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TESTIMONY OF
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before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
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Statement Required by 12 U.S.C. § 250:

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

Chairman Johnson, Ranking Member Shelby, and members of the Committee, it is a pleasure to be here as the 30th Comptroller of the Currency to testify as part of the Committee's ongoing hearings on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Before beginning, I want to express my appreciation for the confidence and trust that members of this Committee and the President have bestowed upon me to lead the Office of the Comptroller of the Currency (OCC).

The OCC supervises nearly 2,000 national banks and federal savings associations (collectively "banks"), which constitute approximately 26 percent of all federally insured banks and thrifts, holding more than 69 percent of all commercial bank and thrift assets. These institutions range in size from nearly 1,800 community banks with assets of \$1 billion or less to the nation's largest and most complex financial institutions with assets exceeding \$100 billion. More than 90 percent of the institutions the OCC supervises are community banks and 75 percent of our bank supervision staff directly supports the supervision of these important institutions across the country. At the same time, examiners with diverse experience and specialized skills are embedded in the large banks we regulate to provide continuous ongoing supervision. To meet the supervisory needs of banks with such diversity, the OCC has structured its supervision activities into three lines of business: our Large Bank program, which typically covers banks with assets of \$50 billion or more; our Midsize Bank program, which covers banks with assets generally ranging from \$10 billion to \$50 billion; and our Community Bank program, which is focused on banks under \$10 billion in assets. We tailor our supervisory activities for these three groups of institutions to the challenges they face.

The Dodd-Frank Act and rulemakings by the OCC and other agencies have done much to strengthen the regulatory framework for our country's financial institutions. Translating these reforms into improved soundness and fair treatment of customers by individual institutions requires strong, effective supervision. I am committed to strong supervision and to taking additional steps to enhance our supervision where necessary. Strong supervision is a theme that will flow through the balance of my testimony and mark my tenure as Comptroller. The agency has already begun efforts to heighten supervisory expectations among the largest institutions we oversee. This process includes increasing the awareness of risks facing banks and the banking system, reducing risk to manageable levels, and raising expectations for management, capital, reserves, liquidity, risk management, and corporate governance and oversight. This is a process that will take time to accomplish, and we must be vigilant to maintain our course.

In response to the Committee's letter of invitation, my testimony covers five broad topics:

- The status of several rulemakings implementing some key provisions of the Dodd-Frank Act;
- A description of the OCC's supervision of community banks summarizing the steps we take to assure that our supervision is consistent, balanced, and reflective of the risks these banks face, as well as the compliance challenges they experience when new rules or policies are introduced;
- An overview of how the Dodd-Frank Act changed the regulatory framework for the supervision of large banking organizations and the mechanisms for regulatory collaboration;

- A discussion of the OCC's large bank supervisory program and how provisions of the Dodd-Frank Act will enhance and supplement our supervision; and
- A summary of our oversight and work underway at JPMorgan Chase (JPMC) related to their recently announced losses.

I. Update on Key Regulatory Reform and Dodd-Frank Act Rulemakings

The OCC has taken action on several key regulatory reform and Dodd-Frank Act rulemakings since our last testimony before this Committee. These are summarized below.

Final Rule to Revise the OCC's Regulations to Remove References to Credit Ratings

The OCC will soon be publishing in the *Federal Register* a final rule that addresses section 939A of the Dodd-Frank Act by removing references to credit ratings from the OCC's regulations dealing with topics other than capital requirements. For example, the investment securities regulation sets forth the types of investment securities that national banks and federal savings associations may purchase, sell, deal in, underwrite, and hold. Under existing OCC rules, permissible investment securities generally include Treasury securities, agency securities, municipal bonds, and other securities rated "investment grade" by nationally recognized statistical rating organizations such as Moody's, S&P, or Fitch Ratings. The OCC's final rule revises the definition of "investment grade" to remove the reference to credit ratings and replaces it with a new non-ratings based creditworthiness standard. To determine that a security is "investment grade" under the new standard, a bank will be required to perform due diligence necessary to establish: 1) that the risk of default by the obligor is low; and 2)

that full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard.

In comments on the proposed rule, banks and industry groups expressed concern about the amount of due diligence that the OCC would require a bank to conduct to determine whether an issuer has an adequate capacity to meet financial commitments under a security. The OCC believes that the proposed “investment grade” standard and the due diligence required to meet it are consistent with those under the prior ratings-based standards and existing due diligence requirements and guidance. Even under the prior ratings-based standards, national banks and federal savings associations of all sizes should not have relied solely on a credit rating to evaluate the credit risk of a security, and have been advised to supplement any use of credit ratings with additional diligence on the credit risk of a particular security. Nevertheless, the OCC recognizes that it may take time for some national banks and federal savings associations to make the adjustments necessary to make “investment grade” determinations under the new standard. Therefore, the OCC is allowing institutions until January 1, 2013, to come into compliance with the final rule.

To aid this adjustment process, the OCC also will publish guidance to assist banks in interpreting the new standard and to clarify the steps banks can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Final Market Risk Capital Rule

On December 21, 2011, the OCC, Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) issued a notice of

proposed rulemaking (NPR) that amended the agencies' January 2011 market risk capital proposal by removing references to credit ratings, consistent with section 939A of the Dodd-Frank Act. The NPR proposed alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rule.

I will soon approve for publication in the *Federal Register* the final market risk rule that implements various enhancements adopted by the Basel Committee on Banking Supervision to strengthen the capital requirements that apply to banks' trading activities. The final rule modifies the scope of positions covered by the rule to better capture positions for which the market risk capital rules are appropriate; reduce procyclicality in market risk capital requirements; enhance the rule's sensitivity to risks that are not adequately captured under the current regulatory measurement methodologies; and increase transparency through enhanced disclosures. The rule also removes references to credit ratings from the market risk capital framework and requires banks to receive written approval before making material changes to models used to calculate their market risk capital requirement. The rule will be published once approved by the boards of the FDIC and the FRB.

Basel III Capital Standards

I also will soon approve for publication in the *Federal Register* a set of proposals that would revise the agencies' current "advanced approaches" risk-based capital rules and replace the agencies' current generally applicable risk-based capital rules with rules that implement various enhancements adopted by the Basel Committee. These

enhancements, which were more fully discussed in the OCC's December 2011 testimony, include:

- A new, more rigorous definition of capital, which excludes funds raised through hybrid instruments that were unable to absorb losses as the crisis deepened;
- Increased minimum risk-based capital requirements, which include increased minimum Tier 1 capital requirements and a new common equity requirement;
- The creation of a capital conservation “buffer” on top of regulatory minimums to be drawn down in times of economic stress and that trigger restrictions on capital distributions (such as dividends), and discretionary bonus payments;
- Enhanced risk-based capital requirements for counterparty credit to capture the risk that a counterparty in a complex financial transaction could grow weaker at precisely the time that a bank's exposure to the counterparty grows larger;
- The addition of a new leverage ratio requirement for larger institutions that incorporates off-balance-sheet exposures; and
- The removal of the references to credit ratings from the agencies' risk-based capital rules, pursuant to section 939A of the Dodd-Frank Act.

The agencies have divided the proposals into three separate NPRs that will be published together in the *Federal Register* to allow interested parties to better understand and focus on the various aspects of the overall capital framework, including which aspects of the rules will apply to which banking organizations. Separating the proposals into three documents will make it easier for banks of all sizes to understand which proposed changes are related to improving the quality and increasing the quantity of

capital and which are related to enhancing the risk sensitivity of the calculation of total risk-weighted assets.

Dodd-Frank Stress Tests

The Dodd-Frank Act requires two types of stress testing requirements: stress tests conducted by the company and stress tests conducted by the FRB. The company-run stress test applies to all financial companies, including national banks and federal savings associations, with total consolidated assets of more than \$10 billion, and requires the primary financial regulatory agency of those financial companies to issue regulations implementing the stress test requirements. Company-run stress tests are required semi-annually for financial companies with consolidated assets exceeding \$50 billion, and annually for those from \$10 to \$50 billion in size. The primary financial regulatory agency is required to define “stress test,” establish methods for the conduct of the company-conducted stress test that must include at least three different sets of conditions (baseline, adverse, and severely adverse), establish the form and content of the institution’s report, and compel the institution to publish a summary of the results of the institutional stress tests.

On January 24, 2012, the OCC published an NPR to implement the company-run stress test for banks. We are currently reviewing the comments we received and are working closely with the FRB and FDIC to ensure that the final rules are consistent and reduce burden to the greatest extent possible by avoiding duplication.

Volcker Rule

Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act (BHCA) that contains certain prohibitions and limitations on the ability of a banking entity and a nonbank financial company supervised by the FRB to engage in proprietary trading and to have certain interests in, or relationships with, a hedge fund or

private equity fund. The OCC, FDIC, FRB, and the Securities and Exchange Commission (SEC) issued proposed rules implementing that section's requirements on October 11, 2011. On January 3, 2012, the period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012. On January 11, 2012, the Commodity Futures Trading Commission (CFTC) issued a substantively similar proposed rule implementing section 13 of the BHCA and invited public comment through April 16, 2012. The agencies are now considering the more than 18,000 comments received.

On April 19, 2012, the FRB clarified that entities covered by the Volcker Rule have a period of two years after the statutory effective date, which would be until July 21, 2014, to fully conform their activities and investments to the requirements of section 619 of the Dodd-Frank Act and any final rules adopted, unless that period is extended by the FRB.

The OCC, FDIC, SEC, and CFTC announced that they plan to administer their oversight of banking entities under their respective jurisdictions in accordance with the FRB's conformance rule and statement of April 19.

Lending Limits

The OCC's lending limit rules at 12 U.S.C. § 84 provide that the total loans and extensions of credit by a national bank to a person outstanding at one time shall not exceed 15 percent of the unimpaired capital and unimpaired surplus of the bank if the loan is not fully secured, plus an additional 10 percent of unimpaired capital and unimpaired surplus if the loan is fully secured by certain types of collateral. Section 610 of the Dodd-Frank Act amends this provision to expand the definition of "loans and

extensions of credit” to include any credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between a national bank and that person. This amendment is effective July 21, 2012.

The OCC plans to issue a rule shortly to establish how the credit exposures from these types of transactions should be measured for lending-limit purposes. In implementing these provisions, the OCC has been mindful of opportunities to minimize complexity, particularly for community banks, and of providing sufficient time for banks to comply with the new requirements.

II. OCC’s Commitment to and Supervision of Community Banks

The OCC’s community bank supervision program is built around our local field offices, staffed by local examiners, based in more than 60 cities throughout the United States in close proximity to the banks they supervise. Every community bank is assigned to an examiner who monitors the bank’s condition on an ongoing basis and who serves as the focal point for communications with the bank.

The OCC’s structure ensures that community banks receive the benefits of highly trained examiners with local knowledge and experience, along with the resources and specialized expertise that a nationwide organization provides. Examiners conduct their examinations using the *Community Bank Supervision* section of the *Comptroller’s Handbook* that tailors procedures to community banks. While the OCC’s bank supervision policies and procedures establish a common framework and set of expectations, examiners tailor their supervision of each community bank to its individual risk profile, business model, and management strategies. As a result, the OCC’s

Assistant Deputy Comptrollers are given considerable decision-making authority, reflecting their experience, expertise, and their on-the-ground knowledge of the institutions they supervise.

The OCC has mechanisms in place to ensure that examiners apply our supervisory policies, procedures, and expectations in a consistent and balanced manner. The responsible manager reviews and signs off on each report of examination before being finalized. When significant issues are identified and an enforcement action is already in place, or is being contemplated, additional levels of review occur prior to finalizing the examination conclusions. The OCC also has formal quality assurance processes, overseen by the agency's Enterprise Governance office that reports directly to me, that assess the effectiveness of our supervision and compliance with OCC policies through periodic, randomly selected reviews of the supervisory record.

As a former state banking commissioner, I have a keen appreciation for the critical role that community banks play in providing consumers and small businesses in communities across the nation with essential financial services as well as the credit that is critical to economic growth and job creation. While community banks comprise about 11 percent of the banking assets in our country, they make 39 percent of the small business loans that keep America working. I am committed to making sure our supervision of these institutions is fair and balanced, and that wherever possible, we minimize their regulatory and compliance burdens.

As the OCC has previously testified, while the focus of the Dodd-Frank Act is generally on larger financial institutions, other provisions broadly amend banking and

financial laws in ways that affect the entire banking sector, including community banks.¹ Some of these involve provisions where the OCC has rulemaking authority, while others fall outside of the OCC's jurisdiction. As we implement regulations for the Dodd-Frank Act and other key reform efforts, one of my early directives to the OCC staff has been to assess the potential impact on smaller institutions, seek ways to minimize potential burden, and explain and organize our rulemakings in ways that help community bankers understand the scope and application of the rules to their institutions.

The companion guidance to our rulemaking to remove credit ratings from our investment securities regulations, described above, is one example of how we are trying to minimize burden on smaller banks. In implementing this provision of the Dodd-Frank Act, our goal has been to meet the objective of the statute while recognizing the effectiveness of the tools and analyses that well-managed community banks have routinely used to aid their credit analysis and investment decisions.

III. Dodd-Frank Impact on Supervision of Large Banking Organizations

The Dodd-Frank Act will have a significant and lasting impact on the supervision and oversight of our nation's large financial firms. Indeed, among the Act's key objectives are to strengthen the oversight, regulation, and resolution regimes applicable to large financial organizations to lessen the potential that disruptions or failures could have on the stability of the U.S. financial system. The Act also seeks to promote greater market stability through increased transparency and oversight of swaps and other derivative activities. Finally, the Act also seeks to strengthen consumer protection related to financial products and services.

¹ See <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-42-written.pdf>.

The Dodd-Frank Act establishes a variety of mechanisms to achieve these objectives. Some of these mechanisms, such as the risk retention, Volcker, and swap margin and central counterparty and clearing provisions, are targeted at how and where various financial activities and risk taking are to be conducted in the future. As more fully described in the OCC's December 2011 and March 2012 testimonies before this Committee, work on these rulemakings is underway.² Other provisions established new or expanded regulatory authorities. These include the Title II orderly liquidation provisions and tools provided to the FDIC and the FRB; the transfer of powers and functions from the Office of Thrift Supervision to the OCC; and the creation of the Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC). Finally, other provisions, most notably those related to heightened prudential standards are designed to strengthen the risk management, capital, and liquidity that govern and support risk-taking activities.

The financial crisis underscored that supervisors must be cognizant not only of what is going on within the individual firms they oversee, but also how those activities affect, or can be affected by, events at other firms, markets, and the broader economy. The Dodd-Frank Act established the FSOC to provide a formal body to assess and exchange such information. The OCC is an active participant in FSOC and its various operating committees, including those developing and assessing potential designations for systemically important financial market utilities and non-bank financial firms; the systemic risk committee, charged with assessing and monitoring potential emerging systemic issues; and the committee providing input to the FRB's heightened prudential

² See <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-142-written.pdf> and <http://www.occ.gov/news-issuances/congressional-testimony/2012/pub-test-2012-50-written.pdf>.

standards for systemically important banks and designated non-banks. I attended my first FSOC meeting last month and believe it will be a valuable forum for exchanging market intelligence and coordinating regulatory actions on a variety of cross-cutting issues that may affect OCC-supervised large institutions. One such example that was widely reported from the most recent FSOC meeting included a discussion, led by the OCC, of risks and supervisory actions related to reports of JPMC activities and disclosed losses—a topic also discussed later in this testimony.

To promote consistent and comprehensive oversight of large banking organizations, the Dodd-Frank Act appropriately requires close collaboration among the federal financial agencies with respect to rulemaking and various ongoing supervisory activities. In this regard, two provisions of the Act have had a direct impact on the scope and nature of the OCC's supervisory activities.

The first, and most immediate impact, was the transfer to the OCC of all functions of the OTS relating to federal savings associations. From an operational perspective, this transfer was successfully completed last July, and the ongoing supervision of more than 600 federal savings associations has been integrated into our supervisory programs. The integration of the OTS into the OCC will help achieve a more consistent supervisory regime for federally chartered depository institutions. In this regard, and as discussed more fully in the OCC's December 2011 testimony, we are conducting a comprehensive, multi-phased review of our regulations, as well as those of the OTS, to eliminate duplication, reduce unnecessary burden, and provide consistent treatment, where appropriate, for both national banks and federal savings associations. A similar effort is

underway to integrate the more than 1,000 OTS policies into a consolidated OCC policy framework.

While we believe having a common set of rules and policies will benefit national banks and federal savings associations, we recognize that these changes can create uncertainty for federal savings associations. To help federal savings associations understand these changes and the OCC's approach to supervision, we continue to hold various outreach meetings and teleconferences for federal savings associations. These opportunities allow federal savings association executives to voice concerns, to get answers to their questions, and to gain a better understanding of supervisory issues of specific interest to them. We are also in the process of re-establishing the OTS' advisory committees for mutual savings associations and minority institutions to provide a venue for industry input on the unique challenges facing those institutions.

The second shift in OCC supervisory responsibilities as the result of Dodd-Frank has been the transfer of oversight responsibility for compliance with certain federal consumer laws to the CFPB for national banks and federal savings associations with total assets greater than \$10 billion. To minimize regulatory burden on institutions, the Dodd-Frank Act requires the CFPB to coordinate its activities with the supervisory activities conducted by the prudential regulators. Section 1025 requires the CFPB to consult with the prudential regulators regarding respective schedules for examining an institution. Similarly, the CFPB and the prudential regulators are required to conduct their respective examinations simultaneously in an insured depository institution and to share and comment on related draft reports of examination that result from the simultaneous examinations. The law also provides that the regulated institution may opt out of a

simultaneous examination by the prudential regulator and the CFPB. I am pleased to report that the OCC and other federal banking agencies recently signed and earlier this week published a Memorandum of Understanding that implements these coordination requirements in a realistic and practical manner.

With respect to supervision of individual large banking organizations, the OCC serves as the primary federal banking regulator for activities conducted within the national bank or federal savings association charter and its subsidiaries, except for compliance with statutes and regulations where jurisdiction has been expressly provided to another supervisor, such as the SEC for certain broker-dealer activities, and the CFPB for certain federal consumer laws. Since most large banks are part of a bank holding company, we work closely with the FRB in planning and conducting our supervisory activities for these institutions.

Successful implementation of the heightened prudential standards provisions of the Dodd-Frank Act will require close collaboration between the OCC and the FRB. For example, bank holding companies subject to the heightened prudential standards, and their subsidiary national banks and federal savings associations, will be subject to multiple stress tests, including the annual Comprehensive Capital Analysis and Review (CCAR), and the supervisory and company-run stress tests set forth in the FRB's Heightened Prudential Standards rules and the OCC's stress test rule. It is important that our agencies work together to align resources and strategy, and to ensure consistency in scenarios and models, in both the CCAR and Dodd-Frank Act stress testing processes.

IV. OCC Supervision of Large Banks and the Dodd-Frank Act

Overview of the OCC's Supervisory Program for Large Banks

The OCC's Large Bank supervision program is structured to promote consistent risk-based supervision. It is a centralized program headquartered in Washington with a national perspective that facilitates coordination across large institutions.

The foundation of the OCC's supervisory efforts is our continuous, onsite presence of examiners at each of the 19 largest banking companies. These onsite teams are led by an Examiner-In-Charge (EIC) who manages a staff of seasoned examiners, generally with 20 or more years of experience across numerous banks and multiple business cycles, and possessing advanced skills in key risk areas such as credit, capital markets, and compliance. In addition, certain supervisory activities are staffed by our team of PhD economists from the OCC Economics Department. The examiners are also supplemented by lawyers, other economists, as well as policy and subject matter experts to support their ongoing supervision.

The onsite examination teams have three main objectives. The first is to know the objectives of the bank and its lines of business, the key risks, and the controls that are put in place to manage them. The second is to assess the levels of risk in the bank and the quality of risk management over the course of the examination cycle. Finally, examiners are charged with communicating examination findings, concerns, and ratings through our CAMELS and Risk Assessment System. Examiners communicate by meeting with bank management and the board of directors, and through written supervisory letters and reports of examination. They identify concerns and ensure that corrective actions are taken, through the supervisory process, or if needed, appropriate enforcement actions.

To enhance our ability to identify key risks as well as emerging issues and share best practices across the large banks, we have examiner network groups across eight major disciplines: Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk, and Compliance. These groups share information, concerns, and policy application among examiners. They also identify areas of common interest as well as risks that are elevated or emerging. The EICs and leadership teams of each of the network groups work closely with specialists in our Supervision Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to emerging issues.

Examinations are conducted pursuant to risk-based supervisory strategies that are developed for each institution. Although each strategy is tailored to the business model and risk profile of the individual institution, the strategy development process is governed by supervisory objectives established annually by our senior supervision management team. Through this planning process, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concern. Each strategy is reviewed and approved by the appropriate Large Bank Deputy Comptroller. In addition, a Quality Assurance group within our Large Bank program reviews selected strategies as part of a structured process review to ensure that examination activities are executed consistently and in a quality manner.

It is important to remember that the job of risk management is not to eliminate losses. Rather, risk management ensures that risk exposures are fully identified and understood by bank management and directors to allow them to make informed business

decisions about the firm's risks, and that the bank has sufficient capital, reserves, and liquidity to withstand a range of potentially adverse outcomes. Banks must manage their risks effectively to meet the credit and borrowing needs of the customers and communities they serve.

Resident examiners apply risk-based supervision to a broad array of issues and risks, including credit, liquidity, price, interest rate, compliance, and operational risks. The primary focus of examiners is to determine whether banks have sound risk control processes commensurate with the nature of their risk-taking activities, capital, reserves, and liquidity. Given the millions of transactions that large banks conduct daily across varied product lines and businesses, examiners do not review every transaction in a bank.

OCC examiners probe to see where activities, earnings, or losses diverge from expectations to a degree indicative of a breach of approved parameters or breakdown of controls. For example, examiners look for lending or trading activities operating outside approved limits, especially where risk management activities did not identify or escalate such instances; and for models breaking or not going through proper validation. Risk management seeks to mitigate and control risk but not eliminate it entirely. Losses occur even when all controls function properly. That is why banks are required to maintain capital, reserves, and liquidity to absorb adverse outcomes and unexpected losses.

When we find weaknesses or deficiencies, we communicate them to bank senior management and require corrective actions. Most often this is accomplished through "Matters Requiring Attention" (MRA) that are sent to the bank's senior management and board of directors. When needed, we take more formal enforcement actions.

OCC Actions and the Dodd-Frank Act Require Stronger Risk Management for Systemically Important Banks

At the OCC, we have raised the bar on our supervisory expectations for the largest banks we supervise. Large banks are critically important to the vitality of our economy and the orderly functioning of the capital markets. As a result, they must be managed and governed in a higher quality manner than less systemically important banks. Our experience in the recent crisis showed that we needed to elevate expectations with respect to balance sheets as well as governance and oversight processes.

Stronger Capital, Reserves, and Liquidity Standards

Since the onset of the financial crisis, we directed the largest institutions to strengthen their capital, reserves, and liquidity positions. As a result, the quality and level of capital at national banks and bank holding companies with total assets over \$50 billion have improved significantly. The median percentage of Tier 1 common capital relative to total assets for bank holding companies increased from 5.2 percent to more than 7 percent, while the comparable ratio for national banks and federal savings institutions rose from 6.4 percent to 8.7 percent, over that same period.

Under scrutiny of our examiners, the largest banks have more than doubled their loan loss reserves as a percentage of gross loans since the end of 2007, from 1.4 percent to 2.9 percent. Similarly, the largest banks have materially strengthened their liquidity buffers through increases in short-term liquid assets that can be used to meet unanticipated liquidity demands and through a decreased reliance on short-term, volatile funding. While these are positive developments, we are taking actions to ensure that these are permanent and not just temporary improvements.

In concert with the Basel Committee, we are raising both the quality and quantity of regulatory capital that banks generally must hold. Consistent with section 171 of the Dodd-Frank Act, these enhanced capital requirements will also apply to bank holding companies. These changes are being implemented by the forthcoming Basel III capital rulemakings, which were previously described. Under the proposed rules, large banks subject to the “advanced approaches” capital regime will face additional capital requirements that will not apply to smaller banks. These include a countercyclical capital charge, which banking supervisors can activate to curb excessive credit growth, and a supplemental leverage ratio that will capture off-balance-sheet exposures. This enhanced leverage ratio is broadly consistent with section 165 of the Dodd-Frank Act, which directs that off-balance-sheet activities be included in the regulatory capital calculation for bank holding companies with total consolidated assets equal to or greater than \$50 billion. Basel III also calls for adopting a capital surcharge that would apply only to the 29 largest global, systemically important banks, seven of which are U.S. entities. The FRB supervises all of these bank holding companies, and the OCC supervises the national banks in five of these companies. It is envisioned that this provision will be included in the FRB’s heightened prudential capital standards rule as part of its implementation of section 165.

Basel III also introduces two explicit quantitative minimum liquidity ratios to assist a bank in maintaining sufficient liquidity during periods of financial distress: the Liquidity Coverage Ratio and the Net Stable Funding Ratio. These ratios are designed to achieve two separate but complementary objectives. The Liquidity Coverage Ratio, with a one-month time horizon, addresses short-term resilience by ensuring that a bank has

sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Net Stable Funding Ratio is targeted toward promoting longer-term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. Its goal is to limit over-reliance on short-term wholesale funding during times of robust market liquidity and to encourage better assessment of liquidity risk across all on- and off-balance-sheet items.

The Basel Committee included a lengthy implementation timeline for both ratios to provide regulators the opportunity to conduct further analysis and to make changes as necessary. The OCC is continuing its work with the Basel Committee to develop and recommend changes to the Liquidity Coverage Ratio to ensure that it will produce appropriate requirements and incentives, especially during economic downturns, and to otherwise limit potential unintended consequences.

These explicit liquidity thresholds, once fully implemented, will complement the more rigorous liquidity risk management expectations that the OCC and other banking agencies issued in 2010 and that are helping to form the enhanced liquidity standards the FRB is promulgating as part of the heightened prudential standards under section 165 of the Dodd-Frank Act. In the interim, the OCC this week published a revised Liquidity Risk Management booklet as part of its *Comptroller's Handbook* series. This booklet forms the framework for our liquidity examinations. While the core concepts in the booklet apply to national banks and federal savings associations of all sizes, the booklet emphasizes that the complexity and sophistication of liquidity risk management, along with the liquidity positions held must be tailored to a bank's risk profile and scope of activities.

Heightened Expectations for Strong Corporate Governance and Oversight

Higher supervisory expectations, along with sharper execution by bank management and independent directors in fundamental areas, will go a long way toward maintaining the improvements achieved since the financial crisis and minimizing the probability and impact of future crises. We set higher expectations for large banks in five specific areas.

Board willingness to provide credible challenge. A key element in corporate governance is a strong, knowledgeable board with independent directors who provide a credible challenge to bank management. The capacity to dedicate sufficient time and energy in reviewing information and developing an understanding of the key issues related to bank activities are critical to being an effective director. Informed directors are well positioned to engage in value-added discussions that provide knowledgeable approvals and guidance. Effective directors prudently question the propriety of strategic initiatives, talent decisions, and the balance between risk taking and reward. And obviously, it is essential to the ability of directors to perform this role to have effective information flow and risk identification within the organization.

Talent management and compensation. Human capital is a key asset in any organization, and we expect large banks to have a well defined personnel management process that ensures appropriate quality staffing levels and provides for orderly succession. Large bank management processes are typically extensive. OCC EICs are enhancing their knowledge in this area and incorporating their assessments into the “management” rating in CAMELS, with particular focus on the adequacy of current staffing levels, the ability to provide for orderly succession, the proactive identification of

staffing gaps that require external hires, and appropriate compensation tools to motivate and retain talent. Of particular importance is the need to ensure that incentive compensation structures balance risk and financial rewards and are compatible with effective controls and risk management. This is a key objective of the interagency guidance on sound incentive compensation that the OCC, FRB, and FDIC issued in June 2010, and the proposed rulemaking that the federal banking agencies, the National Credit Union Administration, the SEC, and the Federal Housing Finance Agency have issued to implement the incentive-based compensation provisions in the Dodd-Frank Act. Work on that rulemaking is underway.

Defining and communicating risk tolerance expectations across the company.

Consistent with prudent governance practices, banks must define and communicate acceptable risk tolerance, and results need to be periodically compared to pre-defined limits. As banks have grown, the process of defining and measuring risk tolerance has typically been confined to the business unit and more micro levels. While these lower level risk limits can generally control individual areas of risk taking, they do not enable senior management or board members to monitor or evaluate concentrations or risk levels at the broader firm level. Examiners are directing banks to complement existing risk tolerance structures with measures and limits of risk addressing the amount of capital or earnings that may be at risk on a firm-wide basis, the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each of the key risk categories monitored by the banks. This process will result in better identification and measurement of concentrations, with attendant monitoring and controls.

Development and maintenance of strong audit and risk management functions.

The recent crisis reinforced the importance of quality audit and risk management functions. The scale and breadth of large banks presents added challenges to the roles of executive management and directors in knowing the risk profile and whether pre-defined policies and procedures are being followed appropriately. While regulators operated for many years with the premise that *satisfactory*³ oversight functions were generally sufficient, the financial crisis has led us to conclude that large banks should not operate with anything less than *strong* audit and risk management functions. To meet this higher standard, we have directed bank audit and risk management committees to perform gap analyses relative to OCC's standards and industry practices and to take appropriate action to improve their audit and risk management functions. We expect members of the bank's board and its executive management team to ensure audit and risk management teams are visibly and substantively supported. As part of their ongoing supervision, OCC examiners are evaluating the state of these key oversight functions and identifying areas that require strengthening.

Sanctity of the charter. While holding companies of large banks are typically managed on a line of business basis, directors at the bank level are responsible for oversight of the bank's charter—the legal entity. Such responsibility requires separate and focused governance. We have reminded the boards of banks that their primary fiduciary duty is to ensure the safety and soundness of the national bank or federal savings association. Execution of this responsibility involves focus on the risk and control infrastructure necessary to maintain it. Directors must be certain that appropriate

³ OCC examiners rate the quality of the bank's audit function and the quality of risk management as weak, satisfactory, or strong.

personnel, strategic planning, risk tolerance, operating processes, delegations of authority, and controls are in place to effectively oversee the performance of the bank. The bank should not simply function as a booking entity for the holding company. It is incumbent upon bank directors to be mindful of this primary fiduciary duty as they execute their responsibilities.

V. JPMorgan Chase Loss and OCC Role and Responsibilities

With this background, let me turn to the recently announced losses at JPMC. This event raises questions about the adequacy and rigor of JPMC's risk management practices that we are actively examining.

JPMC is a \$2.3 trillion bank holding company with approximately \$128 billion in Tier 1 common capital as of March 31, 2012. The FRB oversees the holding company and its affiliates. The OCC oversees JPMC's national banks and various subsidiaries. The lead national bank has approximately \$1.8 trillion in total consolidated assets and \$101 billion in Tier 1 common capital. The OCC's supervisory team includes approximately 65 onsite examiners who are responsible for reviewing nearly all facets of the bank's activities and operations, including commercial and retail credit, mortgage banking, trading and other capital markets activities, asset liability management, bank technology and other aspects of operational risk, audit and internal controls, and compliance with the Bank Secrecy Act, and anti-money laundering laws and the Community Reinvestment Act. These onsite examiners are supported by additional subject-matter experts from across the OCC.

Given the scale of the bank, the loss by JPMC affects its earnings, but does not present a solvency issue. JPMC, like other large banks, has improved its capital,

reserves, and liquidity since the financial crisis, and its levels are sufficient to absorb this loss. The Basel III rulemakings described earlier will further increase the required level of high-quality capital for all U.S. banks, and work underway by the Financial Stability Board will further increase capital requirements for systemically significant firms, like JPMC.

Similarly, the events at JPMC do not threaten the broader financial system. Under current market conditions, the JPMC effort to manage its positions is not creating an unusual risk of contagion to other banks. Beyond JPMC, we have directed OCC examiners to evaluate the risk management strategies and practices in place at other large banks, and examiners have reported that there is no activity similar to the scale or complexity of JPMC. However, this is a continuing focus of our supervision.

The activities that generated the reported \$2 billion loss were conducted in the national bank by JPMC's Chief Investment Office (CIO), which is responsible for the bank's asset-liability management activities. This asset-liability management function is separate from JPMC's investment banking business, where most trading and market making takes place. The CIO reports to the Chief Executive Officer of JPMC. Its activities are conducted globally but managed and controlled out of JPMC's New York offices. These activities are supervised by OCC staff assigned to the JPMC headquarters in New York. Part of our ongoing review includes an evaluation of this structure, its oversight, and controls.

In 2007 and 2008, the bank constructed a portfolio designed to partially offset credit risk using credit default swaps to help protect the company from potential credit losses in a stressed global economy. This strategy was reflected in regular reports

received by OCC examiners. The OCC focused on the risk management systems and controls that the bank employed to mitigate credit risk in its portfolio. For several years thereafter, risk levels operated within bank-approved stress and other limits.

In late 2011 and early 2012, bank management revised its strategy and decided to offset its original position and reduce the amount of stress loss protection. The instruments chosen by the bank to execute the strategy were not identical to the instruments used in the original position, which introduced basis, liquidity, and other risks. As the new strategy was executed in the first quarter, actual performance deviated from expectations, and resulted in substantial losses in the second quarter. Whether risk management controls, procedures, and reports were properly structured, reviewed, approved, and acted upon in the execution of this strategy is another focus of our ongoing examination.

In April 2012, as part of our supervisory activities, OCC examiners met with bank management to discuss the bank's transaction activity and the current state of the position. OCC examiners directed the bank to provide additional details regarding the transactions, their scope, and risk. Our examiners were in the process of evaluating the bank's current position and strategy when, at the end of April and during the first days of May, the value of the position deteriorated rapidly.

Since that time, the OCC has been meeting daily with bank management with respect to the bank's response to this situation, to re-evaluate the risk management activities and controls of the bank and how they applied to its CIO function, and to determine what additional action is necessary. This includes the ongoing daily oversight of the bank's actions to mitigate and reduce the risk of the positions at issue. We and the

Federal Reserve are conducting reviews in the bank and are sharing information with the FDIC and other regulators.

We are also undertaking a two-pronged review of our supervisory activities and response. The first component is focused on evaluating the adequacy of current risk controls and risk governance at the bank, informed by their application to the positions at issue. The second component evaluates the lessons learned from this episode that could enhance risk control and risk management processes at this and other banks and improve OCC supervisory approaches. Consistent with our supervisory policy of heightened expectations for large banks, we will require that the bank adhere to the highest risk management standards.

We are not limiting our inquiry just to the particular transactions at issue. We will assess not just the adequacy of risk management and controls for the positions now spotlighted, but also activities in comparable bank operations. We will use these events to more broadly evaluate the effectiveness of the bank's risk management throughout the firm and to identify ways to improve our supervision.

The first prong of our approach involves our onsite exam team focusing on three broad areas. To begin with, we are actively assessing the quality of management and risk management in the CIO function, including decision making; board oversight, including whether the risk committee is appropriately informed and engaged; the types and reasonableness of risk measurement metrics and limits; the model governance review process; and the quality of work by the independent risk management team as well as internal audit. We are also assessing the adequacy of the information provided within the bank and made available to the OCC to evaluate the risks and risk controls associated

with the positions undertaken by the CIO. Finally, we are evaluating the compensation process of the CIO and will assess the bank's determination on "claw backs" as part of that analysis. If corrective action is warranted, we will pursue and implement appropriate informal and/or formal remedial measures.

Working on a parallel track, as part of the second prong of our supervisory response, we are evaluating the events leading up to and through the bank announcement of losses associated with the CIO, and what these events teach us to improve risk management and to enhance our supervisory activity. Particular attention is being directed to the rationale for the transactions and how they fit within the framework of the bank's risk management processes; the quality and extent of information provided to the OCC; and consistency of the bank's activities with OCC supervisory guidance.

We are reviewing the bank's management information systems, committee minutes, audit reports, and conducting discussions with examiners to establish a detailed chronology of events surrounding the CIO decision-making and the resulting losses. Our analysis will focus on where breakdowns or failures occurred. This will include assessments of senior management communication and monitoring of strategies; business judgment and execution; the articulation of risk tolerance relative to strategy; risk measurement (including models, limits, stress scenarios, and changes to those tools during the period in question); flow of information, proper authority, and approvals; and the appropriateness and timeliness of particular actions.

As part of this second prong of our supervisory response, we are also assessing relevant audit or examination findings and whether they were addressed; how the risks associated with the strategy were recognized and evaluated; whether there was an

effective exchange of views among the business unit and control groups; whether incentives were properly aligned with desired behaviors; and whether the bank's actions were consistent with OCC supervisory guidance and expectations. Again, if corrective action is warranted, we will pursue and implement appropriate informal and/or formal remedial measures.

Finally, a vital part of this second component of our supervisory effort is identifying the lessons learned for improving the effectiveness of our supervision. The areas that we will explore here include whether the quality and extent of information available to OCC examiners was sufficient to permit an understanding of the risk and management processes in place to govern it. We will also determine what, in retrospect, the OCC could have done differently, and how to ensure that the risk management processes of this bank—and others—are effective.

I should also note that the OCC is not drawing any conclusion about whether the activities of JPMC's CIO would be subject to the Volcker Rule. It is premature to reach any conclusion based upon the facts and information as they currently exist.

VI. Conclusion

I appreciate the opportunity to appear before this Committee. While my testimony reports significant progress on implementing the Dodd-Frank Act and other reforms and shares insight into our ongoing efforts to enhance supervision of community banks and large banks, I want to stress my commitment to ensuring this process continues. The recent events at JPMC also remind us of the need to continuously assess OCC's supervisory processes. I look forward to providing additional information to the Committee throughout my tenure as Comptroller and continuing to share how we are

meeting our commitment to strong, effective, fair, and balanced supervision of the national banks and federal savings associations that we supervise.