

Remarks by

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Good morning. It's a pleasure to be here in Chicago, and to have this opportunity to talk about some of the issues affecting community banks. The past few years have been extraordinarily challenging for all financial institutions and for community banks and thrifts in particular. Margins are under pressure, the regulatory environment is evolving, and creditworthy borrowers are hard to find. Commercial real estate, a bread-and-butter product for many community institutions, is still suffering from high vacancy rates, as well as a significant level of problem assets.

However, the environment is getting better for small banks and thrifts. I don't want to minimize the difficulties, but we are seeing real improvements in asset quality, liquidity, underwriting, and capital, among other indicators. The number of problem banks is beginning to stabilize, and the volume of problem assets is falling. After the financial crisis and the recession that followed, these steady signs of improvement are welcome indeed.

But as the industry moves to a better place, we ought to ask ourselves what it was that differentiated the more than 460 banks and thrifts that failed over the past few years from those that not only survived, but in many cases thrived. Clearly, the ones who made it had stronger capital, better liquidity management, better underwriting, and, in most cases, smaller asset concentrations. They are the ones who stuck to their knitting, served their communities, and didn't try to reach too far for profits. They are the community banks that maintained their reputations, and were able to build upon their customers' trust and confidence.

But as important as each of those characteristics was, the strength of the community banks that prospered in difficult times came from more than just the sum of those parts. In fact, I would say it was something far more fundamental. They managed to prosper through hard times because they had effective risk management systems in place.

In one sense, that's almost self-evident. After all, banking is a business of managing risk, of understanding how decisions that are made today will affect the condition of the bank in the future, and planning accordingly. And importantly, the banks that were successful weren't those with the fanciest systems. They were the institutions that focused on understanding the risks they were taking on and anticipating the future consequences of those risks.

I'd like to spend the rest of my time today on the subject of risk management, and in particular on enterprise risk management. And yes, that's a subject broad enough to capture almost everything you do in managing your institutions. But I'll limit my comments to a few specific areas that I think are particularly important today, including capital planning, stress testing, and operational risk, which I'm sure will be more than enough for the time we have available.

If you haven't seen it yet, then I would encourage you to take a look at the OCC's [*Semiannual Risk Perspective*](#), which we published for the first time this spring.

The report highlights three areas of risk that are front and center for the OCC, and each of them illustrates the importance of enterprise risk management. The first has to do with the aftereffects of the housing-driven boom-to-bust credit cycle. The second involves the challenge of increasing revenues in a slow-growth economy, and the third is focused on the potential for banks and thrifts to take excessive risks to improve profitability.

None of this is really new: we've seen booms turn into busts before, and we've dealt with the consequences that followed. And of course, we've gone through cycles where revenue growth and earnings were hard to come by, and some banks and thrifts took on inappropriate risks to compensate.

But there is something different about this cycle. It's been far more challenging than any I've experienced in my working career, and it has been far more painful to work

through it. And for all the improvements we're seeing, creditworthy borrowers who want loans are still hard to find. This is a time where banks and thrifts of all sizes need to manage their operations carefully to ensure that they aren't planting the seeds for the next crisis. Reaching out on the risk spectrum for earnings can be problematic. We have seen institutions cutting back on operating controls to enhance income, and this is a cause for concern.

And I would say that's where a strong enterprise risk management or a strong risk assessment system comes in. Enterprise risk management is an integrated approach to identifying, assessing, managing, and monitoring risk in a way that maximizes business success. It starts at the top, with the board and senior management making decisions about the institution's business model and its appetite for risk, but it can't be successful unless those policies are filtered into the bank's culture.

A strong risk culture is proactive, and it drives the way your bank sets strategy and makes decisions. It also translates into how your management team and employees anticipate and respond to risk throughout the bank. This means that individual risks aren't considered only within the lines of business or by function, although the board and management can and should think about them in this way. It also means that risk and risk management are considered in their totality across the bank, as well as how different risks are related and interact with one another.

So one aspect of enterprise risk management involves sharing information and breaking down the silos. For example, your loan staff should be talking with compliance staff when developing new products or services. This is especially important, and we've seen problems in the past when silos prevent these two groups from talking to each other. The fact is, everyone with a vested interest in new product decisions should be involved in the conversation, and that includes your supervisor. The regulatory agencies can be good resources to help you make sure you've identified all aspects of new product decisions that should be considered.

Another key element of risk management involves taking advantage of the guidance issued by the OCC and other regulators and tailoring it to your own unique circumstances. Stress testing is an example. Our guidance describes a variety of methods that community banks can use to stress test their portfolios, and provides one

example of a simple stress test framework. However, each institution is different, and every bank and thrift will need to decide for itself what method is most appropriate for its own specific circumstances. The key here—and the purpose of the guidance—was to encourage community banks to do some simple stress testing, and to help them understand how to do it.

I want to underscore that we're not requiring community banks to have the types of sophisticated models and processes that we expect from larger institutions, or that we think banks have to go hire consultants to meet our expectations. What we really want to see is that your banks do consider some form of stress testing or sensitivity analysis of your key loan portfolios on at least an annual basis. The goal is to help you analyze “what ifs”—what happens if a group of borrowers or an industry segment runs into problems—what will be the impact on your loan portfolios, your ALLL, your earnings and your capital. Community banks that have incorporated such concepts and analyses into their credit risk management and strategic and capital planning processes have demonstrated the ability to minimize the impact of negative market developments more effectively than those that did not use stress testing.

Risk management is also a key element of a bank's capital planning process, a point that we highlighted in guidance issued earlier in the year. In fact, the first step in capital planning is the identification and evaluation of all material risks. Again, every bank is different in the way it funds itself, its willingness to enter new lines of business, or its tolerance for asset concentrations, among other factors. Not every risk can be offset by the addition of capital—overly high CRE concentrations, for example—but once risks are identified, management and the board can begin to assess the institution's capital needs.

Of course, capital isn't the only buffer available to banks and thrifts to provide a cushion against economic shocks. A well-managed allowance for loan and lease losses is also a vital risk management tool, and it's one that I hope each of you is monitoring very closely. As the quality of some classes of assets has improved and charge-offs have moderated, there has been a tendency to reduce quarterly provisions, in many cases to levels that are inadequate to cover charge-offs. It would be short-sighted to say that banks and thrifts can't engage in some level of reserve releases, given the improvement

we've seen in the fundamentals, and we at the OCC aren't saying that. But I have warned on several occasions lately that we are monitoring this trend very closely, and we're ready to take action if necessary.

In this context, let me say that this is a trend each of you should be monitoring as well. One of the key lessons of the financial crisis has to do with the importance of capital and reserves. If you are letting your reserves decline rapidly, our examiners will want to see that you have a carefully-considered strategy for matching the allowance to risk in your loan portfolio.

Finally, I said toward the outset that I wanted to discuss operational risk. I doubt that any single area of risk management has occupied as much of my time since I became Comptroller in April as operating risk. From the foreclosure processing mess to fair lending violations to credit card marketing issues, the risk of loss that results from the failures of people, processes, systems, and external events has become a significant safety and soundness issue.

I'm sure that all of you noted that the problems I cited are all ones that involved large banks and thrifts, not community institutions. However, I want to caution each of you to be particularly vigilant about monitoring and managing operational risk, particularly in areas that involve the fair treatment of your customers. Op-risk failures are the surest way to undermine the reputation of your bank, and one of the greatest advantages community banks and thrifts have in today's marketplace is their reputation. Your customers trust you and want to do business with you, and that is a vital resource that you should protect at all costs.

The op-risk example highlights one key aspect of enterprise risk management, and that is the competitive advantage it confers on those who do it well. Whether it is taking the steps necessary to safeguard your reputation or matching your long term capital needs against your risk profile, risk management should not be viewed as a defensive strategy, but as a proactive means of gaining a competitive advantage in the market.

The reason I am so concerned about all of this is simple. Community banks and thrifts play a vital role in supporting local economies throughout the country, and America's families and communities can't be successful unless you are. So our goal in promoting sound risk management is to help ensure that the nation's smaller banks and

thrifts remain healthy, profitable, and strong enough to serve communities across the United States.

Thank you.