundamentals such as debt service capacity, equity or capital commitments by borrowers, quality of collateral, and the integrity/character of the borrower prevail across the business cycle. Further, no asset class is risk free as evidenced by home prices entering a deep decline with supply/demand imbalances or a weak economy (prospectively, low coupon U.S. Treasuries can decline significantly after we emerge from recession) so risk concentrations need to be identified and controlled to guard against low-probability but high impact events. Substantial relaxation of underwriting standards in products sold to third parties, in comparison to products held on balance sheet, proved to be an ineffective process for managing risk, and we have since begun requiring banks to use comparable underwriting standards for both. The time honored dangers of rapid growth and excessive leverage are also lessons re-learned.

The key issue in supervision of underwriting standards was less about recognizing the weakening of standards, which regulators did, and which occurs in all benign periods of the credit cycle. Instead, the issue was the point and extent to which regulators should have intervened to stop underwriting standards from weakening further. This is always a difficult judgment call in benign times when there is little evidence of significant, institution-threatening loss. In addition, intervention is not likely to be effective unless it applies to all market participants. In this respect, the decision whether to intervene was made much more difficult by the lack of regulatory oversight over credit providers in the shadow banking system, as well as, at times, differences in views among the four federal bank regulators.

m. *Any other comments?*

- **Supervision of smaller institutions**
  In many ways, smaller institutions face different challenges from larger institutions.

a. *What lessons has your agency learned from the crisis with respect to the supervision of smaller institutions?*

Although the financial crisis has clearly affected banks/banking companies in different ways, smaller institutions have not been immune from the effects of the poor economy. Even within the community bank population, the impact of the crisis has varied, in part, by an institution's location, size, business model, and the decisions made by management and boards of directors before and during the downturn – and this highlights some of the important lessons to be learned.

Smaller institutions rarely offer as broad a range of products as the nation's very largest institutions. For this reason, concentrations are often present and are reflected within the bank's asset base (lending and investments) and its funding base. The crisis has driven home the importance of soundly managing these inherent concentrations and the risks they pose. Institutions with more robust risk management practices, and with in-depth knowledge of the particular asset class in which the bank is concentrated, have often fared better than others and we need to keep pressing smaller banks to make improvements in these areas. Yet we have also learned that there are some types and levels of concentrations that, in a severe or protracted downturn, may simply be too high for the bank to absorb, notwithstanding the presence of robust risk management systems. For example, some banks that had sound underwriting standards and internal controls for their commercial real estate (CRE) operations are nonetheless facing significant strains simply due to their level of concentrations in this sector and the cascading effects that the downturn is having on their borrowers and projects, including bankruptcies of major tenants, lack of available permanent financing, and distressed collateral values. While more thorough and robust stress testing of these portfolios can improve bank management's ability to identify these risks, such actions alone do not assure the bank's ability to absorb the potential losses from them. As we noted in our response to question 1, one approach to address this problem might be to impose more stringent guidelines or caps on concentrations. However, as we also noted, such a step can have unintended consequences, including a de facto allocation of credit to certain sectors. Given the importance that community banks play to our rural communities, such an action could also leave those communities and certain sectors of borrowers without a ready source of credit. As an alternative, we believe we need to more aggressively use our existing authority to require higher capital when we see significant concentrations.

Through the years we have also learned the importance of effectively communicating with bankers about the problems facing their institutions and how we expect them to confront those problems without exacerbating the situation. Delay or denial about conditions – by bankers or supervisors – is not an effective strategy. This can require tough conversations with bank management – telling them to be realistic in their evaluation of borrowers and to take appropriate actions, including additional loan loss reserves or charge-offs and reducing concentrations, when warranted. We did have these conversations with many of our banks and directed them to take corrective action. For example, we conducted horizontal reviews of commercial real estate across some of our mid-size and community banks with higher CRE concentrations. These horizontal reviews allowed us to identify and convey best practices more effectively, and provide consistent advice on additional measures that we believed needed to be taken. We subsequently tiered our entire community bank portfolio by their CRE concentrations and conducted targeted asset quality reviews at those banks whose exposures exceeded the thresholds outlined in the 2006 interagency guidance on CRE concentrations. Our goal in conducting these reviews has been to get bank management to identify problems and take corrective action sooner, rather than later. Clearly, there are some national banks where our interventions may have been too late, not forceful enough, or where the scope of problems was too large to overcome. In those cases, our goal has been to seek a timely resolution of the bank. There have been other instances where, because of our aggressive actions, bank management chose to convert out of the national banking system. As we discuss more fully in our response to questions about regulatory arbitrage, we do think charter conversions to avoid supervisory action has been a problem and thus we strongly supported the FFIEC's recent *Statement on Regulatory Conversions*.

b. *What processes does your agency have in place to make sure that concentration risks and vulnerabilities at individual firms are identified and escalated for attention within the supervision function?*

As previously discussed, we develop a supervisory strategy for each individual national bank, regardless of size. The key to establishing these strategies and through them, the appropriate scope of the examination, is a strong knowledge of the bank, including knowing the strengths and weaknesses of the management team, the risks to which the bank is exposed, and the business strategy employed. Concentrations and other potential vulnerabilities identified through previous examination efforts or through our off-site monitoring and surveillance tools are incorporated into those strategies and examination activities.

In addition to our on-site examination activities, we have a number of additional tools to identify and monitor potential concentrations and vulnerabilities. Throughout the examination cycle, contact is made with bank management periodically, usually on a quarterly basis. These contacts include, but are not limited to, discussions of the bank's quarterly performance and changes in its balance sheet where concentrations and other vulnerabilities could come to light if not already known. We also use various reports based on the regulatory Consolidated Reports of Condition and Income (Call Report) filters and screens to identify national banks that may be potential outliers with regard to their interest rate, liquidity, or credit exposures. This includes the OCC's Canary system that provides an analysis of certain measures and benchmarks for each national bank with our midsize and community bank portfolios. Within this application financial risk measures and benchmarks have been established for credit risk, interest rate risk, and liquidity risk. These static financial measures are leading indicators of risk-taking that are designed to be concise and intuitive. For banks that already exceed the median level for a benchmark, the application also includes a rate of change (ROC) measure that focuses attention on rapid movement. This measure helps to identify those banks moving rapidly toward a financial risk position, but is only calculated for those banks already at a meaningful starting point. The application allows examiners and analysts within our supervisory offices to pull reports both on individual banks as well as a portfolio of banks.

As in our Large Bank program, examiners perform a RAS for every national bank within our Midsize and Community bank program, which assesses the bank's risk exposure across 9 categories of risk. The risk assessment system is updated and recorded in our electronic supervisory databases whenever the examiner becomes aware of changes in the bank's risk profile. The risk assessments are always formally communicated to the bank at the conclusion of the supervisory cycle through the ROE, but may also be included in other communications to the bank if appropriate. Any changes in the aggregate risk assessments during the supervisory cycle are required to be formally communicated to the bank at the time they are identified. Examiners also are directed to list and discuss various forms of concentrations within the ROE. Consistent with our Large Bank program, the ROE must be reviewed and approved by the appropriate supervisory office before it is given to bank management.

c. *How should the supervision of smaller, simpler firms differ from supervision of larger, more complex firms?*

While banks of every size are subject to similar risks, we recognize that the breadth and complexity of risks, and the systems needed to manage those risks, typically increase with the size and scope of a bank's operations. To reflect these differences, the OCC aligns its supervisory programs and activities into two primary lines of business: our large bank program and our mid-size and community bank program. Although the core supervisory processes and fundamental risk management principles are the same for both, some of the tools and procedures we use in our examinations, as well as the types of policies, risk management, and controls we would expect banks to maintain, may vary across these two lines of businesses. For example, the OCC and the other federal banking agencies have elected not to apply the Basel II capital standards to all U.S. banks. In general, we believe that while all banks should be expected to comply with the same general risk management principles, there are differences in how those principles can and should be affectively applied, based on an institution's size and complexity.

d. *How does your agency allocate resources between large and small banks and other financial firms? For example, does your agency allocate resources based on charter, assets, or some measure of complexity? If your agency charges examination fees, do assessments on large firms subsidize small firms or vice versa?*

Examination resources are primarily driven by the risk of the institution, not size. Nevertheless, supervising smaller banks is more labor intensive than supervising large banks, while larger banks usually have more complex risk profiles – by the scope, breadth and variety of their activities – in turn require more agency resources per bank and higher levels of specialized expertise.

The OCC has developed and implemented a specialty skills program that, linked with our line of business resource planning system helps us match and allocate our examination resources with our supervisory priorities and the complexity of the risks of the various national banks. Through the specialty skills program, we can identify examiners with various levels of advanced skills in key risk areas (asset management, bank technology, compliance, commercial credit, retail credit, capital markets, mortgage banking, and operational risk) and match them to examination assignments based on the complexity of the work to be performed.

The OCC is authorized under the National Bank Act to impose and collect assessments as necessary or appropriate to carry out its responsibilities. Pursuant to this authority each national bank pays an assessment to the OCC twice each year, generally based on the bank's total assets. The assessment is based on a sliding scale, recognizing that as institutions increase in size, the OCC's costs associated with those institutions is not proportional to their size. However, OCC assessments must cover not only the costs of direct supervision of national banks, but, as the statute provides the costs of the agency's overall operations, including indirect functions and administrative costs supporting the agency mission. Much of the legal and supervisory resources in headquarters are dedicated to the complex legal and policy issues facing larger institutions, which bear more of this cost. As noted, the largest banks do subsidize the supervision of the smaller banks, in one sense, as over two-thirds of our examiners supervise community and mid-size institutions. However, our training efforts are centered in community banks and, viewed from the long term of carrying out the responsibilities of the OCC, it is this training that allows examiners to develop the necessary skills to supervise the largest and most complex national banks.

The OCC has the ability to charge for extraordinary examination efforts, which we have done in rare cases, and an assessment "surcharge" is imposed where banks have CAMELS ratings that are indicative of increased supervisory issues which require enhanced supervisory attention.

e. *Any other comments?*

- **Examination programs**
  Critics have argued that supervisors in the run-up to the current crisis failed at the basic tasks of a bank examiner: for instance, testing credits and monitoring liquidity.

a. *What lessons has your agency learned from the crisis with respect to the execution of the basic tasks of the examination function?*

We believe our examination model is sound and we do perform a fair degree of transaction testing. However, in retrospect, we could have stepped in earlier and more forcefully when we saw deterioration in underwriting, risk layering in loan products, escalation of risk appetites, and build up of concentrations. Many, albeit not all, of the risks that led to the crisis were identified at least to some extent by our examiners. In many cases, we issued guidance to examiners and warnings and guidance to the industry (e.g. deteriorating loan underwriting standards and build-up of CRE concentrations). However, we underestimated the negative potential outcomes of these risks such as the historic decline in U.S. home values and the sudden loss of confidence across the U.S. and global capital markets. In areas where we did not identify risks well, it was often because we over-relied on NRSRO ratings or did not sufficiently aggregate related risks across all business lines and legal entities. Lessons learned include the following:

- We may need to become more prescriptive with underwriting practices in consumer credit, for example banning or severely limiting stated income and negative amortizing loan products.

- We need to be more critical earlier when underwriting practices inevitably deteriorate in the benign periods of the credit cycle.

- We may need to limit concentrations or at least require more capital for banks which have these concentrations.

- We should not over-rely on NRSRO ratings, particularly when complex products (CDOs, etc.) are involved.

- We need to work more closely with other regulators.

b. *Did supervisors rely too heavily on banks' internal models? Did examiners do enough loan sampling; did they do enough model testing and validation?*

Supervisory reliance on banks' internal models has not been a notable problem during recent turmoil because the supervisory process depends only indirectly on the results of internal models. Supervisors make use of risk reports designed and generated by a bank as part of their ongoing assessment of risks at the firm; in some cases, those reports reflect the results of internal models of risk. However, supervisors do not rely on internal risk reports uncritically, whether model-based or not, and resident examiners generally have a solid grasp of the reliability and relative quality of those reports. When models are central, supervisory strategies include a review of the models by PhD economists and mathematicians from the OCC's Risk Analysis Divisions, experts who have the specialized quantitative modeling skills needed for such reviews. Model reviews typically focus on a bank's ability to manage "model risk", the risk that a model used in a particular context may fail to perform as expected. Careful probing of the bank's model validation, in accordance with expectations articulated in OCC Bulletin 2000-16, usually is the foundation of those model reviews. The OCC expends considerable resources on the examination and review of model use and validation by national banks, and is widely recognized as a leader in this regard within the supervisory community.

However, model risk, like any other risk banks face, never can be eliminated entirely; it also never appears in entirely predictable areas, since otherwise it would have been mitigated or controlled in advance. Model failures that represent the downside of model risk did play a substantial role during recent market turmoil. To the extent that those model failures led to significant losses, with the benefit of hindsight, decisions made using those models, and measures of risk computed from those models, were wrong. In some cases this was due to misuse of models – models developed for use in one context (such as for valuing corporate bonds) were used in a different and inappropriate context (valuing structured financial products based on subprime residential mortgages). In other cases, model developers or model users failed to recognize that external market conditions were changing – many mortgage models did not adequately account for changes in underwriting standards and borrower behavior. In still other cases, the data available to calibrate models did not reflect the full range of possible outcomes – for example, did not reflect market movements as dramatic as recently observed, or did not adequately capture correlation or co-movement of underlying risk factors – and no steps were taken as part of the modeling process to adjust for such deficiencies in the data.

Observed model failures have led banks and supervisors to strengthen model validation practices. In some cases, models that had not been well validated were used by banks for decision making; this is a clear deficiency in validation practices. However in many cases potential model failures may not have been identified through the additional statistical testing emphasized in much conventional validation. As noted above, many of the model failures stemmed from misuse of models, or from failure to anticipate changing market conditions or adjust for deficiencies in developmental data. This reemphasizes the need for a broader view of the "validation" process, in which model use by a bank is accompanied by a sound assessment of the sources and magnitude of model risk, and competent modelers with appropriate incentives and influence within the bank provide appropriate oversight of the validation and use of models. These are all concepts that are addressed within OCC Bulletin 2000-16, but recent model failures have reemphasized their critical importance, both for banks and supervisors, and current efforts by the OCC focus on strengthening validation in this regard.

The central concern has not been overreliance on internal models by supervisors; rather, it has been reliance by supervisors, and more importantly by banks, on internal models without appropriate skepticism about the results of models. Model use must better recognize the full extent of model risk, assess the consequences of potential model failure due to that risk, and include rigorous model validation that reflects a comprehensive view of validation processes as articulated in the OCC's existing supervisory guidance and examination practices.

c. *Did the risk-focused approach to supervision help or interfere with the identification of emerging issues?*

Properly executed, risk-focused supervision enhances and does not hinder the identification of emerging issues, because the goal is to pay attention to the risks that could produce the greatest negative impacts on the bank. The challenge is how to properly identify and calibrate the magnitude of these risks. Meeting this challenge requires a fair degree of ongoing monitoring of the institution's and industry's activities combined with sufficient flexibility in the supervisory program to allow for changes in examination activities as circumstances change. The OCC uses a balanced mix of seasoned judgment and quantitative skills in developing and implementing an effective risk-based supervision process.

d. *Any other comments?*

- **Systemic risk and the Financial Services Oversight Council**
  Supervisors are tasked to protect the safety and soundness of individual financial institutions. The Treasury recommended in its white paper the creation of a Financial Services Oversight Council to take a broader view, considering risks to the financial stability of the system as a whole. The Council would have a staff at the Treasury. Its mandate would be to facilitate information sharing and coordination among agencies, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness, and provide a forum to discuss cross-cutting issues among regulators. An analogy could be the National Intelligence Council, which reports to the Director of National Intelligence, is staffed by expert National Intelligence Officers, works

closely with staff at the intelligence agencies, and reports on emerging issues and broad trends.

a. What are your suggestions for how the Council should implement these responsibilities?

The Financial Services Oversight Council's (FSOC) general role would be to identify and monitor systemic risk, and it would have authority to gather the information necessary for that mission, including from any entity that might pose systemic risk. The Council should leverage, to the maximum extent possible, information and analysis from the prudential regulators across the financial system. It should implement its responsibilities by conducting regular meetings that encourage input and discussion from its committee membership on emerging risk trends and issues. The FSOC should prioritize potential systemic issues and direct staff to prepare research and analysis to identify risk issues with potential systemic implications. It also could provide a venue or mechanism for resolving differences of opinions among regulators. We believe that having a centralized and formalized mechanism for gathering and sharing systemically significant information, and making recommendations to individual regulators, makes good sense. Information on potential systemic risk issues should be shared with the appropriate regulatory agencies along with recommendations for dealing with those that cut across agencies or industries. FSOC research and analysis could be issued publicly so the industry and financial markets would be informed on any potential systemic risk issues across the financial sector. Additionally, to close any potential regulatory gaps, the FSOC could issue guidance for risk issues that cross industry sectors. This would help ensure potential supervisory or risk concerns at all financial firms are appropriately addressed in a clear and consistent manner.

b. How would your agency view its role in helping to implement the Council?

The OCC views itself as an active collaborator with the Treasury and other federal financial regulators in helping implement the council, both through direct participation on the Council and through our role as the prudential supervisor of the national banks that form the financial lynchpin of most of the financial firms that would be regarded as systemically significant under the new framework or which the Council would be a part. The OCC would be an active participant by providing input to the Council on relevant policy and risk issues as well as any emerging issues to facilitate sharing and coordination among supervisors, discussing important issues among financial regulators, and identifying any gaps in regulation. This input would be developed from supervision of many of the largest domestic banking companies and therefore highly relevant to the Council's mandate to identify emerging risks and coordinate among agencies on potential systemic risk issues. In this regard, however, it is vital that the role of the OCC (or its successor) as supervisor of large national banks, not be displaced or confused by authorities that may be granted to the Federal Reserve Board for systemically-oriented oversight of companies that own large national banks.

c. The intent is that the Council would offer an independent view on emerging systemic risks. This goal may not be achievable if the work of the Council must represent a consensus of its members. How can the structure and mandate of the Council be designed so that there is a proper balance between independence and originality, on the one hand, and serving many masters, on the other?

The Council would consist of the Secretary of the Treasury and all of the federal financial regulators, and would be supported by a permanent staff. The Council should govern by written charter detailing its authority, role, and responsibilities. The charter should provide for a Chairman, and the Treasury Secretary would be a logical choice for this role. Governance of the Council would be a key issue for Congress to decide. For example, would the Council take positions based on the vote of a majority of its members, or based on the Chair's view, after consultation with members? In any event, key principles of Council operations should be that the Council staff should act independently in assessing and reporting emerging systemic risks to Council members and that the Council would not dictate supervisory decisions concerning individual financial institutions regulated by Council member agencies.

d. *Should the FSOC or another entity issue regular financial stability reports such as those issued by the Bank of England, the Banque de France, and the IMF? If so, how should such reports be structured, how often should they be issued?*

While Council staff or the Federal Reserve could assume responsibility for the issuance of regular financial stability reports, the Federal Reserve's institutional capacity argues for this being a central bank responsibility. Accordingly, the Federal Reserve Board should be responsible for publishing financial stability reports. The OCC would welcome an opportunity to review and comment on any financial stability report produced by the Federal Reserve, to contribute the unique perspective of the national bank supervisor.

- **Shadow banking system**
  Critics have said that supervisors did not understand or appropriately address the risks posed to supervised institutions and to the system as a whole by their interactions with the shadow banking system.

a. *What lessons did your agency learn about the losses incurred on structured credit products by banks and other financial institutions during the crisis?*

We learned important lessons about contagion of risks from outside the banking sector and how poorly designed or inappropriately applied risk models can seriously underestimate risk. As noted in our response to question 2, risks that largely were originated outside national banks, nonetheless affected national banks' liquidity, earnings, and capital, both directly and indirectly. For example, various structured products; such as CDOs, containing loans that the bank did not originate, ended up on national banks' balance sheets and exposed them to subprime mortgage risks that they did not fully appreciate. More generally, lax underwriting standards for various residential mortgage products by non-bank mortgage originators, and the willingness of investors to buy securitized versions of those riskier loans, created competitive pressures on bank lenders. Also, in an effort to meet investor demand, some large banks loosened their underwriting standards for large syndicated credits that they intended to sell to investors (using a so called "originate to distribute" model). When investors retreated from this market, national banks were forced to fund and hold these loans.

Most national banks' risk models failed to adequately consider and capture these contagion risks. Simple value-at-risk measures of price risk, which are inherently backward looking, seriously understated the actual risk banks were taking because these exposures had never exhibited any meaningful price volatility prior to the crisis. Correlation or dependence assumptions embedded in these models also were too simple to encompass subsequent events. As a result, the models showed virtually no risk for very large, but very highly rated, CDO exposures. In short, the models failed to identify low probability, high impact events. Also, bank risk models did not include loss estimates for products (e.g., SIVs and auction rate securities) for which banks had no legal obligation to support transactions, yet did so anyway to avoid damage to their reputation. Finally, subordination provides limited protection for senior investors in a structured security if a systematic market risk event occurs.

Model assumptions about home prices were inadequate, since both bank and rating agency models did not contemplate that home prices could decline systemwide and significantly. Risk models assumed that geographic diversification of mortgage exposures would limit the default correlation of mortgages. However, given the decline in home prices, sub-prime mortgages became very highly correlated, which meant that banks were exposed to systematic, rather than unsystematic, risks.

b. *How should supervisors approach activities by non-supervised institutions that have an impact on markets in which supervised institutions participate? For example, if supervisors at the time had a better appreciation of the systemic risks posed by the lower underwriting standards of mortgage brokers who were following the originate-to-distribute model, what measures could they have taken?*

We discuss the implications of the "shadow banking system" in more detail under our responses to the "Regulatory arbitrage" section below. In brief, while federal regulators could have been more restrictive regarding loan origination relationships between federally-regulated lenders and largely unregulated nonbank mortgage brokers and lenders, the fundamental gap was the absence of robust lending standards applicable to – and enforced by state authorities against – nonbank lenders and mortgage brokers. There simply was no effective mechanism or framework to ensure that nonbank financial institutions complied with either compliance rules or prudent underwriting standards to the same extent as regulated banks. This shadow banking system has been widely recognized as central to the most abusive subprime lending that fueled the mortgage crisis. The proposed Consumer Financial Protection Agency (CFPA) could help address the crucial gap that led to the subprime mortgage crisis if it were focused on consumer protection oversight and enforcement mechanisms in the "shadow banking system" to assure a level of oversight comparable to what exists for banks – and without diminishing the existing regime for bank compliance. Even in that case, however, there could still be additional gaps in comparable safety and soundness standards – such as underwriting standards – being applied to the shadow banking system in the same way that they apply to regulated banks. This is the reason that the OCC has separately supported minimum underwriting standards for all mortgage providers.

c. *How did your agency evaluate asset quality in the area of structured products? Did examiners rely on credit quality assessments of ratings agencies and the supervised institutions themselves? What changes has your agency made or is it considering?*

While credit ratings provide useful information to bankers and regulators, it is clear that bankers, regulators and the rating agencies themselves put too much reliance on the various credit enhancements that were designed to support various structured products such as ABS CDO securitizations and thus failed to fully recognize the leverage and underlying concentrated credit exposures embedded in these securities. We are emphasizing to national banks that they need to conduct sufficient due diligence of any structured product that they may purchase and that they need to have an understanding of the underwriting characteristics and risks of the assets underlying these securities. We're also emphasizing that substantial holdings of similar complex structured financial instruments, even if rated AAA, is inconsistent with sound concentration risk management.

d. Any other comments on the shadow banking system?

- **Peer comparisons and stress tests**
  Supervisors conduct stress tests and use a number of other tools to encourage examiners and analysts to compare the financial soundness and risk management of peer institutions. The stress test conducted in the first half of 2009 on 19 large firms took a more comprehensive approach to peer or "horizontal" analysis of individual firms.

a. What stress testing has your agency conducted on large banks in the past? Has it been firm- or enterprise-wide or limited to specific products? What lessons did your agency learn from previous efforts to promote peer comparisons among similar institutions?

The OCC uses stress testing models and tools to assess portfolio risks for individual national banks, for specific risk issues and products, and for the national banking system as a whole. We use a suite of models to assess potential risks in commercial lending and commercial real estate portfolios under various economic scenarios, including stress conditions. Commercial lending risks are based on separate models developed internally for 30 major industry groups using actual portfolio data from a large U.S. For CRE, the OCC uses models supplied by a major vendor; the models cover every metropolitan statistical area (MSA) and each of the four major property types (retail, warehouse, apartment, and office) within each MSA. We use these models to apply severe but plausible hypothetical stress conditions to the banking system as a whole. In addition, we also have used these models to assess specific business line risks, such as the impact of significant changes in house prices or other key economic indicators on banks' retail portfolios.

The OCC produces an internal "Global Economic Outlook" report that provides an assessment of the economic and financial risks to the national banking system and key business lines within the banking system. This report incorporates stress tests using the models and tools described above, as well as other analytical techniques. The last report was provided in 2008; the next report is scheduled for completion in the fourth quarter of 2009.

One of the primary "lessons learned" from work on stress testing has been that peer comparisons among large banks are valuable only if a significant investment is made to understand and adjust for key differences across the banks. This requires considerable investment of expertise and time to compile and evaluate the specific characteristics of each bank's portfolio, including for example the type and quality of collateral and underwriting, the location of borrowers, the specific characteristics of borrowers, and the maturity and other specific features of loans.

Absent this kind of detailed analysis, peer comparisons are likely to lead to incorrect assessments of a bank's condition and very misleading supervisory actions.

This suggests a natural and valuable complementarity: analytical methods are valuable tools that can be used to apply a uniform approach to all, or to a subset of, institutions, but to be most valuable those models must incorporate insights from subject matter experts during their development. Results from well designed models can highlight areas of potential risk that would not otherwise receive attention; these results then raise questions that can be addressed by supervisory experts using their detailed knowledge of unique aspects of banks and market conditions, to determine whether the model results warrant any additional follow-up by supervisory staff.

b. *What lessons did your agency learn from the 2009 stress test? Should supervisors institutionalize the use of stress tests to complement the supervisory process – if so, how frequent should such tests be, and how specific should the supervisors be in defining parameters and benchmarks? Did our understanding of the businesses and risks of individual institutions increase?*

Stress testing can be a useful complement to the supervisory process if well-designed and if the stress tests incorporate effectively the relevant characteristics of banks' portfolios and risk management processes that are essential to be able to draw meaningful conclusions. Stress testing should be risk-focused, for example being conducted more frequently for banks with portfolios and operations that are more sensitive to changing conditions.

One of the key lessons from the 2009 stress testing program was the importance of understanding and incorporating the specific characteristics of the bank's portfolio, the business line characteristics and conditions, and risk management into the stress testing assessment. Examiners are a primary source of knowledge of these important characteristics, and therefore play a necessary and vital role in this type of an assessment. "High altitude" stress testing that does not incorporate such information tends to yield questionable results and may be very misleading as a guide for bank supervision.

The SCAP stess tests also highlighted the critical importance of an explicit assessment of revenues and expenses, as well as the impact of acquisitions and divestitures, areas that are given limited attention in some stress testing analyses. The dynamic response of revenues and expenses through stress periods is a particularly critical factor when horizons for stress tests are relatively long (such as more than one or two quarters). While there is significant data available to be used when stress testing loss rates, much less work has been done in researching how best to stress revenues and expenses. The approaches used to date have been crude, and require more thought and research.

Stress test components, including the underlying modeling and assumptions as well as other key features, must be very clear to the banks to promote a more effective application to their portfolios. Seemingly arbitrary parameters or projected trends will run the risk of serious inconsistency and misinterpretation by the participant banks and will likely lead to seriously misleading and unexplainable results that impair the overall credibility of the stress tests.

Users of stress tests must recognize that uniform approaches tend to result in some sectors being emphasized more than others. Stress tests often draw on conventional models of the macro-economy to specify suitably severe but plausible stress scenarios. However, many existing macro models are much more rigorous with regard to sectors that are more easily modeled. Uniform stress specifications derived from such models will tend to emphasize those that are most significant. For example, many macroeconomic models are relatively weak in the modeling of the financial sector, and more rigorous in the areas of traditional economic activity, such as consumption and investment spending. Yet conditions in the financial sector clearly are important for an adequate stress assessment of many banks. Even for the housing markets in the U.S. – which of course is a major segment of economic activity – the data and modeling are at best incomplete.

c. *Do your supervisors conduct their own modeling of credit and other risks facing individual firms and the financial system overall?*

As noted in response to question a, in this section, the OCC uses various models to assess credit and other risks. In addition, OCC economists conduct ongoing research and analysis of risk modeling methods and data, and regularly engage quantitative staff at supervised institutions in discussions of risk modeling practices.

d. *Should supervisors strengthen the supervisory process by reinforcing horizontal analysis of firms in other ways?*

The OCC supervisory process makes regular use of horizontal examinations, reviews, and comparative analyses. The typical application has been a horizontal review of a specific business line or product type, and has been useful in discerning potential areas for further assessment and research.

e. *Should uniform stress tests be mandated and regularly run? If so, who should decide which scenarios to evaluate and how should such stress tests be selected and changed over time? How should such tests measure and evaluate correlations across institutions?*

The frequency of stress testing, as well as the scenarios on which the stress tests are based, should be established by supervisory agencies based on their understanding of the general portfolios and likely sensitivity of those portfolios to potential changes in economic and financial conditions. In addition, , it is advisable that the supervisory agencies consult with the banks on the expectations of the program and the specifics of the stress testing exercise – meaningful consultations to make this process as transparent as possible with full engagement by bank management. In addition to leading to better-designed stress tests, such consultation serves another critical purpose. Economic stress scenarios are by nature hypothetical, not factual, and any action to mitigate the "potential risks" under such hypothetical events must often be undertaken by the bank management. If bank management is not prepared to have a candid discussion of the outcomes, the effectiveness of the stress testing program as a practical tool to manage potential risks will be considerably reduced. The engagement of bank management helps ensure that stress results are taken seriously by the bank.

Uniform stress tests could be used on a limited basis to provide a range of possible outcomes under given scenarios. As noted above in response to question a, stress tests can be valuable tools; results from well designed models may highlight areas of potential risk that would not otherwise receive attention, and pose questions that can then be addressed by supervisory experts using their detailed knowledge of unique aspects of banks and market conditions. Uniform stress tests might also alert supervisors to potential sources of correlation among institutions.

Given the range of banking practices and portfolio strategies, however, the potential contribution of uniform stress tests should not be overstated. As the SCAP exercise made clear, fully interpreting and using the results of stress tests requires a substantial amount of exploration and follow-up; without that, and without the use of informed judgment by supervisory experts, the results will be of limited valuable and likely misleading. Uniform stress tests conducted entirely from a centralized "command center" independent of the on-site supervisory process are unlikely to be productive. Examiner judgment is a critical component to make the exercise more credible and to factor in institution specific nuances.

f. Any other comments?

Because of the unique environment we were confronted with during the Supervisory Capital Assessment Program (SCAP) exercise (*e.g.*, the virtual shutdown of markets for capital raising with rampant speculation about the soundness of the banking system), coupled with the decision that there would be a government backstop in the form of Treasury's Capital Assistance Program to augment potential capital shortfalls, we believe it was necessary and appropriate to release the summary results of these tests. In the absence of these conditions, we would have serious concerns about routinely releasing results of various stress tests as such results could be misinterpreted and promote rather than resolve market instability. Public disclosure could also undermine efforts to ensure that stress test programs include candid and thorough assessments by banks or supervisors of "low probability/high loss events."

- **Information-gathering**
  A great deal of information about individual institutions is available to bank supervisors, some through mandatory filing of regulatory reports and public disclosures, and some through the provision of internal reports such as risk reports to company boards of directors.

a. What lessons did your agency learn from the current crisis with respect to the information supervisors had and should have had about individual institutions?

The OCC took away several key lessons learned from the current crisis. These include the following:

- Data used in comparative analyses must be informed by onsite field examiners and subject matter experts who have the knowledge and expertise to put data into appropriate context.
- Macro and micro prudential supervision is dependent on comprehensive data being available to regulators on a more timely basis.

- Analysis needs to be more comparative across firms. This will require common and comparable data. Without common and comparable data it will continue to be difficult to aggregate data and make meaningful comparisons across firms.
- Greater data and information sharing among regulators is needed to better understand systemic risk and contagion.

b. *What additional information should supervisors obtain from regulated firms on a regular basis, particularly large and highly integrated institutions – for example, to facilitate the ability of supervisors and market participants to conduct analysis and stress tests as described in the previous question?*

In order to conduct analyses and stress testing regulators should collect common and comparable data on capital, liquidity and significant credit risk exposures from institutions that pose systemic risk.

c. *Should the agencies issue guidance on the format and content of information that large institutions should provide to their own boards of directors?*

The OCC does not believe issuing guidance on the content and format of information to be provided to a bank's board will address the root cause of the issue. Instead the focus should be on verifying through our examinations, the accuracy, reliability, and usefulness of data presented to bank management and the board. The specific types and content of such reports will likely vary, depending on the scope and complexity of each bank's activities.

d. *Any other comments?*

- **Market discipline and transparency**
  Some observers have argued that the capital markets, through shareholders, creditors, and counterparties, can play a positive role in the governance of bank behavior.

a. *What role should market indicators such as bond and equity prices and credit default swap spreads play in the supervisory process?*

Market indicators such as equity and bond prices and credit default swaps may provide useful information to supervisors with regards to market perceptions of the riskiness of the firm. The market perception of a financial firm can be an important indication of sensitivity of counterparties, investors, and funds providers. This in turn provides a signal as to a firm's ability to raise funding or capital in the capital markets. However, market indicators tend to require sophisticated methods of interpretation to be truly useful in supervision, since market signals can be quite complex. Moreover, in some cases markets simply "get it wrong", and the signals from market indicators should be recognized for what they are: summary measures of market perception.

b. *Is the current balance of supervisory information made public appropriate? Would greater disclosure of supervisory analysis be useful to strengthen the supervisory toolkit and promote market discipline? How would greater disclosure impact supervisory behavior and the relationship between the bank and its supervisor?*

A significant volume of data is available to the public. While we are open to considering disclosure of additional supervisory information if reasons are compelling, the OCC believes the current balance of supervisory information made public is generally appropriate. Greater disclosure of supervisory analysis might improve market discipline, but it would likely cause banks to be less forthcoming with regulators. Further, supervisors must weight the benefits of making such information public against potential damage to the institution. As noted in our discussion above, we believe the facts and circumstances surrounding the recent SCAP exercise were a notable exception, largely due to the explicit government backstop the Treasury Capital Assistance Program provides for banking institutions that are unable to raise the additional capital in the private sector. This backstop, coupled with the extreme uncertainty in the market about these institutions meant that there was probably greater risk in *not* disclosing the stress test results.

c. *Were the disclosures of regulated financial firms and their supervisors sufficiently transparent for investors, customers, and counterparties to comprehend the nature and magnitude of risk taking and the quality of risk management practices?*

While many may view the disclosure requirements to be extensive, in some cases (e.g., securitization, derivatives and other off balance sheet conduits) the required disclosures did not result in an adequate level of transparency for investors, customers, or counterparties to understand the risk in these activities. The FSF noted in its report on Enhancing Market and Institutional Resilience that weaknesses in public disclosures by financial institutions had damaged market confidence. The report noted that public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures. There were also shortcomings in the other information firms provided about market and credit risk exposures, particularly as these related to structured products. The FSF further noted that when information was disclosed, it was often not done in an easily accessible or usable way. Further, the Basel Committee on Bank Supervision recently published a revision to the Pillar 3 requirements due to observed weaknesses in public disclosures.

d. *Should supervisors make public information about individual institutions or regarding horizontal stress test results, to strengthen the supervisory toolkit and promote market discipline?*

Banking supervisors must strike an appropriate balance disclosing confidential supervisory information about individual institutions or regarding horizontal stress test results to the public between the potential for adverse affects on the institutions and the benefit of public disclosure. As previously noted, we believe the circumstances that led to the decision to release the SCAP results were unique and closely linked to an array of government programs undertaken to restore confidence in the banking system and financial markets. While more disclosure of supervisory information may promote market discipline if interpreted properly, we believe the potential for unnecessary harmful effects on banks generally weighs against disclosing confidential supervisory information.

e. *Any other comments?*

3. **Structure of supervision**

- **Cooperation and collaboration among supervisors**
  With more than one federal financial supervisor, it is critical that they share information and collaborate closely, particularly in order to effectively supervise large institutions.

a. *What lessons did your agency learn from the current crisis with respect to cooperation, coordination, and collaboration among supervisors, for example, between consolidated supervisors and functional and bank supervisors?*

The events of the past several years have highlighted the need to have more uniform supervision across financial products and sectors. As noted earlier, a key issue is ensuring that the risks posed throughout the entire banking organization are identified and appropriately managed. Similar activities and products should be subject to uniform and consistent regulatory standards, regardless of whether they are housed within the bank or in a holding company affiliate. As we have seen, failure to do so can undermine not only the non-bank entity, but also threaten the safety and soundness of the insured bank, either directly or indirectly. For example, while ratings agencies rate national banks and their bank holding companies separately, the market does not always discern between the bank and the bank holding company. We have seen several instances where the bank holding company reported losses generated by non-bank entities however, the market demonstrated concern about the financial condition of the entire organization affecting the bank's ability to attract liquidity and capital sources, and increasing the bank's costs.

The OCC is committed to interagency cooperation and coordination. We have established and ongoing working relationships with the other federal banking regulators, which have proved valuable during the financial disruptions. But it is clear that we need to continue to strive to improve the effectiveness of these relationships. With respect to the efficiency of our joint rulemaking efforts on matters of bank supervision and regulation, it also would be important for the OCC and its successor agency to be subject to the same standards as the Federal Reserve and the FDIC with respect to OMB review of its rulemaking.

Our working relationships with other regulatory agencies that supervise other market participants (e.g. insurance companies, pension funds, asset managers, hedge funds, mortgage brokers that are not national banks, thrifts, state regulated banking companies, etc.) is less well developed. Although we on occasion communicate and share information with these regulatory bodies, we have more to do.

While improved coordination and cooperation among federal and functional supervisors is important, it will not address one of the other key gaps we and others have highlighted – the role and oversight of the "shadow banking system." As we discuss elsewhere this is a critical gap that needs to be closed.

b. *How do functional and bank supervisors interact with consolidated holding company supervisors to ensure strong and thorough consolidated supervision? What works and what doesn't work?*

The interaction between functional bank and consolidated holding company supervisors entails several aspects. These include sharing supervisory strategies, efforts to coordinate examination work to avoid inefficient duplication of efforts, performing joint examinations when appropriate, and sharing supervisory assessments and conclusions. Under current practice and statutory rules, the consolidated supervisor should rely, as far as possible, on the reports of examination prepared by the functional bank supervisor. This approach is generally demonstrated today with the relationship between the Federal Reserve and the OCC. The interagency relationship and efficiency of supervision can be improved by more purposeful reliance on each others work – which would result in diminished redundancy at the bank level.

The functional and consolidated relationship works best with a robust, independent bank supervisor that is solely dedicated to the prudential oversight of depository institutions. Dedicated supervision assures there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility and accountability are well-defined. We take seriously our responsibility to ensure the bank remains a strong anchor within the company as a whole. This has translated into the generally more favorable loss experience of banks within a holding company versus other companies owned by the holding company, including those large bank holding companies that have sustained the greatest losses.

While the consolidated supervisor at large bank holding companies has strong authority, no comparable authority existed with respect to large securities firms, insurance companies, finance companies and government-sponsored enterprises that were not affiliated with banks. This regulatory gap proved to be an enormous problem, since a disproportionate share of losses was borne by these institutions. The lack of a consistent and coherent regulatory regime applicable to them by a single regulator helped mask problems in these nonbanking companies and the gaps in our regulatory regime hindered the government's ability to deal with them once they emerged.

c. *How can supervisory agencies better coordinate their examination and analysis activities and share information? Is there information that your agency needs but has trouble getting from another supervisor?*

We continue efforts to substantially increase our coordination and cooperation with supervisors from Federal Reserve and the FDIC. We often perform joint examinations, so we can capture and aggregate risks across the enterprise. The PWG or successor organization should hold the agencies accountable for adhering to defined roles and responsibilities.

The lessons learned exercises resulting from the market disruption indicate the need to further improve our coordination in order to achieve seamless supervision. Another issue is that banking regulators do not have good information sharing arrangements with other regulatory agencies that supervise other market participants (e.g. insurance companies, pension funds, asset managers, hedge funds, mortgage brokers that are not national banks, thrifts, state regulated banking companies, etc.). In addition, there is inconsistency in regulatory requirements for market participants. Consolidation in the industry may magnify the differences in the regulatory supervision of the various regulatory bodies.

d. *How do federal and state supervisors coordinate with foreign supervisors in the supervision of multi-national financial firms? What works and what doesn't work? Are there specific instances in which it would have been helpful to have more information from the home supervisor to understand a troubled foreign-owned institution during the current crisis?*

U.S. federal banking agencies provide adequate data and information in a timely manner to host country supervisors about U.S. banks and holding companies, including any significant issues of a supervisory nature, to enable the host authority to supervise the overseas operations of the U.S. banks effectively and appropriately. The U.S. federal banking agencies have ongoing contact with supervisors in other countries in which U.S. banks have material operations.

Information sharing by the U.S. agencies as both home and host supervisors involves sharing significant supervisory concerns and supervisory documents; providing information to assist with the authorization process and with investigations; discussing and coordinating supervisory plans and strategies with foreign supervisors; managing and participating in bilateral and multilateral meetings in the United States and overseas; developing joint enforcement actions when warranted; and participating in "colleges" of supervisors to focus on a specific bank, holding company or supervisory issue. Additionally, U.S. supervision staff periodically visit foreign supervisory authorities to discuss supervisory issues.

These efforts notwithstanding, as pressure for protectionist measures mount, more and better coordination is necessary to minimize actions and cost that result from ring-fencing capital and liquidity.

e. *How should the incentives and organizational structure of the agencies' supervision of firms with more than one supervisor be revised to strengthen cooperation and collaboration among supervisors? For example, what kind of coordination mechanism or legal mechanism might help resolve differences?*

Clear roles and responsibilities are essential to minimize unnecessary overlap and to avoid unintended gaps in coverage. Today we have both redundant supervision of the banks, and less supervision of nonbank subsidiaries. Going forward, the intentions associated with any restructuring of regulatory responsibilities should be clear. In particular, it is vital that in any new legislation establishing systemic oversight responsibilities for the Federal Reserve that the role of the OCC (or its successor) as supervisor of large national banks, not be displaced or confused by authorities that may be granted to the Federal Reserve Board for systemically-oriented oversight of companies that own large national banks.

The organizational structures at the OCC, FRB and FDIC have been aligned to cover large banking companies as a distinct line of business. This structure enables efficient communication and coordination across agencies and we see no reasons for it to be changed. Improvements can be achieved by consolidating oversight of large banking companies in a central location as is the case with the OCC. For various reasons both the FRB and the FDIC operate their large bank supervision units in tandem with regional organizations (districts at the FDIC and reserve banks at the FRB) and these structures do present occasional inefficiencies and confusion in making supervisory decisions.

As with current practice and legal parameters, it is imperative that the independence of the federal banking agencies be preserved.

f. Should consolidated supervisors and functional and bank supervisors be required to collaborate on a single, consolidated supervisory plan for large institutions?

Currently, bank supervision agencies (Fed, OCC, FDIC) share supervisory strategies to ensure duplication of efforts is minimized and identification of risks is consistent or, if not, that the inconsistency is justified by supervisory responsibility. The sharing also highlights opportunities for coordinated examination activities. Sharing and coordinating is a helpful process but we are careful to not lose sight of our legal responsibilities with respect to banking activities. We believe the sharing process facilitates an effective, coordinated supervisory approach

g. How can supervisors further encourage the development of a sense of shared mission and increase interagency expertise – for example, would you support staff rotations or secondments among agencies?

There are a number of mechanisms already in place that promote and encourage shared interagency expertise and shared mission. We believe greater use of these types of mechanisms, rather than formal staff rotations or secondments among the U.S. agencies, is the most effective way to promote enhanced supervision and coordination among the agencies.

These mechanisms include:

- <u>Joint formal classroom training, seminars, and conferences</u> – The agencies conduct a variety of joint training initiatives for examiners. Most of this training is focused on more experienced examiners who have had several years of experience. For example, the FFIEC's Examiner Education Office offers a variety of schools, conferences, and workshops for the agencies' examiners. These courses are also made available to examiners from the state supervisory agencies. Through the FFIEC's Examiner Education Task Force the agencies also share information and materials from the agencies' in-house training programs. In addition, the agencies sponsor periodic joint conferences to discuss emerging supervisory concerns. For example, the agencies' chief accountants sponsor an annual conference to discussion emerging accounting and auditing issues with the agencies' examiners and accounting staff. The 2008 conference was attended by approximately 360 staff. Similar conferences are held on information technology and BSA/AML.

- <u>Training and Technical Assistance to Foreign Supervisors</u> - The U.S. banking agencies also sponsor and participate in numerous training activities to assist foreign supervisors. These include training courses taught by agencies' staff exclusively for foreign supervisors and various on-site technical assistance and training missions.

- <u>Joint Strategy Development and Information Sharing for Large, Complex Institutions</u> – As previously noted, the agencies coordinate their supervision for large, complex financial institutions. This includes sharing risk profile information and proposed examination and supervisory activities. Periodic meetings are held to discuss issues and supervisory findings.

For example, the OCC and FRB coordinate on examination strategies and targets for the largest BHCs. When issues cut across both the holding company and bank, joint exams and targeted reviews may be conducted. The OCC and FRB also co-chair supervisory colleges for the large complex financial institutions that meet the Financial Stability Board's criteria for companies requiring a supervisory college. In addition, the FDIC has a designated dedicated examiner at the four largest national banks who has access to supervisory information, findings, and strategies.

- Joint Rulemakings, Policy Guidance, Examination Procedures – The agencies work closely together on key rulemakings, policy guidance, and various examination procedures. These efforts promote uniform standards and shared supervisory objectives. For example, virtually all of the agencies' capital rules are developed on an interagency basis, as are key policy guidelines for various aspects of credit risk, including the classifications of loans and securities.

- Informal Networks and Communications – In addition to these formal processes and programs, there are a variety of more informal, but highly effective, networks that the agencies and their staffs use to discuss and coordinate on key issues. These networks exist both at the national and regional level. For example, key supervisory staffs from each agency regularly meet on a monthly basis (and more frequently as needed) to exchange information on potential troubled institutions and to coordinate resolution strategies for those institutions. The policy experts from the agencies' staffs in areas such as capital, credit, and market risk are in frequent contact to exchange information and discuss potential policy initiatives. Weekly calls are held by agency principals to discuss various market and institution specific issues.

h. *There are many examples of collaboration among agencies that follow different models, such as SNC, FFIEC, supervision of TSPs, and the recent SCAP stress test. What works and doesn't work?*

Our experience suggests that initiatives where there are clear objectives and expectations established upfront, with clear and reasonable timeframes, are generally the most successful. Examples of such initiatives include the SNC reviews – where there are established program criteria and timeframes, the SCAP stress test, and the various efforts the agencies undertook to ensure successful Year 2000 conversions.

Initiatives that are more open-ended or where there are not agreed upon objectives upfront, are often more difficult to execute. We would note, however, that by their nature, some policy initiatives fall within this category. Often these initiatives raise substantive issues that require extension deliberation both among the agencies and with the industry and other interested parties before final decisions can be made. In nearly all cases, faster decisions could be reached if, in lieu of a joint effort, each agency addressed the issue independently. Such an outcome, however, may not serve the public interest. Nonetheless, we do believe that there are steps the agencies can and should make to improve these processes. Such steps could include more regular status reports to agency principals on issues where staff agreement cannot be reached or where additional guidance and direction is needed, and clearer articulation of and agreement among the agencies on priorities for joint projects and initiatives.

i. *Has the Federal Financial Institutions Examination Council satisfactorily fulfilled its role as a forum for discussion of policy-setting among the agencies? Could your agency provide specific examples where it worked or failed to work well?*

We believe the FFIEC has served as a useful mechanism to coordinate policy work and discussions across the banking agencies. Much of this coordination occurs at levels below the formal Council – for example through the various task forces and both formal and informal work groups that the FFIEC structure helps to facilitate. As noted above, much of the agencies' key guidance on various credit risk issues (e.g., subprime loans, nontraditional mortgage and subprime mortgages, concentrations of CRE) was developed on an interagency basis through work groups fostered and facilitated by the FFIEC's Task Force on Supervision. In this regard, we think the FFIEC and the federal banking agencies have generally struck an appropriate balance between the FFIEC's role to facilitate policy setting while recognizing and respecting the fact that it is generally the responsibility of each agency and its principal(s) to act upon FFIEC recommendations by promulgating and implementing rules and policies. We believe the existing system has generally worked well and that there is no need to mandate specific policies or issues that must be handled on an FFIEC versus an interagency basis. In fact, we believe that such a mandate would be counterproductive because there are times and issues where the agencies need flexibility to act quickly and issue items outside of the formal FFIEC coordinating mechanism.

j. *Any other comments?*

- **Regulatory arbitrage**
  Critics have noted that the existence of competing charters creates the opportunity for regulatory arbitrage or charter-swapping among agencies. In some cases, financial institutions have been able to avoid serious regulation by finding loopholes in the supervisory structure.

a. *How does your agency define its mission, and how does its mission differ from the other federal agencies?*

The activities of the OCC rest on four goals that support the agency's mission to ensure a safe and sound national banking system for all Americans. The four goals are:

- A safe and sound national banking system
- Fair access to financial services and fair treatment of bank customers
- A flexible legal and regulatory framework that enables the national banking system to provide a full competitive array of financial services
- An expert, highly motivated, and diverse workforce that makes effective use of OCC resources

Unlike the other banking agencies that have multiple missions in addition to prudential supervision, the OCC has a single mission: supervision of national banks. This singular focus on supervision assures that OCC has no confusion regarding goals and objectives, and no potential conflict with competing objectives. This focus also means that OCC's responsibility is well defined, facilitating accountability and oversight. The benefits from the singular focus of the OCC's supervisory mission are enhanced and reinforced by the fact that the OCC administers a single set of laws, rules, and standards that are uniform and nationwide for all banks in the national banking system, and by the OCC's structure for conducting bank supervision. The OCC has a bank supervision operational structure that is national in design, with direct reporting relationships from supervisory locations throughout the country to senior managers at OCC headquarters. This integrated structure of OCC supervisory operations provides for direct accountability at all levels of bank supervision and helps to ensure that the laws and standards we administer are applied appropriately and consistently on a nationwide basis.

b. Is regulatory arbitrage a problem? What is your understanding of the scope of the problem and what causes it? How should regulatory arbitrage be addressed?

Regulatory arbitrage can be a serious problem in several dimensions. First, regulatory arbitrage is a problem when different providers of the same or essentially the same financial product are able to operate under significantly different rules, particularly when coupled with significantly different levels of supervisory oversight of compliance with those rules. A prime example of this type of arbitrage, and its disastrous consequences, is the mortgage crisis, where a "shadow banking system" of nonbank lenders operated under an often weak or non-existent patchwork of state lending standards and were not subject to oversight comparable to the supervision of federally-regulated banks. As a result, at the heart of the mortgage crisis was lax underwriting, predominantly by these nonbank mortgage originators, resulting in too many loans that consumers simply could not pay back.

This sort of arbitrage between firms subject to different standards and different levels of supervision can also occur within a bank holding company itself. In today's regulatory regime, a bank holding company may engage in a particular financial activity, such as mortgage lending, either through a subsidiary bank, or through a subsidiary that is not a bank. If engaged in by the bank subsidiary, the activity is subject to required examination and supervision on a regular basis by the primary banking supervisor, while if engaged in by a nonbank subsidiary, the activity may be subject to examination by the Federal Reserve, but regular supervision and examination is not required. As a policy matter, the Federal Reserve in the past has chosen not to subject such non-bank subsidiaries to bank-like examination and prudential supervision on the theory that such activities would inappropriately extend "the safety net" of federal protections from banks to non-banks.[1] The result has been the application of uneven lending standards to bank and non-bank subsidiaries within bank holding companies. For example, in the area of mortgage lending, banks were held to more rigorous lending standards than non-bank affiliates in the same holding company. As in the case of the different lending standards employed in the shadow banking system, this type of differential regulation has also caused meaningful adverse effects, with non-bank subsidiaries of bank holding companies more heavily involved in originating sub-prime mortgages than their bank affiliates.

[1] *See, e.g.*, remarks by Federal Reserve Chairman Greenspan before the Annual Meeting of the American Council of Life Insurance, Washington, D.C. (Nov. 15, 1999).

These types of regulatory arbitrage can be addressed in various ways. In the case of participants in the "shadow banking system," there are two essential gaps that must be filled: 1) the need for robust and uniform standards applicable to all types firms that provide the same type of product; and 2) the need for a system to assure oversight of participants in the shadow banking system, so that those participants comply with such standards to the same extent a federally-regulated depository institutions.

For regulatory arbitrage between different supervisory regimes within a bank holding company, several approaches are conceivable. One approach would be to make legislative changes to explicitly direct the Federal Reserve to actively supervise non-bank subsidiaries engaged in financial activities in the same way that a bank subsidiary is supervised by its primary federal supervisor, with required regular examinations. An alternative approach that also would require legislation would be to assign responsibility to the primary banking supervisor within a holding company to supervise non-bank holding company subsidiaries engaged in the same business as is conducted by an affiliated bank – mortgage or other consumer lending, for example. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank.

Another type of regulatory arbitrage can occur when a federally-regulated depository institution seeks to covert its charter to a different type of federally-regulated charter, e.g., national bank to state bank, state bank to federal thrift. These types of charter conversions can be undertaken for valid business reasons, but they also can be undertaken as a means to escape supervisory or enforcement actions being undertaken by the institution's current regulator. Indeed, publicized situations have involved institutions leaving the national banking system to seek more tolerant regulatory treatment of their operations.[2] In contrast, our general experience is that state banks do not convert to national charters to escape effective supervision;[3] rather such conversions mostly occur as a result of mergers and acquisitions by larger national banks and to gain the legal attributes of a national charter, notably, the ability to operate nationwide under a single supervisor and single set of laws, rules and standards.

However, as discussed in subparagraph d. below, the risk of regulatory arbitrage via conversions has been markedly diminished by recent cooperative efforts among the federal and state regulators.

c. *One issue is what activities should be allowed to occur within an insured depository, and when an activity should be undertaken only in a non-depository affiliate of the bank. Should existing law and regulations on what activities are appropriate within a state or federal insured depository be changed and, if so, how? Should supervisors have some measure of discretion in making that determination? What would the guiding principles be?*

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[2] *See, e.g.*, Applebaum, Washington Post, *By Switching Their Charters, Banks Skirt Supervision,* January 22, 2009; A01.

[3] There have been some cases in which institutions have applied to convert to a national charter but did not proceed after the OCC identified areas requiring corrective action before a conversion. In addition, it has not been unusual for the OCC to complete a pre-conversion examination for an institution that is 2-rated by its primary regulator and conclude that the institution should be 3-rated.

The scope of permissible activities for depository institutions is defined by their chartering authorities. For national banks, this is the National Bank Act. Under 12 U.S.C. 24(Seventh), national banks are permitted to engage in activities that are "part of the business of banking or incidental thereto." Other sections of the National Bank Act specifically authorize particular types of activities, ranging from trust and fiduciary activities, to real estate lending, to sales of insurance products in an agency capacity. The OCC maintains a list of activities it has found to be permissible activities for national banks on its web site.[4]

The OCC already has a significant amount of discretion in interpreting these provisions of the National Bank Act to determine when particular activities are permissible under the language of the statute. This enables the concept of permissible banking activities to evolve and remain relevant to changes in the business environment and in the needs of customers, and it also enables to OCC to attach requirements when it determines that certain new activities are permissible for a national bank. Among the key factors that the OCC considers with respect to new proposed activities is whether the activities can be conducted in a safe and sound manner, whether banks have sufficient expertise and systems so as to adequately address and manage risks inherent in the activity, and whether the OCC has the ability to appropriately supervise the activity. Only if these necessary (but not sufficient) factors are satisfied will a new activity be authorized to be conducted by the bank. With more complex types of activities, the OCC may require that a national bank proposing to conduct those activities obtain a non-objection from its examiner-in-charge to assure that the particular bank has sufficient expertise, systems and controls to conduct the activity.

The OCC would oppose changes to the statutory standard. Moreover, we do not believe that "new" activities have been the source of the recent market turmoil. To the extent that turmoil has resulted from activities of banks, the problem has arisen from the manner in which clearly permissible activities have been conducted. Moreover, there is substantial evidence that significant sources of the market turmoil were the financial activities of un-regulated and lightly regulated nonbanks, rather than any "new" activities of extensively regulated banks.

d. *What measures could be taken to reduce undesirable outcomes such as, for example, firms seeking to switch charter in the hope of finding a more favorable supervisory regime? Does your agency have any data or examples explaining why institutions convert charter?*

There have been some occasions in the past in which a national bank has converted to a state charter or a thrift charter with the apparent motivation, perhaps among others, to escape or avoid existing or pending supervisory actions or regulatory restraints.[5] However, recently the state and federal bank regulatory agencies have, through the FFIEC, issued a document which should significantly address this concern. Specifically, the FFIEC issued the *Statement on Regulatory Conversions* to reaffirm that the supervisors are unified in their approach to regulatory conversions. Supervisors will only consider applications undertaken for legitimate reasons and will not entertain regulatory conversion applications that undermine the supervisory process. It is

[4] *See* http://www.occ.treas.gov/corpapps/BankAct.pdf.
[5] Motivations for charter choice or conversion are difficult to track scientifically. Anecdotal evidence suggests institutions' decision may be explained by a mixture of motivations, including prior experience with a particular regulator, clarity of a legal framework, fees, market perception, and ability to merge and retain branches.

expected prospective supervisors will follow existing supervisors' work on examination and enforcement actions, including consumer protection and safety and soundness issues. See http://www.ffiec.gov/press/pr070109.htm

e. *To what extent is regulatory competition impacted by how supervisory agencies are funded and structured? How can that issue be addressed?*

We are aware that some claim that the current method of funding banking agencies by assessments on the regulated institutions creates an incentive for bank regulators to engage in "competition in laxity" and to conduct their supervision in a manner that will maximize assessments. We see no evidence of this in the case of the OCC.

Since enactment of the National Bank Act in 1864, the OCC has been funded by various types of fees imposed on national banks. Over the more than 140 years that the OCC has regulated national banks, in times of prosperity and times of economic stress alike, there has never been any evidence that this funding mechanism has caused the OCC to fail to hold national banks responsible for unsafe or unsound practices or violations of law, including laws that protect consumers. Indeed, as noted above, the OCC frequently has been criticized for being too "tough," and we have seen institutions leave the national banking system to seek more favorable regulatory treatment of their operations. The OCC has never compromised robust bank supervision, including enforcement of consumer protection laws, to attract or retain bank charters. Since its creation, the OCC has consistently maintained a culture and reputation as a rigorous supervisor.

Congress established and has maintained this approach to funding OCC's operations through assessments and fees on national banks, and thrifts, rather than through the appropriations process, as an important measure to assure the OCC's independence from the political process. The other federal banking agencies also are not funded through appropriations, but do not impose assessments to fund their operations. The FDIC funds its supervision of state-chartered non-members banks by premiums that all banks and thrifts pay for deposit insurance coverage and from earnings on investments in United States treasury securities. The Federal Reserve funds its cost of supervision of state member banks from the interest it earns on its holdings of treasury securities.

This fee disparity among the banking regulators is a legitimate issue, however, that should be studied and addressed. It is well established that generally assessments for national banks are materially higher than for state banks. That is, state assessments on state-chartered banks are lower than the assessments imposed on comparably sized national banks, and the FDIC and the Federal Reserve to not charge state banks for their federal-level supervision. Banks that convert from a national charter to a state charter frequently cite this fee differential as one reason for their conversion.

f. *Does competition between regulated and unregulated entities undermine the ability of your agency or its regulated entities to maintain safety and soundness? If so, what steps can be taken to mitigate that effect?*

See the response to g. immediately below.

g. *Critics also have noted that an uneven approach to supervision across types of financial services firms (e.g., commercial banks and thrifts, investment banks, insurance companies, unregulated finance companies, investment companies and others) may complicate the ability of bank regulators to impose prudential requirements that are not readily avoided. How important is this concern and what should be done about it?*

This is a real concern. As described in response to b. above, in important market segments, the standards applicable to all providers of the product are not uniform, and oversight of different types of providers of the same product varies considerably. In the mortgage lending context, for example, uniform lending standards were not applicable to nonbank mortgage originators, and the oversight and supervision of the lending practices of nonbank mortgage originators was dramatically less than the supervision and examination to which banks are subject. These differences result in lightly or unregulated firms having lower compliance costs, and in practice can enable them to employ looser lending practices to get more business. These competitive advantages, in turn, lead to pressures on federal regulators from regulated banks offering the same type of product to diminish the standards they apply in order to equalize compliance costs and to allow the federally-regulated banks to employ comparably liberal standards to get business. And where federal regulators hold firm, incentives increase to exploit regulatory arbitrage opportunities by conducting activities in a nonbank holding company affiliate, subject to different standards or lighter supervision. We offer thoughts on dealing with these problems in our response to b. above.

h. *Any other comments?*

- **Oversight of the supervision function**
  Supervisory agencies, like the institutions they regulate, rely on policies and procedures, internal controls, and management information systems to elevate issues to senior management or Board members, ensure quality of the supervisory product, and assure appropriate checks and balances.

a. *Describe your agency's policies and procedures, internal controls, and management information systems – for instance, the role of the internal audit or inspector general function; the review and approval of examination findings and enforcement actions; the oversight of examiners by peers or headquarters.*

The OCC's programs and resources are overseen by the OCC's Executive Committee, comprised of the Comptroller, the First Senior Deputy Comptroller and Chief Counsel, the Chief of Staff and Public Affairs, the Senior Deputy Comptrollers for Economics, Large Bank Supervision, Midsize and Community Bank Supervision, Management/Chief Financial Officer, and Bank Supervision Policy/Chief National Bank Examiner, and the Chief Information Officer. The Executive Committee routinely discusses programmatic and management issues during its meetings and identifies and tracks key strategic risks and priorities through its Strategic Risk Management Plan that is updated quarterly.

The Executive Committee is supported by several executive level subcommittees that provide oversight over key program areas. These include subcommittees on:

- Human Capital, which addresses and coordinates the OCC's human resource needs;
- Regulatory Policy, Legal and External Affairs, which monitors and develops OCC positions on key regulatory policy, legal and legislative issues;
- Budget and Finance, overseeing and ensuring the integrity of the OCC's financial resources and operations, including performance budgeting and planning;
- Technology and Systems, which oversees all of the OCC's Information Technology and MIS and ensures the integrity and safeguarding of OCC's mission critical systems and MIS and compliance with various Office of Management and Budget and the Federal Information Security Management Act (FISMA) requirements;
- Enterprise Governance, which develops and coordinates issues related to strategic planning and enterprise governance; and the
- Committee on Bank Supervision, which oversees the OCC's supervisory programs.

As discussed more fully below, these latter two subcommittee play important roles in the internal governance of the OCC's supervisory programs.

The Enterprise Governance Subcommittee oversees the testing of quality management programs for all major agency business processes and reviews the results of other assurance activities, such as the external financial audit and Treasury Office of the Inspector General (OIG) and U.S. Government Accountability Office (GAO) audits. The subcommittee also liaises with Office of Management and Budget (OMB). The OCC's Enterprise Governance unit reports to the Enterprise Governance Subcommittee through the OCC's Ombudsman's office. This unit, which includes professionals with bank supervision experience, assists in providing guidance to individual business units to ensure program objectives are achieved, that risks are properly managed, and that resources are used responsibly. The unit oversees and coordinates the EC's strategic risk management plan and the Comptroller's annual assurance statement for which each senior deputy's office must attest that management control objectives were achieved, consistent with the Federal Managers' Financial Integrity Act, Federal Financial Management Improvement Act and OMB Circular A-123. The unit also tracks compliance with any external, OIG, or GAO audit findings or recommendations.

The Committee on Bank Supervision (CBS), coordinates, and directs the OCC's supervisory, programs and resources. Day-to-day responsibilities are divided among three business units and senior deputy comptrollers:

- Senior Deputy Comptroller for Large Banks oversees the supervisory programs and activities for the 15 largest national banking companies and international banking supervision.
- Senior Deputy Comptroller for Midsize and Community Banks oversees the rest of the national banking industry, including specialized credit card and trust banks, through its four regional district offices and a team for midsize banks.
- Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner oversees the development and dissemination the OCC's supervisory policies, guidance and

examination procedures that promote national banks' safety and soundness and compliance with laws and regulations.

A variety of mechanisms are in place to promote consistency in, an appropriate review of, supervisory activities and findings. Supervisory activities are based on uniform examination policies and procedures that are used across institutions and districts, but that can be tailored to the risk profile of the individual banks. A key part of this program is the OCC's RAS which provides a consistent means of measuring and evaluating risks across the national bank population. The primary foundation for examination programs are contained in the OCC's *Community Bank Supervision* and *Large Bank Supervision* handbooks.

The annual CBS operating plan establishes the OCC's supervisory priorities for the year and provides the foundation for the supervisory strategies, activities and resources for the coming year. The supervisory strategy developed for each national bank is reviewed by the appropriate Large Bank Deputy Comptroller or Assistant Deputy Comptrollers (ADC). As previously noted in our responses to question 2, examination findings, reported through ROEs or other supervisory letters, are reviewed and approved by the EIC or ADC before they are communicated with management. ROEs for banks in the OCC's Large Bank program are reviewed and signed by a Large Bank Deputy Comptroller. Regulatory risk ratings and risk assessments must be reviewed and approved by the appropriate supervisory office for banks in the OCC's M/CBS program and by a LBDC for banks in the OCC's Large Bank program. Examination findings and other key supervisory information are maintained in the OCC's electronic supervisory databases. CBS members and their key staff, in addition to the relevant line supervisors, have access to these databases. Quarterly summary reports on the overall condition and ratings for individual midsize banks as well as overall conditions for the community banks in each district office are prepared and shared with OCC senior management. Key members of the OCC senior management team, including the Comptroller and CBS members, receive periodic briefings on the condition of each of the largest national banks.

The OCC's enforcement actions are governed by the OCC's written enforcement policy that describes the OCC's policies and process for taking appropriate enforcement actions. Generally, the EIC is responsible for initially recommending the use of an enforcement action to address problems and concerns identified in assigned banks. While ADCs may approve the use of certain informal enforcement actions on 1- and 2-rated banks, district and Large Bank deputy comptrollers are responsible for deciding most enforcement action recommendations against banks under their supervision. To assist with these decisions, the OCC uses the WSRC and District Supervision Review Committees (DSRC) to help ensure that OCC bank supervision and enforcement policies are applied effectively and consistently, and to advise the Senior Deputy Comptrollers for Large Bank and Midsize and Community Banks on enforcement cases and recommended actions. The senior deputies have the ultimate decision making authority on enforcement actions.

In addition to these processes, the OCC has other mechanisms to help promote consistent and effective supervision across national banks. This includes the use of various horizontal reviews of targeted areas across a group of banks; networks of examiners with expertise in various specialties who share best practices and emerging issues and trends; and the OCC's National

Risk Committee, comprised of deputy comptrollers across the OCC's business lines -- supervision policy, economics, and legal -- that identify key supervisory risks and issues. We also use various analytical tools and reporting templates to prepare comparative risk and trend information across national banks. These tools can assist in identifying banks that appear to be potential outliers relative to other peer banks.

b. *How does your agency monitor the quality of the conduct of the supervision function, and how can that be improved?*

The OCC has a number of formal and informal programs to monitor the quality of our supervisory functions. As discussed above, the OCC's Enterprise Governance Subcommittee and Enterprise Governance unit oversee the OCC's strategic direction and annual assurance statement process. The OCC's Ombudsman's office provides a venue for bankers to raise informal and formal appeals of OCC supervisory decisions. That office also administers an examination questionnaire that is provided to all national banks at the conclusion of their examination cycle to obtain direct and timely feedback from bankers on the OCC's supervisory program. The OCC's Ombudsman also evaluates formal bank complaints.

The OCC's LBS and M/CBS programs each has internal quality assurance processes to provide independent evaluation of compliance with established policies and procedures, to promote consistent application of those policies, to make recommendations for enhancements and to encourage dissemination of best practices.

We use these processes to refine and update our supervisory programs and activities. To improve the quality and effectiveness of policy guidance to national banks, we will be launching a survey of national banks to evaluate the effectiveness of our various mechanisms for disseminating supervisory policies and guidelines.

- **Regulatory independence**
  Critics argue that supervisors may get too close to the institutions they supervise, impeding the appropriate skeptical and independent approach.

a. *Other national supervisors have chosen not to exercise supervision through on-site examiners, preferring instead roving teams of examiners or reliance on outside auditors. The UK FSA recently considered, and again rejected, the on-site examination model. Similarly, within the US, other types of government supervisors follow varied models. What are the costs and benefits of relying on on-site examiners? What would be the benefits and risks of enlisting the expertise of outside experts?*

On-site examiner presence allows for the resident OCC staff to gain an intimate knowledge of company activities and personnel. This knowledge extends to a greater understanding of the bank structure as well as its culture. Practically, on-site presence provides a more efficient process for how and where to obtain bank information. Such knowledge and understanding is difficult or impossible to acquire and maintain without the kind of continuous insight that comes through resident status.

While we believe the on-site approach to supervision in our largest banks has numerous benefits, we recognize any supervisory model has potential risks, such as a supervisor losing the perspective necessary to effectively challenge the assumptions and views of management at the banks they supervise. To guard against this, the OCC requires large bank EIC rotations every 5 years, facilitates staff rotations amongst the large bank population, and does not fully staff the resident examiners with the shortfall supplemented by rotation of examiners from other lines of business such as the mid-size and community bank supervision programs.

More generally, we instill in our examination force the goal is to take a balanced and measured approach to supervision, but not to shy away from making the "hard" or unpopular calls. A key tenet of our approach for bank examiners is "trust but verify" – maintaining a healthy dose of skepticism and sensing when something "doesn't look right" and warrants further drilling down or testing. While we do work to provide constructive advice to bankers, we recognize and stress to our examiners that their role is not that of a consultant; when bank management is unable or unwilling to take corrective actions, we need to escalate our actions even if it means removal of management. Similarly, while we do not tolerate any type of retaliatory behavior on the part of an examiner, we are also very clear that senior management must accept examiners judgments that are supported by examination and supervisory findings.

In short, there is very strong, independent bank examiner culture that is consciously fostered and promoted at the OCC. This informs every part of the organization, and the power of this cultural fabric should not be underestimated as a foundation for the agency's independence from the banks we supervise.

b. What measures or policies does your agency have to prevent examiners and their program managers from getting too close to supervised institutions – for example, mandatory rotations of examiners and/or their program managers? What are your processes for exemptions to those processes?

The OCC has a policy covering a Large Bank examiner-in-charge. Specifically, the policy states:

- An employee may serve as examiner-in-charge (EIC) of a Large Bank company for no more than five years, commencing with the official appointment date of the EIC to that company. Based on exceptional organizational needs, a LBEIC's assignment can be shortened or extended at Large Bank management's discretion.
- All LBEICs will sign a Rotational Assignment Agreement, which will be maintained in the employee's official personnel file.
- Exemptions are decided by management and not the employee.
- The only exemptions given in recent years involve one year extensions because of significant mergers between two companies and the desire for continuity through key integration and hiring of new staff.

OCC senior examination staff are subject to a one year post-employment "cooling off" period with respect to entities they supervised. *See, e.g.*, 12 U.S.C. § 1820(k); 12 CFR 4, subpart E; "One-Year Restrictions on Post-Employment Activities of Senior Examiners" (OCC). Violators are subject to civil monetary penalties, can be removed from office, and can be prohibited from participating in the affairs of the bank, the holding company, or any other company for up to five years.

c. *What are your agency's lessons learned from the crisis with respect to the incentives and behavior of supervisors relative to the firms they supervise? Is your agency contemplating any change to your current organizational structure?*

Throughout the recent crisis we have seen repeated and sustained tests of examiner judgment, technical skills, communication skills, and work ethic across our examiner workforce. We have not seen evidence of "captured regulators" and our examiners have risen to the occasion during the unprecedented period of market turmoil. Our work in ensuring appropriate allowance levels and the propriety of credit risk measurement and control are reflected in the overall strength of the national banking system. As previously noted, we align our most experienced and dedicated staffs to the most complex institutions and augment our examination staff with expertise provided by our economists, legal and policy staffs.

While we compensate (incent) examiner behaviors based on performance, it is clear that the primary incentive to succeed is based on individual and team commitment to the role of bank supervision and its importance to the well being of our country's economy. Accordingly, the key roles of examiner-in-charge and the EIC's direct reports are hand-selected by senior OCC management, including approval by the Comptroller for all EICs and many of the direct report roles for the largest national banks. As discussed above, EICs at large national banks are required to rotate to a new institution within five years; and we also purposefully rotate staff among varying jobs and across large banks to both mitigate staleness or complacency and to facilitate talent development. We will continue these staffing and rotation processes and will continue to look for ways to further strengthen our examiner expertise and ways we can more effectively deploy our supervision resources.

d. *What incentives are in place to ensure examiners and their program managers will feel unimpeded in their ability to challenge the firm's management and to take a skeptical and independent approach?*

As noted above, the OCC's culture promotes critical thinking, analysis, and a "trust but verify" approach when dealing with bank management. We stress a "no surprises" policy with our examiners to encourage them to surface potential issues early. An examiner's ability to effectively identify and resolve significant risk issues depends on the professional execution of this approach and attitude.

The OCC insists all staff maintain high professional standards and exhibit high integrity. Federal laws and regulations, as well as conflict-of-interest rules and codes of conduct help to ensure that these standards are met. The federal banking agencies and their staffs are generally protected against lawsuits for actions and/or omissions made while discharging their duties in good faith. Sovereign immunity bars lawsuits without specific statutory authorization to pursue such litigation. Common law qualified immunity protects federal banking agencies' heads and staff from liability for the violation of an individual's federal Constitutional rights in connection with employees' performance of discretionary functions, as long as the employees' conduct does not clearly violate established statutory or Constitutional rights.

e. *How does your agency monitor the skepticism and independence exhibited by examiners and program managers in the exercise of their supervisory judgments? What checks and balances does your agency have in place? What further steps is your agency contemplating?*

Maintaining independence is a critical component to effective bank supervision. As discussed, processes to guard against getting too close to the banks include the mandatory large bank EIC rotation every 5 years and the requirement of examiners to participate in examinations and/or activities at other large banks on a periodic basis. This participation aids in ensuring independence by having different examiners provide a fresh perspective as well as allowing examiners the opportunity to develop their skills and broaden their knowledge base by observing similar processes at other banks. Other checks and balances are discussed in our response to "Oversight of the supervision function" above.

f. *Any other comments?*

- **Resources**
  Insufficient examiner resources and expertise may have been a significant cause of supervisory failure during the financial crisis.

a. *What are your agency's lessons learned about staffing, resources, and expertise?*

It is critical to have examiners with sufficient skills and experience to understand the risks, complex products, and expansive lines of business in which the banks engage. It is also important to have systems in place to share knowledge and information. We have network groups by risk areas in our large banks to facilitate the sharing of information, to escalate the need for guidance, to raise emerging risks, and to advance skills development. We have also developed a specialty skills program that helps us to identify and develop specialized examination and knowledge skills in eight key areas: asset management, bank technology, capital markets, commercial credit, retail credit, mortgage banking, compliance, and operational risk. We have also taken significant steps to build and maintain a pipeline of examiners, recognizing that many of our more experienced examiners are approaching retirement age. Through this pipeline we will have within the next few years, approximately 700 to 800 newly commissioned examiners.

b. *How can we ensure that individuals in the examination process have adequate resources, including analytical tools and expertise, to effectively question and challenge the firm's management regarding key risks and vulnerabilities?*

See above. The OCC has adequate resources to attract and retain sufficient numbers of qualified staff, with skills commensurate with the size and complexity of the institutions supervised. The OCC undertakes an internal evaluation process to ensure its staff meets its supervisory needs. Examples include annual skills gaps analysis to determine if available staff are meeting critical supervisory needs. This entails evaluating hiring and retention programs in place to attract and retain staff that have critical and highly marketable skills. Existing efforts that the OCC has in place are variable-pay and retention programs, benchmarking, and bonus programs. The salary scales, benefits, and work-life programs of the federal banking agencies are not based on the U.S. Federal Government pay system (12 U.S.C. § 481 (OCC)) and provide more generous compensation. This provides greater flexibility to attract and retain qualified staff. Finally, the OCC has the ability to hire outside experts or consultants when and where needed to fill any supervisory gaps, particularly during periods of financial stress.

c. *Are there impediments to acquiring and retaining subject-matter experts or other qualified staff – for example, compensation or non-pecuniary rewards such as opportunities for personal development, training, and rotations? What changes has your agency made or is it considering?*

We have not experienced significant impediments to acquiring or retaining subject matter experts. While the OCC's level of financial compensation is less than that of comparable counterparts in the industry, the combination of the OCC's compensation and the opportunity to examine the largest and most important financial services firms in the world is very attractive. Also, the current job market has substantially increased the number of external applicants we receive for job postings and we have selectively taken advantage of this opportunity to supplement our technical expertise in virtually all disciplines.

Our most significant challenge in developing talent is gaining experience through multiple business cycles. This is generally a function of years of experience, but may also be a function of banks having different products/risk as well as the geographic concentration of certain industries or market declines resulting in different examiner experiences. In this context, it is much easier for us to acquire and retain technical experts (which is very important) than candidates with seasoned judgment (which is comparatively more important) that also understand how a bank works across numerous lines of business engaged in multiple products.

d. *Any other comments?*

Acronyms Defined

ABCP: Asset-Backed Commercial Paper

ABS: Asset-Backed Securities

ADC: Assistant Deputy Comptroller

ALLL: Allowance for Loan and Lease Losses

ARM: Adjustable Rate Mortgage

Basel: Basel Committee on Banking Supervision

BHC: Bank Holding Company

BSA/AML: Bank Secrecy Act/Anti-Money Laundering

Call Report: Consolidated Reports of Condition and Income

CAMELS: Uniform Financial Institutions Rating System -- **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk

CBS: Committee on Bank Supervision

CDO: Collateralized Debt Obligation

CFPA: Consumer Financial Protection Agency

CMBS: Commercial Mortgage-Backed Securities

CMR: Credit and Market Risk

COLI/BOLI: Corporate Owned Life Insurance/ Bank Owned Life Insurance

CRE: Commercial Real Estate

DSRC: District Supervision Review Committee

EIC: Examiner-In-Charge

FAS: Financial Accounting Standard

FASB: Financial Accounting Standards Board

FDIC: Federal Deposit Insurance Corporation

FFIEC: Federal Financial Institutions Examination Council

FISMA: Federal Information Security Management Act

FRB: Federal Reserve Board

FSF: Financial Stability Forum

FSOC: Financial Services Oversight Council

FY: Fiscal Year

GAAP: Generally Accepted Accounting Principles

GAO: U.S. Government Accountability Office

LBDC: Large Bank Deputy Comptroller

LBEIC: Large Bank Examiner-In-Charge

LBS: Large Bank Supervision

LTV: Loan-To-Value

M/CBS: Mid-Size/Community Bank Supervision

MIS: Management Information Systems

MRA: Matter Requiring Attention

MSA: Metropolitan Statistical Areas

NRC: National Risk Committee

NSRO: Nationally Recognized Statistical Rating Organization

OCC: Office of the Comptroller of the Currency

OIG: Treasury Office of the Inspector General

OMB: Office of Management and Budget

Policy: Bank Supervision Policy/Chief National Bank Examiner's Office

PWG: President's Working Group

RAS: Risk Assessment Summary

RMBS: Residential Mortgage-Backed Securities

ROC: Rate Of Change

ROE: Report Of Examination

SCAP: Supervisory Capital Assessment Program

SEC: Securities and Exchange Commission

SIV: Structured Investment Vehicle

SNC: Shared National Credits

SSG: Senior Supervisors Group

VAR: Value-At-Risk

WSRC: Washington Supervision Review Committee