Audit Report

OIG-14-035

OCC Needs to Strengthen Supervison of Trading Activities in Light of the JPMorgan Chase Losses

May 14, 2014

Office of Inspector General

Department of the Treasury

This report has been reviewed for public dissemination by the Office of Counsel to the Inspector General. Information requiring protection from public dissemination has been redacted from this report in accordance with the Freedom of Information Act, 5 U.S.C. §552.

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Abbreviations

CDO	collateralized debt obligation
CIO	Chief Investment Office
FDIC	Federal Deposit Insurance Corporation
JPMC	JPMorgan Chase Bank, N.A.
EIC	examiner-in-charge
FRB	Board of Governors of the Federal Reserve System
MRA	matter requiring attention
OCC	Office of the Comptroller of the Currency
SCP	Synthetic Credit Portfolio
VaR	Value at Risk

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May 14, 2014

Thomas J. Curry
Comptroller of the Currency

This report presents the results of our audit of the Office of the Comptroller of the Currency's (OCC) supervision of bank trading activities. This audit was prompted by the media attention and congressional hearings focused on the 2012 trading losses at the JPMorgan Chase Bank, N.A. (JPMC) Chief Investment Office (CIO) in London.

Our audit objective was to determine and assess OCC's process of supervising bank trading activities, primarily focusing on OCC's supervision of trading activities at the JPMC CIO. We interviewed OCC personnel involved in supervising these activities and reviewed relevant OCC documentation during audit fieldwork conducted from July 2012 through January 2013. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

Results in Brief

We found that OCC had many opportunities to address weaknesses in the CIO's risk management of trading activities, but did not act strongly or timely enough to address those weaknesses. In some cases, OCC failed to act at all. Specifically, OCC did not (1) follow up on a 2010 matter requiring attention (MRA)[1] regarding the CIO's lack of risk management policies, (2) follow up

[1] An MRA is a bank practice identified during an examination that deviates from sound governance, internal control, and risk management principles, which may adversely affect the bank's earnings or capital, risk profile, or reputation if not addressed. It may also result in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank. In some circumstances, a matter requiring attention could also be an unsafe or unsound practice. OCC's expectation is that bank management will act upon the MRA.

on concerns it had with the CIO internal audit function; and (3) appropriately address signs of increasing risk in the Synthetic Credit Portfolio (SCP).[2] We believe that a stronger, timelier OCC response to these weaknesses may have limited the losses.

Further, we determined that (1) the Comptroller's Handbook lacked comprehensive guidance on supervision of bank trading activities and (2) OCC's coordination of its dual supervision responsibilities with the Board of Governors of the Federal Reserve System (FRB) needs improvement. We also include one matter regarding OCC's London office.

We recommend that OCC take the following actions:

1. Ensure that examiners review bank reports and obtain satisfactory explanations when those reports show significant signs of increasing risk in trading activities.

2. Amend OCC policies and procedures to clarify that examiners should follow up on MRAs no later than during the next supervisory cycle, or sooner as dictated by the urgency of the examination finding.

3. Ensure that examiners follow up on findings or concerns with a bank's internal audit office and expand the review of the internal audit function, as necessary, to determine its effectiveness.

4. Improve supervisory coordination with other regulatory agencies and consider formalizing any understanding or agreement.

5. Ensure that revisions to the Handbook for supervision of trading activities communicate to examiners all activities required to be performed during both ongoing supervision and targeted examinations.

[2] The SCP was a portfolio of credit derivatives that grew to have a large and complex set of risks. Credit derivatives are financial contracts designed to hedge credit-risk exposure by providing insurance against losses suffered through credit events, such as downgrade by a rating agency below a specified minimum level, bankruptcy or insolvency by the obligor, or default on payment obligations.

Management Response In a written response, included as appendix 2, OCC stated that it undertook a two-pronged review of its supervisory activities in response to the events at JPMC. The first prong focused on an informed evaluation of the adequacy of current risk controls at the bank. OCC assessed the quality of management and risk management; board oversight; 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 and internal auditors. OCC also assessed the adequacy of the information and reporting provided to bank management and to OCC. This review resulted in the OCC entering into a consent order with JPMC to correct unsafe and unsound practices and violations of law or regulation related to derivatives trading activities conducted on behalf of the bank by the CIO. The OCC also assessed a $300 million civil money penalty.

The second prong addresses trading activities more broadly and draws on the lessons learned from this event that could enhance risk management processes at other banks. Consistent with supervisory policy of heightened expectations for large banks, OCC is demanding that banks adhere to the highest risk management standards. OCC is also assessing the adequacy of risk management throughout the bank. If corrective action is warranted, OCC will pursue appropriate informal or formal remedial measures. Additionally, OCC is identifying ways to improve its supervision.

OCC also stated that it has issued procedures[3] that supplement the Comptroller's Handbook for end-user derivatives and trading activities that address many of our recommendations. These supplemental procedures include scope-setting and ongoing monitoring procedures. As part of its roll-out of the supplemental procedures, OCC stated it will issue a supervisory memo to all examiners that communicates its expectations about their use. In regard to the recommendation to improve supervisory coordination with other regulatory agencies, OCC stated it has instituted a number of actions including making interagency coordination a

[3] Auditor's Note: The procedures referenced in the response were issued as an attachment to OCC Bulletin 2014-8 titled *End-User Derivatives and Trading Activities: Supplemental Examination Procedures* (Mar. 24, 2014).

priority and working with FRB and the Federal Deposit Insurance Corporation (FDIC) to coordinate supervisory strategies in large bank supervision. OCC also stated in some cases, it has entered into memoranda of understanding with other agencies to formalize the understandings for sharing information and coordinating supervision.

OIG Comment We consider the actions taken and planned by OCC as responsive to our recommendations.

Background

Bank trading activities are defined as the buying or selling of securities, financial instruments, or commodities on behalf of customers or the bank's own account. Trading account assets owned by the bank are segregated from the bank's investment portfolio, which includes trading account assets managed on behalf of customers.

OCC's capital-markets teams are responsible for the supervision of bank trading activities at JPMC and other large banks.[4] The teams conduct both ongoing supervision and targeted examinations. Ongoing supervision includes regular monitoring of the bank's trading activities to assess risk and management's control of that risk. The size of the teams varies. Some examiners on capital-market teams have prior trading experience at large banks.

OCC conducts targeted examinations on specific trading desks or areas perceived to have the highest level of risk. During targeted examinations, OCC examiners perform walk-throughs of bank trading activities, testing of data integrity, valuation, and risk management; and meet with bank traders, risk managers, internal audit personnel, and other senior management. Each examination results in a report or supervisory letter that may include findings on risk, violations of laws or regulations, MRAs, and recommendations. Typically, the capital-markets teams complete four to six targeted examinations per year.

[4] Large banks include the largest national banking companies that generally are involved in the most complex activities and operate over wide geographic areas.

JPMC performs a number of trading activities, including debt and equity underwriting; market making and trading of fixed income and equity investments, derivatives, and commodities; corporate lending; and principal investing. The CIO is a management unit of the JPMC Bank Holding Company used to manage JPMC's exposure to various risks and to invest cash for JPMC. The SCP was used to provide protection to JPMC from credit risk. The CIO did not trade on behalf of bank customers.

Beginning in January 2012, the SCP experienced large losses. In trying to counteract the losses, the CIO executed a flawed strategy to reduce exposures by doubling the size of the positions in the SCP twice, quickly and dramatically increasing the size of the portfolio. This strategy failed, resulting in losses of approximately $6 billion.

As of the date of this report, various agencies, including the Treasury Inspector General's Office of Investigations, had open cases related to JPMC and its trading activities. In addition, the U.S. Senate Permanent Subcommittee on Investigations conducted an investigation and issued its final report on the CIO trading losses in March 2013.[5]

Findings

OCC's Supervisory Response to the Chief Investment Office's Poor Risk Management and Increasing Risk in the Synthetic Credit Portfolio Was Insufficient

OCC had many opportunities to respond to JPMC CIO's poor risk management and escalating risk in the SCP, but did not act strongly or timely enough to address its concerns and, in some instances, failed to act at all. As early as 2010, OCC examiners identified deficiencies in the CIO's risk management policies and internal audit function. However, the examiners did not follow up to ensure that the CIO corrected the problems. Further, examiners did not seek explanations for the significant and unprecedented SCP gains in 2011 and losses in early 2012. This sequence of

[5] U.S. Senate Permanent Subcommittee on Investigations, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," Mar. 15, 2013.

events shows a breakdown in risk management, controls, and supervision.

A more in-depth discussion of the identified deficiencies and OCC's response follows.

Lack of Risk Management Policies in CIO

OCC's *Large Bank Supervision* booklet states that, as an organization grows more diverse and complex, the sophistication of its risk management must keep pace. Further, it calls for banks to establish and communicate risk limits through policies, standards, and procedures that define responsibility and authority, specifying that these limits should serve as a means to control exposures to the various risks associated with the bank's activities. OCC's Policies & Procedures Manual (OCC PPM 5310-3) states that bank corrective action should deal with weaknesses at an early stage, before they can develop into more serious problems. Corrective action may involve securing management and board commitments to undertake specific remedial measures to address OCC's concerns. It also states that once a bank has begun taking proper actions to correct problems and prevent further deterioration, OCC will follow up to ensure the success of such measures.

In July 2010, OCC conducted an examination of the CIO's investment portfolios. [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

Because OCC did not address CIO's unsatisfactory response to the MRA and did not follow up on compliance with the MRA, it did not learn that risk management in the CIO continued to remain weak, with very little oversight. This weak risk management allowed SCP exposures to grow to an unmanageable level, which led to the $6 billion trading loss.

OCC officials told us that the standard operating procedure used by examiners to address MRAs during large bank supervision will be revised to improve the tracking, documentation, and timeliness of follow-up actions.

Weak Internal Audit Function at CIO

OCC's *Large Bank Supervision* booklet states that examiners should evaluate and validate the bank's internal audit function as part of the core assessment[6] to determine, based on a review of the core assessment factors, whether it is strong, satisfactory, or weak. Examiners may identify significant auditor control discrepancies or weaknesses, or may raise questions about the audit function's effectiveness after completing the core assessment. In those situations, examiners should consider expanding the scope of the review of internal audit.

[REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[6] The supervisory framework for large banks includes a core assessment, which provides the standards and procedures for OCC examiners to use to meet the requirements of a full-scope, on-site examination. Examiners use the core assessment and the risk assessment system (RAS) to measure and assess existing and emerging risks in large banks. This risk assessment drives supervisory strategies and activities.

OCC did not address these internal audit weaknesses in the CIO by expanding the scope of its review of internal audit or issuing an MRA. Examiners told us they were planning to review the CIO internal audit function again during the next supervisory cycle in 2012. We believe OCC's insufficient supervisory response to CIO's internal audit office contributed to a weak risk management function continuing in the CIO. If internal audit in the CIO had been stronger, issues with the SCP trading desk may have been highlighted earlier, and adequate risk management policies and procedures may have been put in place.

<u>Increasing Risk in SCP</u>

In addition to evidence of poor risk management in the CIO prior to the 2012 trading losses, OCC examiners had access to bank reports that showed evidence of increasing risk in the SCP.

[REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[7]

[8]

[9]

[7] [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[8] [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[9] [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[10] [11]

[10] [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]
[11] [REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

[REDACTED – FOIA EXEMPTION 8, 5 U.S.C. §552(b)(8)]

In addition, in January 2013, OCC issued a cease and desist order (C&D order) to JPMC. The C&D order required JPMC, among other things, to submit an acceptable written plan to ensure that the board of directors has appropriate oversight and governance of the SCP trading.

We believe that OCC took appropriate action after the SCP trading losses became public, but it should have acted stronger and timelier to address CIO's poor risk management and the increasing risk in the SCP prior to May 2012. For example, evidence of a weak internal audit function should have warranted more scrutiny and an MRA, if necessary. Multiple instances of management approval of limit excessions should have also raised doubt about the quality of the CIO's risk management function. However, OCC did not sufficiently address these deficiencies, which contributed to the buildup of SCP positions that led to significant trading losses.

OCC conducted an internal review of its supervision of the CIO and of the JPMC losses, reporting its findings in October 2012. We reviewed the OCC report, which is not publicly available. OCC's findings are consistent with our conclusions. The OCC report noted that (1) OCC did not recognize the extent of SCP risk and its potential for such large losses, despite opportunities to become aware of the risk through JPMC reporting available to examiners; and (2) OCC examiners could have followed up more diligently with regard to the 2010 CIO MRA and 2012 VaR model discussed above. We note that the OCC report concluded that the CIO management was not forthcoming to OCC examiners about its SCP strategy. While the report did not include recommendations, it did include lessons learned that stated, among other things, examiners should (1) review desk level risk and performance reports to check that executive and corporate level reporting does a good job of summarizing important information, and to evaluate the adequacy of that reporting; (2) investigate outsized gains similar to the SCP windfall gain in November 2011; and (3) assign target dates for closing MRAs and follow up on MRAs with deadlines.

OCC Should Improve Coordination of Its Dual Regulatory Responsibilities with FRB

In accordance with 12 CFR 211, a depository institution may organize or acquire a separate subsidiary to engage in international banking activities as an Edge Act corporation (Edge entity). Congress authorized banks to establish subsidiaries under the Edge Act principally to encourage foreign trade and to permit banks to engage in activities that are not permissible under U.S. banking regulations. Under federal law, FRB licenses and regulates JPMC's holding company and Edge entities. OCC regulates JPMC's national bank.

OCC's *Large Bank Supervision* booklet states that effective planning for all large companies requires adequate and timely communication among supervisory agencies, including functional regulators. The regulatory authority over the activities carried out by the CIO is divided and overlapping. This is because the CIO is a management unit of the holding company with its holdings booked in various legal entities including the national bank and Edge entities. The trading activities that caused the losses in the SCP were originally booked in the national bank. At the end of each month, the bank transferred these positions from its books to the books of a subsidiary of an Edge entity, which is regulated by FRB. According to OCC examiners, this is a common practice, intended to transfer risk from the national bank to the Edge entity. OCC examiners stated that they did not know FRB's requirements for supervising Edge activities, or whether FRB reviewed these month-end accounting transactions.

Opportunities exist for improved communication and coordination between OCC and FRB regarding supervisory activities. Dual supervision without proper coordination and communication may lead to lapses in supervision or duplication of supervisory efforts. An OCC official told us that the Comptroller has undertaken an initiative to improve coordination with other agencies, and JPMC is part of the pilot effort.

The Comptroller's Handbook Lacks Comprehensive Examiner Guidance for Supervision of Trading Activities

The Comptroller's Handbook states that it contains the most current concepts and procedures for the examination of national banks, and is designed to provide examiners and their managers with the information necessary to plan and coordinate an examination, monitor problems or other conditions, and implement appropriate follow up.

As described in the background section of this report, OCC capital-markets teams perform both ongoing supervision and targeted examinations of bank trading activities. We noted that the handbook has procedures for examiners to follow during targeted examinations of specific trading activities, such as derivatives, but it does not provide comprehensive examiner guidance for ongoing supervision or for targeted examinations of trading activities. When asked, OCC examiners said they rely on judgment rather than a set of procedures or checklists when supervising bank trading activities.

Given the amount of risk and complexity surrounding bank trading activities, we believe it is important that OCC provide examiners both guidance and expectations regarding the supervision of those trading activities. Using judgment alone in determining how to supervise trading activities may result in underestimating the level of risk within a bank's line of business or specific trading desk.

According to an OCC official, the Chief National Bank Examiner's office is revising the Comptroller's Handbook to clarify expectations regarding identifying and reporting on significant investment portfolios and trading-book exposures.

Other Matter

OCC has a team of five examiners in London that assist with targeted examinations at several large banks with foreign offices. In addition to JPMC, OCC supervises five other U.S. banks with operations in London: Bank of America, N.A.; Citibank, N.A.; Wells Fargo Bank, N.A.; Capital One Bank, N.A.; and BlackRock Institutional Trust Company, N.A. Although the London examiners do not perform dedicated ongoing supervision, according to OCC officials, they discuss topics with London bank personnel to support on-site supervision performed in the U.S. OCC officials told us that the London examiners could potentially be used more efficiently and that OCC is looking at ways to assess its global footprint.

Recommendations

We recommend that the Comptroller of the Currency take the following actions:

1. Ensure that examiners review bank reports and obtain satisfactory explanations when those reports show significant signs of increasing risk in trading activities.

   Management Response

   Two objectives of the ongoing monitoring procedures (included in the supplemental procedures issued on March 24, 2014) focus on identifying new or changing risks related to trading and end-user activity. Examiners are required to review on a regular basis reports of the bank's trading operations. The procedures for large complex trading operations instruct examiners that daily review of profit and loss and limit breaches will generally be appropriate, supplemented by weekly reviews of position limits, limit usage, and stress results.

   OIG Comment

   OCC's corrective action is responsive to the recommendation to the extent that examiners obtain explanations for significant signs of increasing risk revealed by their reviews.

2. Amend OCC policies and procedures to clarify that examiners should follow up on MRAs no later than during the next supervisory cycle, or sooner as dictated by the urgency of the examination finding.

Management Response

OCC stated that while it does have guidance in place that addresses follow-up on MRAs, the guidance does not set time parameters. Two steps in the supplemental procedures issued by OCC address this. Examiners are required to assign a date by which a MRA must be resolved and they must ascertain the status of the MRA on a quarterly basis. If a bank fails to resolve the MRA by the due date, and does not have adequate justification for that failure, examiners are instructed to reflect that failure in their core assessments and the management component of the CAMELS rating[12] and to consider whether an enforcement action may be warranted.

OIG Response

OCC's corrective action is responsive to the recommendation.

3. Ensure that examiners follow up on findings or concerns with a bank's internal audit office and expand the review of the internal audit function, as necessary, to determine effectiveness.

Management Response

In the context of end-user derivatives and trading activity, the second objective of the minimum scope section of the supplemental procedures is devoted entirely to internal/external audit. It requires examiners to determine the appropriateness of the audit function for the bank's end-user and trading activities. The last objective of the ongoing monitoring section is to determine that the bank addresses promptly deficiencies and weaknesses related to end-user derivatives and trading activity that internal or external auditors have identified.

[12] Auditor's Note: Federal banking agencies use the Uniform Financial Institutions Rating System, or "CAMELS," to assign composite and component ratings to financial institutions. An institution's composite CAMELS rating integrates ratings from six component areas—capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. The ratings range from 1 to 5 with 1 being the highest rating and least supervisory concern.

OIG Response

OCC's corrective action is responsive to the recommendation.

4. Improve supervisory coordination with other regulatory agencies and consider formalizing any understanding or agreement.

   Management Response

   OCC instituted a number of actions to improve supervisory coordination with other regulatory agencies, such as making interagency coordination a supervisory priority and working with FRB and FDIC to coordinate supervisory strategies in large bank supervision. In some cases, OCC has entered into memoranda of understanding with other agencies to formalize the understandings for sharing information and coordinating supervision, and OCC will continue to enter into such agreements in the future as appropriate.

   OIG Response

   OCC's corrective action is responsive to the recommendation.

5. Ensure that revisions to the handbook for supervision of trading activities communicate to examiners all activities required to be performed during both ongoing supervision and targeted examinations.

   Management Response

   The supplemental procedures include both minimum scope procedures for targeted examinations to assess the effectiveness and integrity of risk management systems, and ongoing monitoring procedures to identify trading activity, end-user derivatives, and trends in risk profiles. As part of its roll-out of the supplemental procedures, OCC will issue a supervisory memo to all examiners that communicates expectations about their use. Examiners of large banks will be instructed to begin using these procedures immediately. Examiners of midsize banks will use the procedures—

particularly the procedures related to end-user derivatives—as appropriate for the bank's complexity and risk profile. The procedures are likely not necessary for examinations of community banks.

<u>OIG Comment</u>

OCC's corrective action, taken and planned, is responsive to the recommendation. OCC will need to record the planned completion date for issuing the supervisory memo to examiners in the Joint Audit Management Enterprise System (JAMES), the Department of the Treasury's audit recommendation tracking system.

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We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384 or Theresa Cameron, Audit Manager, at (202) 927-1011. Major contributors to this report are listed in appendix 3.

Jeffrey Dye /s/
Director, Banking Audits

Our objective was to determine and assess the Office of the Comptroller of the Currency's (OCC) process of supervising bank trading activities, primarily focusing on OCC's supervision of trading activities at the JPMorgan Chase Bank, N.A. (JPMC) Chief Investment Office (CIO) in London.

To accomplish these objectives, we performed the following activities during audit fieldwork conducted from July 2012 through January 2013:

- interviewed OCC examiners for JPMC; Bank of America, N.A.; and HSBC Bank USA, N.A., and other OCC officials and personnel to gain an understanding of supervising bank trading activities
- reviewed OCC's supervisory guidance on bank trading activities
- reviewed OCC's supervisory documentation related to JPMC's trading activities
- reviewed an October 2012 OCC internal report on its supervision of the CIO and of the JPMC losses
- performed research on the Edge Act and Edge entities
- reviewed the report by the Senate Permanent Subcommittee on Investigations titled *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses* (Mar. 15, 2013)
- reviewed other public information, such as documents from the JPMC website, to gain additional information about the trading losses that occurred in 2012

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Office of the Comptroller of the Currency

Washington, DC 20219

March 27, 2014

Jeffrey Dye
Director, Banking Audits
Office of Inspector General
Department of the Treasury
Washington, DC 20220

Subject: Response to Draft Report

Dear Mr. Dye:

We have reviewed your draft report titled "OCC Needs to Strengthen Supervision of Trading Activities in Light of the JPMorgan Chase Trading Losses." Your objective was to determine and assess the Office of the Comptroller of the Currency's (OCC) process of supervising bank trading activities, primarily focusing on OCC's supervision of trading activities at the JPMorgan Chase (JPMC) Chief Investment Office (CIO) in London.

You concluded that OCC's supervisory response to the CIO's poor risk management and increasing risk in the synthetic credit portfolio was insufficient. You also found that OCC should improve coordination of its dual regulatory responsibilities with the Federal Reserve (FRB). Lastly, you concluded that the *Comptroller's Handbook* lacks comprehensive examiner guidance for supervision of trading activities. You make five recommendations to address these issues.

In response to the events at JPMC, we undertook a two-pronged review of our supervisory activities. The first component focused on evaluating the adequacy of current risk controls at the bank, informed by their application to the positions at issue. We assessed the quality of management and risk management; board oversight; 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 and internal auditors. We also assessed the adequacy of the information and reporting provided to bank management and to the OCC. Effective supervision is dependent on the quality of information available to examiners. This review resulted in the OCC entering into a consent order with JPMC to correct unsafe and unsound practices and violations of law or regulation related to derivatives trading activities conducted on behalf of the bank by the CIO. The OCC also assessed a $300,000,000 civil money penalty.

The second component addresses trading activities more broadly and draws on the lessons learned from this episode that could enhance risk management processes at other banks. Consistent with our supervisory policy of heightened expectations for large banks, we are demanding the banks adhere to the highest risk management standards. We are not limiting our inquiry to the particular transactions at issue. We are assessing the adequacy of risk management throughout the bank. If corrective action is warranted, we will pursue appropriate informal or formal remedial measures. We are also identifying ways to improve our supervision.

On March 24, we issued procedures that supplement the *Comptroller's Handbook* for end-user derivatives and trading activities while we work through the steps necessary to incorporate them into a revised publication of this. The supplemental examination procedures include scope-setting and ongoing monitoring procedures. They address many of your recommendations as described below.

First, you recommend the OCC ensure that examiners review bank reports and obtain satisfactory explanations when those reports show significant signs of increasing risk in trading activities. Two objectives of the ongoing monitoring procedures focus on identifying new or changing risks related to trading and end-user activity. Examiners are required to review on a regular basis reports of the bank's trading operations. The procedures for large complex trading operations instruct examiners that daily review of profit and loss and limit breaches will generally be appropriate, supplemented by weekly reviews of position limits, limit usage and stress results.

Second, you recommend the OCC amend policies and procedures to clarify that examiners should follow up on matters requiring attention (MRA) no later than during the next supervisory cycle, or sooner as dictated by the urgency of the examination finding. While we do have guidance in place that addresses follow-up on MRAs, we agree it does not set time parameters. Two steps in the supplemental procedures address this. Examiners are required to assign a date by which a MRA must be resolved and they must ascertain the status of the MRA on a quarterly basis. If a bank fails to resolve the MRA by the due date, and does not have adequate justification for that failure, examiners are instructed to reflect that failure in their core assessments and the management component of the CAMELS rating and to consider whether an enforcement action may be warranted.

Third, you recommend the OCC ensure that examiners follow up on findings or concerns with a bank's internal audit office and expand the review of the internal audit function, as necessary, to determine effectiveness. In the context of end-user derivatives and trading activity, the second objective of the minimum scope section of the supplemental procedures is devoted entirely to internal/external audit. It requires examiners to determine the appropriateness of the audit function for the bank's end-user and trading activities. The last objective of the ongoing monitoring section is to determine that the bank addresses promptly deficiencies and weaknesses related to end-user derivatives and trading activity that internal or external auditors have identified.

Fourth, you recommend the OCC improve supervisory coordination with other regulatory agencies and consider formalizing any understanding or agreement. The OCC has instituted a number of actions to improve supervisory coordination with other regulatory agencies, such as making interagency coordination a supervisory priority and working with the FRB and the Federal Deposit Insurance Corporation (FDIC) to coordinate supervisory strategies in Large Bank Supervision. In some cases the OCC has entered into memoranda of understanding with

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other agencies to formalize the understandings for sharing information and coordinating supervision, and we will continue to enter into such agreements in the future as appropriate.

Lastly, you recommend the OCC ensure that revisions to the handbook for supervision of trading activities communicate to examiners all activities required to be performed during both ongoing supervision and targeted examinations. The supplemental procedures include both minimum scope procedures for targeted exams to assess the effectiveness and integrity of risk management systems, and ongoing monitoring procedures to identify trading activity, end-user derivatives, and trends in risk profiles. As part of our roll-out of the supplemental procedures, we will issue a supervisory memo to all examiners that communicates our expectations about their use. Examiners of large banks will be instructed to begin using these procedures immediately. Examiners of midsize banks will use the procedures—particularly the procedures related to end-user derivatives—as appropriate for the bank's complexity and risk profile. The procedures are likely not necessary for examinations of community banks.

If you need additional information, please contact me or Martin Pfinsgraff, Senior Deputy Comptroller for Large Bank Supervision, at 202-649-5590.

Sincerely,

Thomas J. Curry
Comptroller of the Currency

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Theresa Cameron, Audit Manager
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Office of the Deputy Chief Financial Officer, Risk and Control Group

Office of the Comptroller of the Currency

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