

Remarks by
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Thank you. It's a pleasure to be here and to have this opportunity to share some thoughts on current issues with a group of industry professionals that are dedicated to risk management. RMA may not be a household name, but it's hard to imagine a group more central to the success of commercial banks and thrifts in this country than yours. You have responsibilities enterprise-wide for ensuring that risks are identified and managed, from credit underwriting to market risk to operational risk.

That's a pretty broad portfolio of responsibilities, and it's been an especially challenging one in the years surrounding the financial crisis. I doubt there's been a more difficult time for a bank risk manager in a good many years – certainly not in my lifetime – and I for one fervently hope we'll never again have to weather so severe a storm. I worked through the crisis from my seat on the board of the Federal Deposit Insurance Corporation, and I still remember a number of heart-stopping moments. I don't know about you, but the term stress-test still has multiple meanings for me.

At the OCC, risk management is central to everything we do, and we use a variety of channels and windows to gain perspectives on emerging risks. One valuable channel

involves forums such as these, where we gain insights by hearing from folks like you who are dealing with risk issues every day. Another important channel is the information we get from our field examiners who often spot troublesome trends early on and communicate them back to the agency. We also have economists and other professionals who monitor markets and macro trends, and we do a lot of system-wide analysis. Our National Risk Committee brings together professionals from our Supervision, Policy, Law, and Economics departments, and they meet regularly to assess information that comes in from the field and elsewhere, and to pull disparate pieces of information together into guidance that helps us manage risk across the federal banking system.

Recently, we published our first Semiannual Risk Perspective report, which we believe will provide the institutions we supervise, as well as a number of other interested parties, with some insights into the risks that we are most concerned about. We hope it will provide greater transparency about our supervisory process and also help federal banks and thrifts identify and benchmark risk in their own businesses. If you haven't had an opportunity to read it, I encourage you to go to our Web site at www.occ.gov, and give it a look. We'll be publishing the fall edition later this year.

In our spring report, we cited three broad areas of concern. One involves the earnings challenges many of your institutions face in an environment of slow growth and volatile financial markets. The second involves mortgage lending, including home equity lines of credit, which presents special problems for lenders, and I'll have a bit more to say on that in a few moments.

The third is the overarching strategic risk that is inherent when financial institutions search for greater profitability in an uncertain environment, sometimes taking

on inappropriate types of risk. For example, we are seeing signs of slippage in underwriting standards, particularly in the area of leveraged lending, but also in middle market commercial and industrial lending, where lenders are competing vigorously for customers. As part of this search for new lending opportunities, we see banks and thrifts reaching for less familiar products, which obviously brings heightened risk. On the operational risk side, we are concerned that institutions will shortchange the compliance resources, systems, and controls needed to manage this area effectively.

A common theme in each of these areas is the quest to maintain and improve profitability in an extremely difficult economic environment, sometimes in ways that provide a short-term boost at the expense of long-term safety and soundness. An example – and one that I want to spend the rest of my time on today – has to do with so-called reserve releases – the reduction in the allowance for loans and lease losses that results when net charge-offs outpace provisioning.

Now it's easy, and not unreasonable, to argue that lower reserves are appropriate at a time in which charge-offs are declining and underwriting has improved. And it might also be fair to suggest that generally accepted accounting standards, as enforced by external auditors and agencies such as the SEC, militate in favor of lower reserves when credit conditions improve. Those are reasonable positions, and I'd like to address each one in turn.

First, the economy is not out of the woods yet. For all the welcome improvement we've seen in the economic environment, risk remains elevated in a number of areas, and that will affect the collectability of loans. Europe is in recession, and growth in Asia has slowed. In the United States, the housing market is soft, and unemployment remains

stubbornly high. The economy is continuing to post only modest growth, and there are a number of soft spots, particularly in the real estate sector. Although real estate related nonaccruals are well off their peak, they remain elevated, especially at community banks and thrifts.

Commercial property fundamentals are improving, but net operating income and property values are likely to remain below prior peaks for office buildings, retail space, and warehouses in most markets in the near term. Up to half of all CRE loans will need to be rolled over by 2014, so banks and investors still face challenging repayment issues.

Home equity loans are also under pressure. Nonperforming HELOCs are up sharply from the middle of 2008, when they first began to skyrocket, and net charge-off rates, while down from their peak levels, remain well above their pre-crisis lows. An even more worrisome picture emerges when you look at the lifecycle of HELOCs that were issued between 2004 and 2008. Most of those loans featured an interest-only draw period of seven to ten years, with ten years being most common. After the draw period ends, the loans either begin to amortize or mature. Just over 80 percent of the balances currently outstanding were originated in that period.

Our concern is that many of the borrowers who are able to make interest-only payments in the current low rate environment may not be able to make amortizing payments. And with so many properties underwater, many homeowners who can't pay off balloons may not have enough equity in their house to refinance.

So, collectability is clearly a problem almost across the board, and that argues against allowing real estate related reserves to fall. I remain very concerned that too many institutions are continuing to reduce provisions solely to boost earnings. While

reserves remain at a high level industry wide, quarterly provisions are smaller than charge-offs. In fact, if provisioning continues at current levels and charge-offs remain constant, the allowance as a share of noncurrent loans could return to historical lows in just a few years. With fresh memories of the financial crisis and a deep recession that led to hundreds of bank and thrift failures, that has to be a matter of concern to all of us.

To be clear, I am not saying that we see an immediate problem at national banks and federal savings associations that demands urgent corrective action. But I am saying that we are watching reserves very closely, and we expect national banks and federal savings associations to maintain them at appropriate levels. We are ready to take action if and when it is needed.

But of course that begs the question of how much is enough when it comes to reserves. I know that many of you probably think that we regulators have never met a loan loss allowance that was too big. That's not true – at least not completely. But in the current economic environment, I don't think we can afford to err on the side of allowing reserves to become too lean.

At the same time, it is important that we maintain the integrity of the balance sheet so that investors and others can reasonably assess a financial institution's condition. That's why traditional accounting practices have prescribed rigorous methodologies for determining the amount of the loan loss allowance.

That sets up a potential conflict, and many of you have told us you find it extremely difficult to satisfy all of your regulators – the banking agencies on the one hand and the accounting and audit oversight bodies, such as the SEC and the Public Company Accounting Oversight Board, or PCAOB, on the other.

In fact, I would say that isn't true. The bank regulatory agencies and the accounting and audit oversight bodies are on the same page on these issues. We both agree that judgment has to be part of the process of setting the allowance. And we also agree that the process requires documentation and a strong underlying rationale. To get that word out, the banking regulators and the accounting and audit oversight bodies have partnered in an outreach campaign. The OCC, the other banking regulators, and the accounting and audit oversight bodies are holding talks with banks, accounting firms, and trade associations to make sure everyone understands that there is broad agreement on the essential requirements of the process for estimating an appropriate loan loss allowance.

There's still a concern about the incurred loss model, and whether it relies too heavily on historical experience. The recent financial crisis, which followed a boom period, illustrates the danger of relying too heavily on past patterns. For example, in hindsight, the incurred loss methodologies didn't adequately incorporate the build-up of risk from things like loosening underwriting standards and aggressive pricing of risk during the last crisis. Both items are coming back as well as a tenuous recovery in asset quality. That is why the incurred loss model requires significant judgment, and it also requires that management document its rationale in setting the level of the allowance.

However, even with the caveat that judgment can be brought to bear in applying the incurred loss model, the current model has clear limitations. The industry recognizes those limitations, and the Financial Accounting Standards Board is working on a more forward looking approach. I can tell you that all of the bank regulatory agencies are very supportive of that initiative, and we at the OCC will be actively engaged in providing our analysis and feedback.

One of the clear lessons of the financial crisis is that loan loss allowances that are appropriately set can help financial institutions ride out even the worst storms. We at the OCC believe it is important that national banks and federal thrifts bring judgment to bear in setting those reserves, even when it results in a lower allowance – provided that they can document an appropriate basis for releasing reserves. But we have a close eye on the allowance, and we are watching closely to make sure that the institutions we supervise maintain the allowance for loans and lease losses at levels appropriate for the credit risk in their portfolios.

Thank you. I'd be happy to take your questions.