

Remarks by
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It's a great pleasure to represent the nation's oldest regulatory agency, now nearing its 150th anniversary, before the ABA, which itself dates back to 1875. Over these many years the OCC and the ABA have often seen eye-to-eye on the top issues facing the banking system, but we've had plenty of honest disagreements as well. That's as it should be. But the key to our relationship has been a healthy and constructive dialogue, and I appreciate the opportunity to continue that tradition here today.

It is my distinct good fortune not only to be with you here in San Diego, but also to come to the Comptroller's office at a time when many of the indicators of safety and soundness are trending positively. A look at the banking system from 10,000 feet reveals stronger balance sheets, improving earnings, and fewer problem institutions and failures. Asset quality has been improving over the past several years and charge-off rates have fallen across all product lines, including credit cards, commercial and industrial lending, and commercial real estate. Capital, system-wide, stands at its highest level in a decade. Considering where we were back in 2008 and 2009, when the recession officially came to an end, this is a remarkable improvement.

I am not suggesting that the long process of rebuilding safety and soundness, and public confidence, is complete. While we've seen progress, we're not out of the woods yet. Too many community banks and thrifts continue to struggle with weak earnings and a backlog of problem loans. Non-loan income is down and compliance costs are up, dealing direct hits to your bottom line. The number of troubled institutions, while declining, is still higher than we would like. Meanwhile, fresh reports of trouble from around the world and uncertainties about the U.S. fiscal situation feed worries that the global economy might yet lapse back into recession.

But for all the uncertainty in the economic outlook, community banks and thrifts have an advantage here. Your standing in your communities has always been one of your strengths, and it is something you can build on.

Still, while the worst days of the financial crisis and ensuing recession are almost certainly behind us, significant challenges and uncertainties remain, including questions about how regulators will implement key provisions of the Dodd-Frank Act and other significant rules. One such issue that I know has been of great concern to you is the Basel III capital proposal. I'd like to spend some time this morning discussing what we are doing to address your concerns as we implement it.

First, it's important that our proposals for capital achieve the right balance. As you know, in June we published three notices of proposed rules for enhancing capital with the Fed and the FDIC, two of which apply to community banking institutions as well as larger institutions. In writing these, we were very aware of the need to balance soundness and regulatory burden considerations. We are hoping that the comment letters we receive will help us figure out how to improve this balance.

Some have suggested that we should simply exempt community banks from everything in these rules. Community banks and thrifts didn't cause the crisis, they observe, so why should they be forced to change their ways in the wake of it? We need to keep in mind, however, that over 400 community banks and thrifts have failed since 2008, and ultimately, they failed because they didn't have enough capital for the risks they took.

Improving the quality and raising the quantity of capital is the main reason for the first of the June NPRs. The agencies and the press have called it the Basel III NPR, which has fed the notion that we are importing standards invented in Basel and imposing them on community banks and thrifts here in the U.S. However, I believe some of the Basel standards are appropriate for banking institutions of all sizes and levels of complexity, and they belong in our rulemaking. For example, isn't it prudent policy to exclude from regulatory capital those instruments that cannot be trusted to be there when they are most needed to absorb losses – no matter where the idea originated? So too is the idea of a capital conservation buffer: if a bank or thrift gets close to its minimum capital ratios for whatever reason, shouldn't it be thinking about limiting bonuses and dividend distributions?

But, as reflected in our proposed rules, there are several elements of the Basel standards that we don't believe are appropriate for community banks and thrifts. For example, the counter-cyclical buffer is a Basel III idea that applies only to large banks. Of course, all of the advanced approaches provisions don't apply. And many aspects of the first two of the June capital NPRs won't affect individual institutions if, for example,

they do not book mortgage servicing rights or hold minority interests in other financial institutions.

One issue where we have already received many comments is the treatment of accumulated other comprehensive income or “AOCI.” In particular, many of you have expressed concern that unrecognized losses and gains in available-for-sale portfolios will create unnecessary and even unmanageable capital volatility if they flow through into the regulatory capital numbers.

There are compelling arguments for both sides on this issue. On the one hand, if securities have lost value, it would seem reasonable to take that into account when figuring out how much capacity a bank or thrift has to absorb unexpected losses in the future. This was the relevant computation that the markets made during the crisis for large banks. On the other hand, the AOCI pass-through may result in an understatement of the ability of the bank to absorb losses, because there can be offsets elsewhere in the balance sheet.

We recognize that the extra volatility that such an AOCI pass through would cause would be expensive and difficult to manage – a source of significant regulatory burden – especially to banking institutions, including mutual thrifts, that do not regularly access the short term capital markets. We have already received enough substantive comments on AOCI that I can promise you that we will be taking a very serious look at what our options are to address this conundrum once the comment period ends.

Along with having higher and better quality capital, the second basic principle you will find reflected in the June capital NPRs is that more risk should require more capital. That is the focus of the second capital NPR that we published in June – the

Standardized Approach NPR. Once again, there are many aspects of this NPR, such as the enhanced disclosure requirements, that won't touch community banks and thrifts at all. And there are others where the proposed rule gives community banks and thrifts the option to ignore possible complications.

A second area where we will be reviewing comments very carefully involves mortgages – high volatility commercial real estate and residential mortgages. If ever there was an area where higher risk and higher capital should go together, this is it. This was a very clear lesson of the crisis. However, we recognize that the way we proposed to set minimum capital levels for these assets based on such measures as loan-to-value ratios, or singling out some balloon mortgages as especially risky, may impose a serious burden on many community banks and thrifts, particularly when applied to existing mortgages or if phased in too quickly. Here again, it is essential that we strike a balance that addresses risk while minimizing burden.

It may sometimes seem that regulators are completely insensitive to regulatory burden. In preparing the June capital NPRs, we did actually worry a lot about three sorts of burden: the short term costs of simply digesting the rules; the long term costs of developing and implementing any procedures and systems needed to comply; and then of course the costs of increasing capital.

We took several steps to try to lessen the short term burden. We split the rules into three parts so that many of you would not have to even glance at the Advanced Approaches material; we provided an addendum to the first two rules summarizing these for community bankers; we built an estimator tool to help you assess the impact of the

rules on the amount of capital needed to comply; we conducted outreach in a variety of forums; and we extended the comment period.

With respect to longer term regulatory burdens, we hope that the comments we receive will help us refine our estimates of the system and procedures costs that are likely to be associated with compliance. These are real costs, and if the comments reveal where the costs might be concentrated or what the rough overall cost implications might be, that would be especially useful.

That leaves the question of whether additional capital will be needed. The analysis we did when preparing the June proposals suggested that the impact on most community banks and thrifts will be small. In most cases, we expect it to fall largely on institutions whose capital is lower or risks are higher than average – as should be the case for any minimum capital rule. But we need to hear from you on this issue. We hope the estimator we published recently will help you assess this impact. And we need you to share the results with us.

As we finalize the rules, we will be thinking broadly about ways to reduce regulatory burden. As well as considering the substance of each provision, we will be taking a fresh look at the possible scope for transition arrangements, including the potential for grandfathering, to evaluate what we could do to lighten burden without compromising our two key principles of raising the quantity and quality of capital and setting minimum standards that generally require more capital for more risk.

As a career community bank and thrift supervisor, I understand how you feel about compliance burden. In fact, I still consider myself a community bank supervisor, because most of the institutions the OCC supervises are community banks and thrifts, and

most of our resources are devoted to that work. So I think I have a pretty firm understanding of your business and can relate to your unique concerns.

I worry that the sheer poundage of the regulations that we are issuing – and some of them can almost be measured by the pound, though hopefully not by the ton – present a compliance burden that can be very hard to meet. Community banks and thrifts should not need to have battalions of lawyers and compliance experts to review the new rules or to help ensure that you are meeting their requirements. So I think we need to consider whether we can do a better job of introducing both proposed and final rules and regulations in a way that highlights the areas of significance to community institutions, and I welcome suggestions you may have.

I want to conclude with an important thought that is sometimes forgotten in the heat of the debate. We, the federal banking agencies, have the same basic objectives as you do. We recognize and value the vital role you play in our national economy and your local communities. Your business model has to stay viable. As a foundation for your future success, your capital has to stay adequate. If we can do that, we will be well along the road in ensuring that there is a stable and competitive community banking system meeting household and business credit needs across America in the years ahead.

Thank you.