

Remarks by
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Thank you, it's a pleasure to be here, especially since this is my first speech of the new year. I don't know about you, but I've made a couple of New Year's resolutions that I'm trying very hard to keep. One that I hope you'll especially appreciate has to do with delivering shorter speeches. I've given up on the resolutions involving the gym and junk food, but I'm hoping that I'll finish here today with at least that one resolution intact.

Since we're still in the first weeks of 2013, this seems like a good opportunity to look ahead at some of the challenges and opportunities we're likely to face in the new year. Looking ahead has its advantages; I'm sure many of you are ready to close the books on 2012 and, for that matter, the four or five previous years. It's been a very tough economy for everybody, including banks and thrifts. But the difficulties that characterized the economic environment in the years since the 2008 financial meltdown shouldn't obscure the very real progress that California institutions have made in dealing with a very tough credit cycle or the improvement in the state's economy. You not only took a number of steps to strengthen risk management practices to meet the challenges of a difficult economy, but you did it while working with your customers to help them weather the economic storm.

But for all the very real progress that has been made, the lingering effects of the housing bust are still having an outsized impact upon business activity. Unemployment here dipped below 10 percent in November, the first single digit rate recorded in nearly four years. But at 9.8 percent, it's still two percentage points above the national average. We are seeing improvement in the state's commercial real estate markets, but the pace of the recovery varies widely by metropolitan area and property type. For example, apartment vacancies are well below the national average, in part because of the decline in homeownership rates since 2006, but vacancies in retail and warehouse markets have stayed above pre-recession levels, with the lone exception of retail space in San Francisco.

So, whatever the opportunities, it's clear that the road ahead will have its share of challenges. I'd like to use the rest of my time today to talk about some of the issues that face you, as California bankers, as well as a few of the concerns that confront the industry as a whole.

California in many ways provides a microcosm of the U.S. banking system – and for that matter, the national banking system that the OCC supervises – with institutions that span the spectrum from the very small to the very large. Housing and mortgage lending have traditionally been very important to the state and to the national banking system overall. Thus, they are sectors that have been a key focus of the OCC as well. That's especially true today, given our new responsibilities for the supervision of federal savings associations.

It's been a year and a half now since most of the people and most of the functions of the Office of Thrift Supervision were integrated into the OCC, and one of my highest priorities has been to ensure that this transition goes smoothly. There are a variety of issues to deal with, of course; those of you that have been involved in mergers know how challenging it can be to bring together two organizations with different traditions and cultures. However, we were helped by the close relationships forged over the years through our work on common problems and issues.

I hope that those of you here today who represent thrift institutions have found the process to be relatively seamless – that you are seeing many of the same faces you saw before our agencies joined together, and that there has been ample communication from the OCC. It is important that we make this process work, and we will do everything possible at the OCC to ensure its success.

I'll divide the rest of my 2013 preview into two parts: a quick look at the regulatory and legislative landscape and a somewhat longer look at the risks we see to industry safety and soundness.

On the regulatory front, we will be continuing the process of implementing Dodd-Frank, and I hope that in relatively short order we'll have several more major rules required by that landmark legislation in place. Among them are the Volcker Rule and the risk-retention regulation. We'll also be continuing work on the Basel III capital regulation, which I know is extremely important to many of you.

I suspect some of you are probably thinking that 2013 is beginning to sound a lot like 2012. But we really are nearing the finish line on Volcker and risk retention, and that's because of the very substantial work that was done over the past year. As we look out over the legislative landscape, I think it is likely that Congress will consider a number of technical corrections to Dodd-Frank – and perhaps some corrections that are a bit more substantive than technical – but I doubt that the basic legislative framework will undergo significant change. So the rules we are finishing work on now are not likely to change much as a result of anything Congress might do.

I won't spend any more time today on Volcker or risk retention, but I would like to talk for a few moments about the Basel rulemaking. I recognize that Basel has been a matter of great concern to many of you, especially for the community bankers in this audience, and I want you to know that we are paying very close attention to those concerns. We are reviewing your comment letters closely, and we are especially focused on the provisions that commenters have told us might have an outsized impact on smaller banks and thrifts.

Some of the standards set out in the proposed rulemaking are clearly appropriate for banking institutions of all sizes, and they belong in the rulemaking. For example, I think most of us would agree that we should exclude from regulatory capital those instruments that can't be trusted to be there when they are most needed to absorb losses. Likewise, the idea of restricting bonuses and dividend distributions for institutions that are nearing minimum capital ratios also seems sound.

But other elements are clearly not appropriate for smaller banks and thrifts, and our proposed rulemaking reflects that. For example, the counter-cyclical buffer as proposed applies only to large banks, and, of course, the parts of the proposal related to the advanced approaches don't apply to community institutions either. I can assure you that we are giving very close attention to all of the issues that have been raised in the comment process, and we are doing our best to craft rules that will maintain strong capital standards without unduly increasing burden.

These and other policy initiatives underway are extremely important. Ultimately, they will make the industry stronger and better able to withstand economic shocks. But while the OCC and the other federal regulatory agencies will be spending a good deal of time on policy initiatives, the bulk of our efforts will be directed toward supervision – ensuring that banks and thrifts are safe and sound and able to meet the needs of their customers.

Toward that end, there are a number of significant risks for banks and thrifts that we at the OCC will be focusing on in the months ahead. We've highlighted these risks in our most recent Semiannual Risk Perspective, and if you haven't seen that report, I'd encourage you to visit our Web site at OCC.gov and take a look. In addition to providing some insight into what our examiners will be focused on in the year to come, it will give you a snapshot of major risks your institutions face.

We cite three broad themes in the report. The first has to do with the potential for banks and thrifts to take on inappropriate levels of risk as they search for ways to remain profitable in a difficult economic environment, while the second focuses on challenges to revenue growth, both from the slow

economy and from heightened financial market volatility. The third involves the aftereffects of the housing market bust.

I think most of you know what I'm talking about with respect to the first theme. The tendency for some financial institutions to take on too much risk in the search for profits isn't a new story. It's one we've seen replayed a number of times, in both good times and bad. But this downturn has been especially difficult and long-lived, and the temptation for financial institutions to stretch too far in the search for earnings will be particularly great. So examiners will of necessity pay close attention when they see the institutions we supervise loosen underwriting standards or move into unfamiliar product lines or geographic areas.

Right now, we see slippage in underwriting standards, especially with respect to leveraged lending and commercial and industrial loans. We also see signs that too many institutions are allowing their loan loss reserves to run down, which is particularly troubling in light of the uncertain macro economic environment as well as the direction underwriting of some commercial credit is taking. This is an issue I've discussed before; it's a trend that OCC examiners are monitoring closely.

A related concern is the challenge to revenue growth from a slow economy. One consequence, of course, is lower than desirable loan demand. But we are also very much focused on the impact of continued low interest rates on balance sheets. Low rates, which are generally expected to persist over the near term, will continue to pressure net interest margins as older assets mature or default and are replaced with lower-yielding instruments. At the same time however, there is little if any room for the rates on your deposits and liabilities to go lower to offset declining asset yields. When interest rates begin to rise, funding costs could ramp up faster than in the past, eating into any revenue gains from rising asset yields.

The last broad theme is the one I mentioned at the outset of these remarks – the aftereffects of the housing-driven credit boom and bust. We're starting to see signs of stabilization in the housing

sector, with modest price increases in some markets and a slowdown in foreclosures and defaults. Likewise, we're seeing improvement in commercial real estate, but problem assets remain high by historical standards and CRE portfolios are vulnerable to any new economic stresses. A revitalized housing market will benefit the entire country, but it will be especially welcome in California, given the importance of this sector to the state's economic well-being.

I know this perspective on risks facing the industry sounds a bit daunting, but as we put the financial crisis one more year further into our past, it's important that all of us – supervisors and financial institutions alike – address risks to safety and soundness realistically so that we are well prepared to take advantage of the opportunities that a recovering economy will present. Banks and thrifts have made a great deal of progress, and the improved strength of bank capital, liquidity, and asset quality positions the industry to lead further economic recovery as well as providing an important anchor should market conditions deteriorate.

Thank you.