

**STATEMENT OF
JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
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Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to testify today on the condition of the banking system. In general, due to a long period of strong economic growth, exceptionally low credit losses, and strong capital ratios, the national banking system has been healthy and vibrant.

Now, however, the system is being tested. Two powerful and related forces are exerting real stress on banks of all sizes and in many different parts of the country. One is the large and unprecedented series of credit market disruptions, still unfolding, that was precipitated by declining house prices and severe problems with subprime mortgages. The other is the slowdown in the economy, which has begun to generate a noticeable decline in credit quality in a number of asset classes. The combination of these forces has strained the resources of many of the national banks we regulate.

Despite these strains, the banking system remains fundamentally sound, in part because it entered this period of stress in such strong condition. Thus far national banks have been able to address a number of significant problems that have arisen while continuing to supply credit and other banking services to the U.S. economy – although there is no doubt that credit standards have tightened. For example, large banks provided

liquidity support to asset-backed commercial paper conduits and structured investment vehicles or SIVs – often involving the painful recognition of losses – to restore more normal funding in these markets. Likewise, banks with concentrated positions in collateralized debt obligations backed by subprime asset-backed securities have recognized large losses – but have also raised large amounts of capital to offset these and other losses. And a large national bank holding company entered into an agreement to purchase the nation’s largest mortgage originator, which had been under severe funding stress, and that action had a calming effect on the market.

Despite such efforts, however, significant market disruption issues remain to be addressed, such as the potential downgrades of monoline insurance companies; significant funding problems in the auction rate securities market; and severe constriction in the securitization markets for residential mortgage-backed securities, commercial mortgage-backed securities, and leveraged loans.

Likewise, the economic slowdown and problems in the housing market have caused banks to increase loan loss reserves significantly for such assets as residential construction and development loans; home equity loans; and credit card loans. Indeed, smaller banks that have exceptionally large concentrations in commercial real estate loans – and there are many of them – face real challenges in those parts of the country where real estate markets have slowed significantly. Unlike the unprecedented market disruptions of the last six months, these more traditional credit problems are familiar territory to bankers and supervisors. The key to addressing them is for bankers to recognize problems early and manage through them, and that is exactly what our examiners are working with them to do.

There is also a need to reemphasize several fundamental banking principles:

- Sound underwriting and robust credit administration practices;
- Diversified funding sources and realistic contingency funding plans;
- Strong internal controls and risk management systems, including stress-testing, valuations, and disclosures; and
- Timely recognition of losses coupled with adequate loan loss reserves and strong capital cushions.

In each of these four areas – asset quality, liquidity, risk management, and reserves and capital – we remain alert to emerging trends and to findings that may trigger additional supervisory action.

Finally, you asked us to describe our current efforts to address foreclosure prevention and mitigation. This is very important for the OCC since the nine largest national banks act as servicers for about 40 percent of all U.S. mortgages, including a significant number of subprime mortgages. The OCC has taken a number of steps to encourage national bank lenders and servicers to work constructively with borrowers to avoid foreclosure except when absolutely necessary. We have joined the other banking agencies in issuing guidance to that effect; we have strongly supported the efforts of the HOPE NOW alliance; and we have supported an amendment to the Community Reinvestment Act regulations that would provide CRA credit for foreclosure prevention activities in distressed middle-income neighborhoods. We also announced last week a significant new effort regarding the reporting of key data on mortgages, including mortgage modifications: we are requiring our largest national bank servicers to provide standardized reports on a range of mortgage metrics, not just for subprime adjustable rate

mortgages, but for *all* mortgages. These data, which are consistent with the HOPE NOW metrics, will provide an important way to track mortgage performance against a broad range of indicators.

Thank you very much.