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It is a pleasure to be with you here this morning at the Kennedy School of Government for the Center for Business and Government's 25th Anniversary – on three counts. First, because I'm a Kennedy School graduate, happy to be back in Cambridge 30 years later. Second, because I never had the opportunity to study in this building, having graduated from the Public Policy program in the last class to study in the Littauer Center. And third, because as graduate assistant to Richard Zeckhauser, my job was to help identify successful models for graduate academic centers. So it's nice to see how all that turned out.

While I am happy to be here, allow me to express the regrets of the Comptroller of the Currency, John Dugan, who was called to deliver a command performance before Chairman Barney Frank and the House Committee on Financial Services today. He had hoped to be here to share the dais with his friend and former boss, Bob Glauber, with whom he worked at the Treasury Department almost 20 years ago. At the time John took that job, the two of us were working together at the Senate Banking Committee, helping to sort out the savings and loan crisis – another real estate emergency – during an exceptionally challenging period for financial regulation.

So here we are today, at another challenging and interesting point in the history of financial regulation, for this timely discussion of potential changes to that regulatory regime. This invitation to speak was extended long before the recent disruption in credit markets, but that disruption provides a good background against which to consider these issues. Before exploring current market developments and their implications, however, I want to give you a perspective on the Office of the Comptroller of the Currency, or OCC, and our particular approach to financial regulation.

Established in 1863, the OCC is the oldest regulatory agency in the federal government. It was part of the program of national institution building during the administration of Abraham Lincoln that encompassed a national currency, a national banking system, and a trans-continental railroad. The OCC's sole mission is to regulate and supervise institutions that are chartered as national banks, which are subject to a uniform set of national authorities established in law by Congress, not the states. National banks come in nearly all sizes, from very small community banks to nearly all of the very largest banks in the United States, three of which each hold more than $1 trillion in assets. Taken together, national banks constitute about one quarter of all U.S. commercial banks; hold approximately 70 percent of total banking assets; and are major if not dominant participants in the markets for deposits, mortgages, credit cards, business and real estate loans, syndicated and leveraged loans, derivatives, asset management, and many other financial products and services.

Like other <u>bank</u> regulators, the primary method that the OCC uses to implement banking laws and regulation is direct, prudential supervision of national banks – not reliance on formal enforcement. Prudential supervision is a process by which a supervisor establishes regulations to control risk taking and then monitors banks to ensure they are complying with the regulations and not taking on excessive risk. Effective prudential supervision depends fundamentally on our extensive and continual presence in the banks that we regulate. And when I say "extensive presence," I mean it: the OCC is unique among banking supervisors, both in the United States and internationally, in placing large teams of resident examiners on the premises of each of the 20 largest banks we supervise. At each of our "mega-banks," well over 50 examiners are continuously on site at the bank. This large, continuous presence allows us to conduct a sophisticated assessment of the bank's policies, operations, and controls, and to evaluate the long-term effect of those policies, operations, and controls on the bank's reputation, customer relationships, risk profile, and earnings.

This form of prudential supervision is a distinct approach that generally is not used for the regulation of non-bank financial firms. But our experience with it leads us to believe that is the most effective means for promoting safety and soundness and achieving compliance with applicable laws and standards in our banks. Put another way, we do not have an enforcement-focused regime; instead, our regime is better described as "supervision first, enforcement if necessary." And we believe that supervision is such a powerful and effective tool for identifying and fixing problems as they arise that enforcement, especially in the form of formal enforcement actions, is much less frequently required.

With that background about my particular vantage point on the supervisory process, let me turn to today's topic: Are changes needed in U.S. financial regulation? To address the question, I plan to focus on issues raised by recent market events, and whether they suggest a need for change. With after-shocks still roiling markets, it's premature to judge whether very topical "hot spots" are being adequately addressed by market corrections, or whether regulatory changes are needed as well. But let me address a few of the key areas of debate, and offer some preliminary thoughts on what we have learned.

Let's begin with the fact that underwriting standards for bank credits have weakened in recent years. There have been a number of recent regulatory reports on underwriting, and they all say the same thing: lending standards have been weakening. Now, that's not an unexpected finding at this point in the credit cycle as lenders tend to loosen standards to sustain lending volume and pursue a dwindling supply of creditworthy borrowers. However, the question I want to raise is whether this is more than a cyclical phenomenon. Has something fundamental changed in the way banks evaluate credit that inevitably leads to weaker underwriting?

One underlying change is a shift from an "originate and hold" to an "originate to distribute" model. Instead of holding loans on their books and bearing long-term credit risk, over the last ten years banks and other lenders have moved increasingly to a model where originated loans are sold immediately into the secondary market via securitizations or syndications, thereby allowing transfer of the credit risk to the markets. The question this technique raises is: Would banks relax standards as much as they have if they were retaining most of the credit risk they underwrite on their own books?

To the extent that purchasing investors were willing to assume more credit risk than the selling originators, the originators would be in a position to relax underwriting standards. That they did. With mortgages, it became possible to originate and sell non-traditional products with such underwriting features as little or no documentation of income; little or no down payments; qualification at temporary "teaser rates" but not at the rates the loans would adjust to. Negative amortization and no-interest features permitted low initial monthly payments, but lax underwriting did not focus on ultimate repayment of the debt. We saw a similar trend in the leveraged loans that have funded corporate buyouts, with such increasingly relaxed terms as a lack of significant lender covenants; lengthened terms of so-called "revolving" credit; and negative amortization options.

Our concern at the OCC is that the incentives for bankers to be cautious and prudent in underwriting those loans relaxed as the market's appetite for risk increased. When a bank makes a loan that it plans to hold, the underwriting must be strong enough to provide a reasonable expectation that the loan will be <u>repaid</u>. But when a bank makes a loan that it plans to sell, the underwriting must only be as strong as necessary to provide a reasonable expectation that the loan can be <u>sold.</u> Put another way, the bank will underwrite to the standards of the investors who buy the loans.

Now, in a world of perfect information in markets, these two different approaches might produce similarly strong underwriting. The fact is that investors want to be repaid, and they aren't going to purchase credits that are likely to default. But some investors are willing to take and hold more credit risk than a bank – hedge funds are often cited – and in the superheated markets of 2006 and the first half of 2007, banks could underwrite and sell credits with less stringent terms than they would require for loans held on their books.

Certainly the asymmetry of information that provides the theoretical underpinning for banking was an issue here. Investors do not understand the credit risk of a loan or pool of loans as well as the originating bank – even when the investors are large and sophisticated and presumably capable of fending for themselves. That issue has compounded as sold loans have been packaged in ever more complex structured products such as multi-tranched securities, collateralized debt obligations, and combinations of these instruments. Not only do investors face the challenge of understanding the risk in the underlying loans, but they also have to understand which slice of that risk they are assuming, and how much their risk has been transformed by the process of that slicing.

As structures have become more complex, there has been increasing reliance on the ratings assigned to those slices by the credit rating agencies. In some cases, this has tended to over-reliance on ratings. Investors who relinquish risk assessment to others can shift their reliance to others but they retain the financial risk, and they need to recognize that. I'm not suggesting that investors or banks shouldn't use ratings; they play an important role in the system. The rating agencies have done a great deal to promote increased liquidity and efficient markets, and indeed, they have been indispensable to the development of the securitization markets with all the benefits they provide. But I am saying that when national banks use ratings, they are not relieved of their management responsibility for independent risk assessment. They still need to – and do – perform their own analysis and their own due diligence.

All of that said, a number of legitimate questions have been raised about just how well the rating agencies assessed and rated the risks of some of the complex securitized products they rated – especially where subprime loans were the underlying collateral. Certainly the subsequent losses experienced by these products have been considerably higher than expected. I don't think we're anywhere near an answer to how this issue should be addressed, much less resolved, but rating agencies are on the agenda of every group studying the recent market upheaval, and I expect we will be hearing a great deal more about this issue in the months ahead.

Regardless of what role rating agencies have played, they affect only a segment of financial activity and aren't the only cause of the pervasive weakening of underwriting standards. At the OCC, we have been taking steps to address this issue at national banks over the last couple of years. Our examiners have been reviewing with banks the expectations set forth in existing supervisory guidance for sound underwriting. Loan commitments that are underwritten without an adequate assessment of the borrower's capacity to repay are subject to supervisory criticism. Areas of noncompliance in bank policy are communicated to bank management, and if significant, they could be cited as Matters Requiring Attention in exam reports – a step that compels a response by bank management to strengthen underwriting and risk management practices. Finally, we ask national banks to assess the impact of weakened underwriting standards on the assumptions used in calculating loan loss reserves.

We have also issued new policies where needed. For example, along with other regulators, we have issued guidance on both subprime and nontraditional mortgages to raise underrating standards. Whether such loans are originated to be held in portfolio or for sale to the secondary market, our examiners expect banks to use the guidance as their benchmark for underwriting.

Another area of supervisory attention has been the very large funding commitments by our largest banks for leveraged buyout deals. In liquid markets, the pipeline of commitments by major banks to these deals looked like a lucrative line of business. In the risk-averse markets that emerged suddenly in late summer, these deals got stuck in the pipeline, but with the banks still on the hook to fund them. The banks took on these risks with full knowledge, and had balance sheets capable of taking the deals on balance sheet if needed. As it has transpired, the bulge of deals is working its way through the snake, the banks are taking modest losses on the deals, and these losses have contributed to the drop in earnings, sometimes substantial, reported by large banks in the third quarter. Instead of earning a handsome return, they lost 4-5 basis points on the deals. This is an area where the a market correction is underway, but which we are keeping under careful observation.

Let me turn to yet another topic that has been very much in the news: the drying up of the market for normally highly liquid Asset Backed Commercial Paper, or ABCP, and the challenge posed to a number of off-balance-sheet financing structures for ABCP. The uncertainty about asset quality that arose out of the US subprime market cascaded into a systemic loss of confidence in any securitized instrument that might contain subprime debt, such as ABCP. This, in turn, morphed into loss of confidence in any ABCP-based market structure such as so-called conduits and Structured Investment Vehicles, or SIVs. Although normalcy is returning to ABCP markets and conduits have generally continued to function as intended, there are questions about whether SIV structures will survive or have been shown to be excessively fragile under market stress.

To define our terms, conduits and SIVs issue short-term commercial paper and medium-term notes, which they use to fund the purchase of higher-yielding long-term assets. Because they are owned by investors, sponsoring banks are not required under accounting rules to consolidate these structures onto their balance sheets. Conduits are typically backed by a liquidity facility from the sponsoring bank. The OCC and the other federal bank regulatory agencies issued guidance in 2004 that required banks to provide capital for the bank liquidity facilities that support conduits, even when they are not drawn, and this has been one of the defining differences in the way the market has treated traditional conduits.

SIVs, on the other hand, don't typically have the same kind of liquidity support and have faced much rougher sledding. The question being asked by many market participants is whether SIVs can continue to roll over commercial paper and short-term debt to fund the assets they've purchased. If not, will they begin unloading assets into an already-skittish market, setting off a downward slide in prices, forcing a wider mark-down of mortgage-backed securities and other assets – even prime assets that have not yet been affected by the market turmoil – with significant repercussions for the wider market?

To protect against such a market reaction, the industry is taking steps on its own to deal with the situation. The widely discussed plan by three large banks to create a Master-Liquidity Enhancement Conduit, or M-LEC, with a $100 billion line of bank credit, is the most visible response. The Master Conduit provides a mechanism for SIVs to sell assets as they unwind position, or a source of back-up liquidity that would enable them to continue in operation.

Although the largest US bank that is a SIV sponsor is a national bank, only a very few US banks have any involvement in this field. Instead, the dominant players are European banks and investment banks. The large national bank that is a SIV sponsor is sufficiently well capitalized that the assets held by its sponsored SIVs could be brought on balance sheet and still leave the bank well capitalized. Still, the experience with these off-balance-sheet entities raises questions whether current approaches to regulatory capital and risk management sufficiently capture the risks inherent in these structures. In a crunch, will banks be forced to stand behind them or bring them onto the balance sheet to avoid reputational risk. If so, should there be changes in capital treatment or higher expectations of firm risk management?

Finally, I'd like to turn very quickly to the subject of liquidity. We've been through an extraordinary time in which massive market liquidity dried up very quickly through an unexpected triggering event. Yet the good news is that there was never a liquidity problem at any of our banks. The United States had no banks in the position of Britain's Northern Rock, where depositors lined up to get their money out. US banks remain financially sound, have diversified funding sources, and, of course, enjoy the backstop of FDIC deposit insurance which is simpler and more generous than the British system.

Let me add, though, that a key to effectiveness of US deposit insurance is prudential supervision – the support structure that protects against excessive risk taking and moral hazard that would undermine the deposit insurance fund. Working behind the scenes to correct problems while they are still manageable, as our examiners do, is the best way to ensure that our banks maintain the confidence of their customers, are well managed, and financially sound.

Looking across the range of issues raised by the recent market disruptions, should we draw the conclusion that prudential supervision has been fully effective, or are there things we might have to reevaluate? I would argue the answer to the basic question is a qualified yes, with strong evidence to support that conclusion. The earnings of even our hardest hit banks remained positive in the face of severe market stresses in the last reporting quarter, protected by their diversified range of activities and sound risk management.

We have focused on sound risk management in our supervision, and we believe that our banks are effective in measuring, managing, and controlling risk. Although our largest banks were engaged in sophisticated lending and market operations, they managed their exposures to these risks effectively. We also stress sound underwriting and despite the recent loosening to which we responded, national bank underwriting has traditionally been quite strong. That's almost certainly one reason that national banks have been such minor players in the subprime markets. Last year, national banks originated less than 10 percent of all subprime loans and the quality of those loans was much higher than for the market as a whole.

It has been a challenging year, to say the least, but I believe that prudential supervision has served the U.S. banking industry – and the nation's businesses and consumers – very well. I thank you for the opportunity to participate in this forum and look forward to your questions.