

For Release Upon Delivery  
9:30 a.m., December 11, 2002

**TESTIMONY OF**  
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**before the**  
**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**  
**of the**  
**COMMITTEE ON GOVERNMENTAL AFFAIRS**  
**of the**  
**UNITED STATES SENATE**  
**December 11, 2002**

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.

## **Introduction**

Chairman Levin, Ranking Member Collins and members of the Subcommittee, I am Douglas Roeder, Senior Deputy Comptroller responsible for large bank supervision. Thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this important hearing.

We share your concerns over the Enron debacle and commend you for holding this hearing. What happened to Enron employees, who lost their jobs and their retirement savings, is tragic. We also have a concern about the role national banks played in some transactions entered into by Enron. As I will discuss, both the banks themselves and the OCC are taking steps to try to guard against future occurrences of this type. It is important to keep in perspective, however, that the role of bank regulators is only one component of the challenge of preventing the repeat of an Enron-like disaster.

My testimony will address how the OCC supervises large national banks in general and complex structured transactions such as those entered into by Enron in particular. For clarity, when I refer to complex structured transactions, I mean highly customized financial transactions that often involve a derivative or off-balance sheet component, such as a Special Purpose Entity (SPE). I will discuss where we think we should broaden our supervisory focus and strengthen our processes and the steps we have taken to do so. I will also describe the OCC's coordination with the Securities and Exchange Commission (SEC), the Internal Revenue Service (IRS) and other agencies in cases where we believe there may have been violations of laws administered by

those agencies. My testimony will close with comments on some of the steps the banks are taking to improve their own processes.

### **Large Bank Supervision**

The OCC is responsible for supervising over 2,000 banks. Some of these banks are among the largest banks in the country, indeed the world; they offer a wide array of financial services and are engaged in millions of transactions every day. For maximum effect, the OCC has dedicated teams of examiners actually residing in our largest national banks. Nonetheless, given the volume and complexity of bank transactions, it simply is not feasible to review every transaction in each bank, or for that matter every single product line or bank activity.

Accordingly, we focus on those products and services posing the greatest risk to the bank.

The first step in risk-based supervision is to identify the most significant risks and then to determine whether a bank has systems and controls to measure, monitor, manage and control those risks affecting the institution. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. If we have concerns, then we “drill down” to test additional transactions. If this reveals problems, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

Resident examiners apply risk-based supervision to a broad array of risks, including reputation risk and transaction risk. Because historically, it is credit risk that has posed the greatest threat to safety and soundness of banks and indeed, the banking system, bank supervisors have devoted significant attention to the supervision of credit risk. The case of Enron demonstrates just how significant other types of risk can be to the operations of a large financial institution.

As a result of this experience, the OCC will refine its approach to supervising aspects of bank operations that may cause reputation, litigation and other operational risks in the area of complex structured transactions. Banks have also learned from this experience. As a result, they have tightened their procedures and controls. I will discuss both of these developments in greater detail below.

### **OCC Policies and Procedures for Complex Structured Transactions**

Complex structured transactions, such as those entered into by Enron, are generally offered at only a small number of large banking companies, although other companies may conduct isolated transactions. Our supervision of complex products focuses on a bank's ability to manage the relevant credit, market and transactions risks. Within the context of our risk-based supervisory approach, we believe we can enhance our supervision of complex structured transactions to better assess the broader risks inherent in those activities. To understand these planned supervisory changes, it is useful to start with the OCC's policies for dealing with complex structured transactions and then describe how we intend to enhance them.

As I mentioned previously, the types of transactions engaged in by Enron generally involved some type of derivative or off-balance sheet product, often an SPE. While derivatives (and SPEs) serve many legitimate purposes and have resulted in more efficient markets and enhanced the safety and soundness of our financial system, they, like any other tool, can also be misused. The OCC's *Risk Management of Financial Derivatives* explicitly addresses derivatives products and provides guidance for examiners to follow when evaluating a bank's risk management system for complex structured transactions. In the wake of Enron, we have asked ourselves how our current approach could be enhanced. We have identified several areas where we believe enhancements are warranted.

*New product approval.* OCC's evaluation of new product approval begins with and assessment of the bank's process. Our examiners evaluate the bank's system for ensuring that responsible senior managers approve new product offerings and that risk management reports adequately capture such products. We direct bankers to ensure that adequate technical knowledge and financial resources are in place before offering new products or services, and we emphasize the importance of a robust control environment that includes sign-off by all members of relevant areas such as: risk control, operations, accounting, legal, audit, and senior line management.

Having a sound approval process for new products is essential, but equally important is the definition of new products. The reputation risk, including potential legal or regulatory action, to which a bank exposes itself if it engages in questionable new products can be

significant. Our current policies provide that when bank management is deciding whether or not a product must be routed through the new product process, it should consider various factors: structure variations, pricing considerations, legal and regulatory compliance, and market characteristics. When in doubt as to whether a product requires vetting through the new product approval process, we advise bank management to err on the side of conservatism and apply the process to the proposed product or activity.

Going forward, we will sample more extensively transactions going through the new products approval process. In particular, we will check on whether banks are following their own processes and whether proper review and authorization are received prior to engaging in complex structured transactions.

In addition, we are considering whether an amendment to our safety and soundness guidelines, which are part of our part 30 regulations, is in order. These interagency guidelines set out minimum safety and soundness standards for banking activities including: internal audit, credit underwriting, loan documentation, and internal controls. Violation of a guideline can result in a bank having to prepare and submit a compliance plan, or it can result in a regulator taking an enforcement action. We are discussing with our sister banking agencies whether to revise these interagency guidelines to address more specifically board and senior management responsibilities for the approval and oversight of corporate strategies, business plans and approval of new products that involve transactions such as complex structured products.

*Customer appropriateness.* While a given product may be approved through the new product approval process as an activity acceptable to the bank's board and senior management, the bank must also carefully consider the appropriateness of complex structured transactions for any particular client. In testing such controls, our focus has been on how well the bank assesses the sophistication of the customer. To that end, our examiners look at the bank's assessment of the nature of the customer's business and the purpose of the customer's derivatives activities. They review the bank's evaluation of the possibility that a customer does not understand a transaction or that the transaction is inconsistent with the customer's policies, thereby inhibiting the customer's ability to perform under the terms of the contract. To make this assessment, examiners review a sample of credit and marketing files to determine whether the files contain sufficient information to understand the risks the customer is attempting to manage, the types of derivatives expected to be used, and the overall impact on the customer's financial condition.

In testing a bank's controls on customer appropriateness, we will enhance our process and consider not only whether the bank has assessed the customer's ability to understand the transaction and to perform under the terms of the contract, but also if bank management understands the purpose and the customer's disclosure/accounting intent, so the bank does not become embroiled in questionable practices engaged in by its customers. We will test compliance with new policies and procedures, including policies regarding customer disclosures of material financings, and review audit's plans and performance.

Bank management involved in structured finance bears crucial responsibilities. Independent risk management personnel should be involved in the review of any transactions

that appear to “push the envelope” and may expose the bank to undue risk. When in doubt, bank management should apply additional scrutiny, for example, obtaining opinions from bank counsel or accountants. While it is not realistic for banks to be responsible for how customers account for transactions on their own financial statements, where uncertainty continues to exist regarding business needs or whether a transaction meets required standards, it is incumbent on bank management to carefully consider their actions and the potential impact on the bank and to decline to participate in transactions that do not meet the standards of integrity that the bank has established.

*Large Relationships.* We think it is important that bank management has established controls that encompass the total relationship the bank has with its large customers. We plan to sample large relationships (even if credit risk is low) and “flag” structured products during our credit work for potential further review. We expect that this will involve using a cross-functional team of examiners to assess credit, price, compliance and reputation risk associated with approved complex structured transactions. Competitive pressures are a natural part of any business environment, but care must be taken to assure that line managers eager to retain or expand business with important customers don’t cross the line and jeopardize the trust and credibility that form the foundation of a bank. The lost business, diminished market capitalization and increased funding costs that a bank may suffer if financial market participants lose confidence in a bank’s control structure can significantly outweigh actual financial losses arising from direct exposures to the customer in question.



## **Cooperation with Other Agencies**

Enron and other corporate governance scandals have revealed some weaknesses in our nation's accounting rules and in the oversight of the accounting profession. The Sarbanes - Oxley Act is a crucial response to those shortcomings. The Securities and Exchange Commission is in the process of adopting and amending regulations to carry out the Sarbanes - Oxley Act and the new Public Company Accounting Oversight Board has vital new responsibilities to oversee accounting standards and the accounting industry. These changes should go a long way toward addressing the weaknesses in our accounting regime and corporate governance that allowed Enron to happen.

For our part, in addition to our direct supervisory responsibilities under the federal banking laws, we work cooperatively with many other federal agencies and law enforcement. These include the other federal banking agencies, the SEC and the IRS, and also National Association of Securities Dealers, Federal Trade Commission, Federal Trade Commission, the Department of Labor, Department of Justice, the Federal Bureau of Investigation, and the Secret Service. When we become aware of information that indicates a national bank may have violated a law or regulation under the jurisdiction of another agency, we make referrals to that agency. We cooperate, as needed, if the agency determines to pursue the matter. The cooperation may entail providing documents, information and expertise, and making OCC examiners available to serve as witnesses in criminal trials and enforcement proceedings. When other agencies refer to the OCC potential violations of banking law, the OCC will investigate and take enforcement action, as appropriate. In addition, pursuant to OCC regulations, national

banks file tens of thousands of suspicious activity reports with federal law enforcement agencies each year.

Focusing on the SEC, for example, the OCC has referred violations of federal securities law to the SEC and cooperated in SEC investigations. Similarly, we have received referrals and information from the SEC concerning infractions of banking laws. Our agencies have shared information concerning potential violations of law from examinations or inspections and from investigations, and OCC examiners have served as witnesses in SEC enforcement actions. In appropriate situations, we have coordinated our enforcement efforts and brought simultaneous or joint enforcement actions. The OCC and SEC also participate together in working groups, such as the National Interagency Bank Fraud Working Group and the Interagency Working Group on Financial Markets, which provide opportunities to share concerns and discuss matters of mutual interest.

### **Actions Taken by the Banks**

The recent series of corporate scandals at Enron and other large corporations has served as a wake-up call for the corporate world, including banks. Whether or not they were involved with Enron, the banks that offer complex structured transactions realize that they can suffer great harm if they become embroiled in questionable activities engaged in by their customers. As a result, all have taken steps to improve their internal controls of complex structured transactions and SPEs.

Some banks have made changes to management, established new oversight committees, developed new policies and/or procedures, tightened controls, improved internal reporting to management and the Board and improved disclosures. Other banks have centralized the process for establishment, use and management of SPEs and conducted separate audits to review SPE activities.

Banks also have strengthened their review and approval processes for complex structured transactions in several ways. First, they too have realized how critical the definition of new products is to the new product approval process, and as a result they have expanded the definition of nonstandard products that require approval. Second, they have enhanced the approval process to provide for a broader range of senior level management review from various areas of the bank, including, audit, compliance and legal. Third, banks are putting a greater focus on assessing customer motivation and appropriateness. Fourth, banks are implementing broader review procedures, which include securing representations from customers regarding disclosures and accounting treatment, and defining strict reporting standards with which customers must comply in order to obtain a structured product.

We believe these are all positive steps toward strengthening internal processes. We will evaluate the changes banks have made and will continue to monitor and assess these reforms as they are implemented. In our assessments, we are reviewing committee structures, charters, minutes and, most importantly, actions taken by management under the new control structures. We continue to sample complex structured transactions to ensure they receive appropriate approval, and to review regulatory capital treatment of these products to ensure capital

requirements are being applied appropriately. We have also reviewed special audit reports and Board presentations on SPEs to assess uses, risk, control systems and audit recommendations.

Progress has been made, but we believe that it is too early in the process to identify the full package of appropriate practices with respect to complex structured transactions. It takes some period of time to evaluate how well new policies and procedures will actually work in practice. To the extent that additional formal guidance from bank regulators is appropriate, we would expect to develop such guidance with our colleagues at the Federal Reserve Board and the FDIC.

## **Conclusion**

The Enron debacle has indeed been tragic. No one wants to see its circumstances repeated. While it is important to keep in perspective the role of bank regulators, we think there are steps we can take to improve our oversight of complex structured transactions. Similarly, the banking industry has recognized it can do a better job. We will continue to refine our processes for assuring that banks have, and follow, proper policies and procedures for dealing with all the risks involved in complex structured transactions.

Thank you once again for inviting the OCC to testify at this important hearing. I will be glad to answer any questions.