Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 1, 2008

The Honorable Paul E. Kanjorski
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Kanjorski:

Your letter dated January 23, 2008 requested information related to the uncertainty in the bond insurance marketplace and the possible effects on the national banking system. Attached is our response to your inquiry. Please be assured that our office appreciates the significance of recent developments in this area and that we are available to work with you and your staff as you address these important issues.

Sincerely,

John C. Dugan
Comptroller of the Currency

Enclosure

1) **Outline any concerns you may perceive facing the bond insurance industry.**

Historically bond insurers concentrated on insuring debt issued by municipalities. Over the last several years, due to a relatively flat growth rate in municipal markets, several bond insurers expanded into protecting asset-backed securities. Asset-backed securities have accounted for more than half of all insured securities since 2004. As a result, the bond insurers' exposure from protection of real estate related securities and other structured finance increased. Guarantees on mortgage-backed and other asset-backed securities have increased from 18% of outstanding guarantees to 34% (as of 6/30/07). This growth in structured products and mortgage-backed security exposure has significantly increased the risk profile of the bond insurers.

With the reality of a real estate market downturn and subprime problems, bond insurers have been punished in both equity and credit markets as concerns regarding loss exposure have escalated. Concerns over insurers' capability to weather the real estate/subprime storm are widely documented, as described in your letter. The ability to maintain and/or raise sufficient capital in order to maintain AAA credit ratings is the primary concern facing the bond insurance industry. Downgrades may affect future business and earnings performance as well. A downgrade even to AA would adversely affect the ability of the insurer to obtain new business from segments of the market requiring the AAA rating to support bond issuances.

2) **Examine the implications of these problems for the entities you regulate, as well as the broader economy.**

National banks have direct and indirect exposures to the financial monoline guarantors. The direct exposures currently exist in direct lending activities, counterparty credit risk from derivatives contracts, investment portfolio holdings, assets under management for customers, and remarketing and other indirect activities. Indirect exposures would arise if problems associated with the monoline guarantors gave rise to additional market uncertainty and unlike the direct exposures, we believe the indirect exposures are not ones that can be easily quantified.

In general, based on information derived from onsite supervision at our banks, we believe that direct exposures from counterparty risk and direct lending are relatively moderate. Additionally, while the nominal amount of holdings in national bank investment portfolios is much larger, the actual risk exposure is also relatively modest. Given that the underlying municipal bonds tend to be highly rated on their own, we don't view investment portfolio exposure as representing a serious concern, although rising municipal budget deficits and declining property tax receipts may negatively affect municipal credit quality. Money market mutual funds, particularly tax exempt funds, and other short-term investment funds managed by national banks or their affiliates are also affected by monoline downgrades. The downgrade of a monoline guarantor may result in the downgrade of a holding from Aaa/AAA to some lower level, as well as a decline in the holding's value. A downgraded holding could fall below money market fund eligibility requirements, or for other assets under management, fall outside the parameters of the fund's investment policy and potentially require divestiture at depreciated prices or other action. The impact of the price adjustment would depend upon the relationship of potential dislocations in the municipal market and the strength of the underlying assets.

In addition, national banks have a number of direct exposures that arise due to remarketing obligations on long-term municipal securities sold to short-term, money market investors. For both tender option bonds (TOB) and variable rate demand bonds (VRDBs), banks are contractually obligated to repurchase municipal securities, at par, from investors. A third product, auction rate securities (ARS), does not impose a contractual obligation to repurchase the securities, but for reputation risk reasons banks may feel compelled to do so. Downgrades of the monolines make it more likely that policy-constrained investors will "put" these securities back to the remarketing banks. If this happens, banks incur price and liquidity risks, as well as increased strain on their capital ratios.

3) **Detail the steps you are taking to monitor developments in the bond insurance marketplace and ensure the continued safety & soundness of banks and/or financial holding companies.**

The OCC, as a part of its safety and soundness supervision, requires national banks to maintain effective risk management processes. In community and midsize banks our supervision includes a review of investment portfolio assets and an assessment of the policies and controls that govern investment decisions. In large national banks, our resident staffs have ongoing access to bank management and key management reports in order to assess the risk profile of their institutions. Examiners continue to evaluate the potential implications of monoline insurer downgrades, and are monitoring the turmoil's potential impact on other bank activities.

Throughout this period of market turbulence we have taken steps to ensure the continued safety and soundness of our banks. In response to general market conditions, we continue to meet with the banks and closely monitor earnings projections and liquidity and capital ratios. We perform periodic stress tests to assess the level of capital cushion available in each bank. We have discussed capital needs and plans with specific bank management as appropriate. We are working closely with bankers to understand their funding and liquidity situations. In addition, we are engaged in regular discussions with the Federal Reserve, SEC, and relevant foreign bank supervisors.

4) **Discuss the adequacy of existing statutory and regulatory tools to address these problems and the need for further reform.**

As discussed above, we recognize and are actively monitoring the exposures to the monoline insurers and the impact to the national banks we regulate. The OCC has a wide variety of statutory and regulatory tools designed to ensure the safety and soundness of national banks and is prepared to utilize those tools to address risks presented by exposures to the bond industry. Such tools range from Matters Requiring Attention reported to bank boards, informal administrative actions including memoranda of understanding, and formal actions such as cease and desist orders. Our ongoing supervision process allows us to timely identify concerns and utilize our supervisory and enforcement tools if appropriate.