

Statement of
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Former Comptroller of the Currency
before the
Financial Crisis Inquiry Commission
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Mr. Chairman, Mr. Vice Chairman and Members of the Commission, as you know, I served as Comptroller of the Currency, the Administrator of National Banks, from 1998 to 2004—a period of relative calm in the banking system and our financial markets. I am pleased to appear before the Commission today to provide whatever information and insights I might have based on this experience relevant to the important matters into which the Commission is inquiring.

As I have discussed with the staff, I do not have first hand information with respect to several of the questions that I was asked to address in the Commission's request for my appearance, and I am reluctant to speculate about these matters.

For example, one of the questions I was asked to address was the impact of the Community Reinvestment Act on the losses incurred by national banks. I do not recall ever having seen data on this subject, and while national banks undoubtedly incurred some losses on CRA loans, I cannot say whether those losses were disproportionate to losses incurred on other types of loans.

There are, however, several issues that I would like to address, and I will be pleased to respond to any questions that Members of the Commission may have on these or other topics.

Subprime Lending and Securitizations

In 1999, early in my tenure as Comptroller, we at the OCC, as well as our counterparts at the Federal Deposit Insurance Corporation, became concerned about what we perceived as a growing interest on the part of some banks to engage in subprime lending—a term we defined as lending to borrowers presenting a significantly higher risk of default than traditional borrowers. Our concerns at that time did not focus principally on the securitization of such loans or on mortgage loans in particular. Rather, we were concerned primarily about the risks to banks that were originating a variety of types of subprime loans for their own portfolios. On March 1, 1999, we and the other agencies put out a statement—which I believe the Commission has—cautioning banks about the need for stronger underwriting and internal controls, better monitoring and administration, and appropriate pricing in their subprime programs. We also cautioned that lenders needed to take special care to avoid violating a variety of consumer protection laws.

We reiterated and expanded on this guidance in January of 2001, addressing other aspects of subprime lending, including the need for more robust capital and loan loss reserves to support such programs. We also addressed the subject of predatory or abusive lending practices, pointing out that predatory lending often involves the making of unaffordable loans based on the value of assets put up as collateral, rather than the borrower's ability to repay. I believe the Commission has also seen this statement. Once again, while we were aware that some banks were securitizing subprime loans, our main concern was with portfolio lending.

The subject of securitization came onto my radar screen not long after I took office when a small national bank in Keystone, Pennsylvania, got into serious trouble after launching a program of purchasing subprime loans from brokers around the country for the purpose of selling them into securitizations. The bank was quite unqualified to engage in this activity, and the loans they were purchasing were of low quality. As our examiners bore down on Keystone they became increasingly troubled about the bank's program, as well as the bank's aggressive resistance to our supervisory concerns. After intensive investigation the examiners found that a large number of the loans Keystone had securitized had gone bad and that Keystone had engaged in a massive fraud to cover up these defaults. Our examiners found that half of Keystone's balance sheet was fictitious, and that bank officials had falsified reports from loan servicers to conceal this fact. The bank was closed and bank officials went to prison.

After Keystone I was concerned that the level of understanding among the agencies of the risks involved in securitizations might not be all it needed to be, and we organized a two-day seminar for bank regulators on the topic, with private sector experts brought in to enlighten us. I should say that this was well prior to the great wave of securitizations that later caused so much damage to the system, but as I reflect on those days I think it is fair to say that we did not predict where securitizations would go. We certainly did not predict that securitizations would drive lending, rather than vice versa, as investment bankers demanded more and more "product" to securitize.

I believe that this "top down" demand--driven not only by securitization fees, but also by a demand in the market for higher yield investments at a time of low market rates-- encouraged an erosion of underwriting standards. Mortgage brokers, who received commissions for originating loans, had little incentive to be rigorous in underwriting borrowers; banks, who were acting as conduits, and who did not retain loans in their own portfolios, had a diminished incentive to be rigorous; the investment bankers, who were taking in big fees for selling the bonds issued by securitization pools, had no particular expertise in loan underwriting, and, in any event, were slicing up the risks in the pools in such a manner as to obscure the risks that really existed; and finally the rating agencies, who, looking backwards, put heavy reliance on recent performance in mortgage markets and did not foresee the prospective consequences of a significant turnaround in housing values.

The proliferation of new types of mortgage instruments certainly contributed to these risks. When I was first briefed on the development of alternative instruments that allowed borrowers to pay interest only for several years, or even a submarket rate of interest, with full amortization at a market rate kicking in at a "reset" date that might be three or more years away, I asked our staff how the banks were underwriting these loans. In particular, I asked if the banks were making judgments about a borrower's ability to handle whatever level of payments might be required at the time of reset. I was told that lenders were looking only at the borrower's ability to make the initial payments, and were not underwriting to the reset. The banks' reasoning was that if the borrower could not handle the reset payments the property could readily be sold, and since the

prevailing wisdom was that real estate values only go up the lenders would be fully protected. This flawed underwriting clearly violated our admonitions to banks that lending to consumers should be based on an ability to pay interest and principal, and not on the expected value of the collateral. I told our examiners that this had to change and that this word should be carried back to the banks, which they did. This requirement was subsequently embodied in the Interagency Guidance on Nontraditional Mortgage Product Risks, which directed that “for all nontraditional mortgage loan products, an institution’s analysis of a borrower’s repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.”

Nor did we fully appreciate the risks that banks faced even with respect to loans they had sold off their books into securitizations. We largely allowed the accounting rules to govern. If the accountants were satisfied that a loan sale was a “true” sale—meaning principally that there were no contractual guarantees, indemnifications or liabilities on the part of the selling bank—the supervisors treated the loans as gone off the books and did not require that capital be held against them. Indeed, one of the driving forces behind securitizations was to enable banks to expand their lending in a way that would not require them to put up additional capital.

What we have seen in the last few years is that banks have indeed faced very substantial liabilities with respect to loans that had been treated as “sold,” even though there were no contractual indemnities or guaranties. As defaults on securitized mortgages increased, securitization trustees claimed that the loans sold to their pools were infected with fraud. The trustees contended that these loans violated the representations and warranties that the banks had given at the time of sale, and they demanded that the banks take these loans back. Literally tens of thousands, if not hundreds of thousands, of such loans have been put back to the banks, with massive litigation and liabilities ensuing. I think it is fair to say that supervisors did not anticipate this risk, which arose from wholesale defaults on securitized loans, and if they had, the need to require banks to maintain capital commensurate with this risk would have been compelling, even if the loans had been taken off the banks’ balance sheets.

Preemption

If one reads the criticisms of the OCC with respect to preemption, one would think we invented the doctrine in recent years solely as a means to curry favor with national banks. The reality is quite different.

Preemption is a constitutional doctrine that was announced by the Supreme Court as early as 1819, in the case of *McCulloch v. Maryland*. It states a very simple proposition, based on the Supremacy Clause: the states have no constitutional authority to interfere with the exercise of powers conferred by Congress on institutions created under federal law. Congress can, of course, allow the states to do so, but if it has not, the states are simply not permitted to regulate the exercise of federally granted powers.

National banks have been subject to this doctrine ever since the creation of the national banking system in 1863. In recent years, however, we have witnessed increasingly aggressive efforts by states and localities to adopt laws, covering a wide variety of topics, that have purported to affect the conduct of banking activities by national banks. Many of these enactments precipitated litigation, in some of which the OCC was involved, as national banks sought clarification from the courts. As far as I am aware, in every one of these cases the federal courts, including the Supreme Court of the United States, have upheld the immunity of national banks and their operating subsidiaries under the preemption doctrine.

In some cases banks petitioned the OCC to make a determination in a particular situation that a state law was preempted, as in the case of the Georgia Fair Lending Act. The Commission has a copy of the preemption determination that I issued in July 2003, which elaborates our thinking on the subject. However, because these confrontations were creating a range of burdens and uncertainties for national banks, we thought it was prudent to publish a more comprehensive statement on preemption, which we did in January 2004. That issuance includes an extensive discussion of the subject, and I commend it to the Commission.

Because we shared the concerns that underlay such laws as the Georgia statute, we used the occasion of the January 2004 issuance once again to set out some very rigorous standards for consumer lending by our banks—something that no other federal agency – or, to my knowledge, state bank regulator—had done before. While some state law enforcement officials have been critical of the OCC’s position on preemption, I believe the record is clear that no other bank regulatory agency, federal or state, has been more protective of the interests of consumers than the OCC.

One example of this is the lead role we played in breathing new life into the unfair and deceptive practices provisions of the Federal Trade Commission Act. The FTC Act conferred on the Federal Reserve the sole authority to issue rules defining unfair and deceptive acts or practices by banks, although the Fed’s history in doing so was somewhat limited. We at OCC took the position that even though we could not define such practices by rule, we could issue cease-and-desist orders for violations of the FTC Act in individual cases if we believed that a particular bank was engaged in unfair or deceptive conduct. All of the other agencies, including the Fed, subsequently came on board with this position, and the ability of the agencies to bring individual enforcement actions has been a significant addition to their range of enforcement tools.

Not all of the OCC’s actions have taken the form of public enforcement orders or formal written agreements. A vast amount of corrective action is taken informally in the course of the day-to-day process of supervision and examination. Where examiners find violations of consumer protection laws and regulations they routinely demand corrective action, which is almost always accomplished with little fanfare. If violations are not cured by the next examination more formal enforcement action is taken. In addition, the OCC’s world-class Ombudsman’s Office receives and investigates literally tens of

thousands of consumer complaints every year. If corrective action is called for, the Office so directs, and if there is resistance, bank examiners and enforcement attorneys enter the picture. My experience has been that most banks do not enjoy a confrontational relationship with their supervisors, and for this reason the informal and nonpublic process of assuring compliance with consumer protections laws and regulations has been very effective.

In this connection, I urge the Commissioners to read Comptroller John Dugan's letter of October 2, 2009 to Chairman Frank of the House Committee on Financial Services, which spells out in detail the OCC's record of consumer protection activities and initiatives..

Let me say emphatically that the OCC's actions with regard to preemption were not taken lightly, nor were they simply an exercise of discretion. Each Comptroller has taken an oath to support and defend the Constitution of the United States, and none of us has the authority to waive or disregard such an important constitutional imperative. While some critics have suggested that the OCC's actions on preemption have been a grab for power, the fact is that the agency has simply responded to increasingly aggressive initiatives at the state level to control the banking activities of federally chartered institutions. For us to have acquiesced in state encroachments on the powers that Congress has conferred on national banks would have been a dereliction of our duties. Moreover, whether or not the OCC made determinations on preemption issues, these issues are frequently raised and litigated by private parties. To be sure, when the OCC takes a position the courts may give some deference to its determinations, but it is ultimately up to the courts to determine whether the Supremacy Clause operates in a particular case.

I would be pleased to respond to the Commission's questions on these or other topics.