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TESTIMONY OF
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COMPTROLLER OF THE CURRENCY

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FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

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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 Bachus, Ranking Member Frank, and members of the Committee, it is a pleasure to testify before you as the 30th Comptroller of the Currency. Before beginning, I want to express my willingness and desire to work closely with the Members of this Committee during my tenure on the many issues under consideration that have an impact on the supervision of national banks and federal savings associations.

Strong supervision is a theme that will mark my tenure as Comptroller. 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. 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.

My testimony today will discuss the OCC’s large bank supervisory program and our oversight and work currently underway at JPMorgan Chase (JPMC) related to their recently announced trading losses.

I. OCC Supervision of Large Banks

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's 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.

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. Our primary focus, rather, is on the bank's own risk management functions and governance. Our assessments in these areas guide where more detailed exam work may be needed. Our review of risk management controls at large banks starts at the top, with governance and oversight provided by the board of directors and senior management. We regularly meet with independent directors and the chairmen of the board's audit and risk committees to assess their understanding of key risks and emerging issues, along with their thinking on current and prospective matters. Through these meetings and our review of the board's actions and decisions, we assess their ability and willingness to effectively challenge management decisions, as well as their qualifications to serve in such a position. We also evaluate those functions via regular review of board and management information reports (executive and business level), as well as risk management reporting and audit reports.

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.

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.

OCC's Heightened Expectations for Large Banks

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. In concert with the Basel III Capital rulemakings recently approved for public comment, we also are raising both the quality and quantity of regulatory capital that banks generally must hold. Under the proposed rules, large banks will face additional capital requirements, including 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. 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 to ensure a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses, and the Net Stable Funding Ratio, which creates additional incentives for a bank to fund ongoing activities with stable sources of funding. While these are all positive developments, we are taking actions to ensure that these are permanent and not just temporary improvements.

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.

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 visible and 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 present 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*¹ 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 personnel, strategic planning, risk tolerance, operating processes, delegations of authority, controls, and reports 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.

¹ OCC examiners rate the quality of the bank's audit function and the quality of risk management as weak, satisfactory, or strong.

It is incumbent upon bank directors to be mindful of this primary fiduciary duty as they execute their responsibilities.

II. JPMorgan Chase Loss and OCC's 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 investigating.

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, 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 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, controls, and the adequacy of risk reporting.

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 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.

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 and procedures were properly structured, reviewed, approved, and acted upon in the execution of this strategy, and risk reporting was sufficiently granular and appropriately escalated, are areas of 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 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, controls, and reports 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, however, this experience is an opportunity to inform our views on the final rulemaking.

III. Conclusion

The recent events at JPMC confirm the need for strong capital, liquidity and reserves in the banking sector, and reaffirm the need for regulators to carefully and continuously scrutinize bank risk management policies, procedures, and practices, as well as to assess the OCC's supervisory processes. I look forward to continuing to share how we are meeting my commitment to strong, effective, fair, and balanced supervision of the national banks and federal savings associations that we supervise.