

Remarks by
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It's a real pleasure to be here, and I want to especially thank Tom Johnson and Joe DeMeo for making it possible. Collectively, you manage the finances of some of the world's largest and most challenging institutions, and I welcome the opportunity to spend a little time with you to offer OCC's perspectives – both on how well the industry has been doing in recent years – and to flag for you some of the issues that we are watching with an eye toward preventing problems in the future.

We can measure the industry's success in different ways. We can measure it in the quantitative terms you – and your regulators – might find it easiest to relate to: earnings numbers, capital levels, asset quality statistics, and the like. The banking industry's recent run of records would be remarkable enough under any circumstances. The fact that these records continued to be compiled through some unpropitious economic times – suggesting that the industry has learned how to insulate its own fortunes in a considerable degree from those of the overall economy – represented a real breakthrough.

Your success was recently captured in a way that the industry's critics might find surprising: the American Banker/Gallup consumer survey, which shows that – despite all the changes in the mix of financial products and the way in which they're delivered -- and despite having a wider range of non-bank financial options than ever before – for the vast

majority of Americans, banks remain their most trusted provider of financial services. This confidence and trust is a priceless asset, but, as I'll discuss later, it is being placed under stress by reputation risks created by certain account management and marketing practices for retail bank products.

Your success is measured in the extraordinary optimism with which the industry's senior leadership – people like yourselves – regards the future. According to another recent survey, financial services executives anticipate continued growth and continued record earnings, and they expressed confidence in their ability to manage the acknowledged risks and challenges that lie in wait – serious challenges that include rising interest rates and liquidity pressures, increased competition for top talent, and technological vulnerabilities.

You would think that with this solid foundation and these positive prospects, one could feel a certain sense of safety and relief. But I don't. Right now, when signs are so promising, is just when we all need most to guard against complacency. Our job at the OCC is not just to cope with the issues at hand, but also to identify trends and developments that could turn into problems, and to address them at a stage when they are manageable.

So, while the indicators I've mentioned tell a good story, they don't necessarily tell the whole story. For deeper insights, we learn from our comprehensive supervision of the national banking system – our nationwide network of highly skilled national bank examiners and our risk monitoring and evaluation systems. These sources point to several areas that we are watching carefully, and that are worthy of bankers' close attention.

For example, in our recent Survey of Underwriting Practices we flagged a decline in lending standards. For the first time in five years, OCC examiners-in-charge at 72 of the largest national banks reported that more banks loosened than tightened credit standards. The difference was small. But the change in direction was marked – and significant. The shift was particularly notable in two commercial products – structured finance and syndicated loans. In 2004, examiners reported that 15 percent of the banks eased credit underwriting standards and no banks tightened underwriting for structured finance, compared with no banks easing and 96 percent tightening four years ago. Examiners also reported a return to net easing for middle market and asset-based loans. While tightening was slightly more prevalent than easing for the other commercial loan products, the percent of banks reported to have tightened in 2004 was much lower than in 2003. With loan demand still relatively sluggish, we’ve seen a trend toward intensified competition and looser terms, including lower prices, longer maturities, larger credit lines, and adjusted covenants.

So far the deals our examiners are seeing lie well within the bounds of sound lending, and advancements in credit risk management have given banks better tools to differentiate risk and understand the implications of shifts in underwriting standards. But it’s striking how rapidly the industry’s appetite for risk has rebounded, and, as a leading indicator of systemic risk, the OCC’s Underwriting Survey ought to raise some caution flags for industry decision-makers.

Another source of incipient concern centers on the composition of bank loan portfolios. Over the past two decades, banks have steadily increased their concentration of commercial real estate loans, to the point that such loans today constitute the single

largest component of bank portfolios. For more than half of the OCC's largest banks, commercial real estate loans account for more than 100 percent of Tier 1 capital.

Fortunately these loans have been performing well. Non-accruals have been modest – under 100 basis points – and losses even lower over the past five years. Improved underwriting, better MIS, deeper market liquidity, and the low interest rate environment have all played a part in these results.

But we do see some warning signs, and bankers should be aware of them, too. We're concerned that the risk management capabilities of some banks may not be improving as rapidly as their loan concentrations have been increasing, and that weakness in certain real estate markets and property types are not being properly recognized and adjusted for. Our examiners also have noted some relaxation of compliance with guidelines that require strict separation between loan production and appraisal functions and, similarly, too many exceptions to established loan-to-value limitation policies. At the very least, exceptions should be carefully monitored. And while banks are faithfully performing routine stress testing, looking at shifting interest rate scenarios, we believe they should be looking at other key variables, such as vacancy rates, property cash flows, property values, and so forth – variables that can dramatically alter the performance of commercial real estate loans.

No one – least of all the OCC -- thinks we're in for a repeat of the late 1980s and early '90s, when the collapse of the commercial real estate market almost brought the commercial banking system down with it. But the industry did not get to its present point of strength and credibility by relaxing its guard and returning to the practices of the past. None of us can afford to forget the lessons of those years.

We've also discovered that in some cases, banks' risk appetites are not matched by corresponding enhancements to their internal control capabilities. That may be the result of a decade of attrition and cutbacks – all in the interests of improving bank efficiency ratios – in such functions as internal audit and credit review, credit administration, and appraisal review. For those banks that have fallen behind, it's time that those capabilities are rebuilt – not only so that they can take safe advantage of the new lending opportunities likely to be presented by an expanding economy, and prepare for the risk they entail, but also, in the case of larger banks, to ensure that they are equal to the demands of the new Basel II capital regime, with its emphasis on accurate and timely internal credit ratings.

Another area that we are watching carefully is the growth of various retail product lines. The banking industry's increased reliance on retail lending has been one of the most notable developments over the past decade – and a major factor in its ability to continue to post record returns through tough economic times. Growth has been especially strong in residential real estate loan products – both in first mortgage and home equity lending.

The growth of home equity lending, particularly home equity lines of credit (HELOCs) has been extraordinary during the past few years. Rising home values, low interest rates, and tax advantages have made home equity lending an attractive borrowing option for consumers. Today, delinquency and loss rates for home equity loans and HELOCs are low, but we have concerns that the rapid growth, historically low interest rates, and changes in the structure of home equity products could mask embedded credit risk in these portfolios.

Structural and operational changes in home equity lending can change the risk dimensions of these products. Use of interest-only features that require no amortization of principal for a protracted period of time; limited or no documentation of a borrower's assets, employment or income; higher loan-to-value (LTV) and debt-to-income, and lower credit risk score underwriting benchmarks; automated valuation models instead of appraisal reports; and increased loan sourcing through third party brokers and correspondents, all introduce risk factors of a type and to an extent not heretofore seen. And these developments call for risk management practices that match the changing risk profile of banks' home equity portfolios.

That's why it's so important that bankers take steps now to assess their lending practices relating to residential real estate lending. A recent OCC targeted review of home equity lending activities pointed to a variety of soft spots, including individual and portfolio account management problems and high loan to value issues. What stood out most of all was the increased willingness of lenders to disregard or minimize the analysis of borrowers' ability to repay these loans, and to rely instead on risk factor shortcuts, such as credit scores – which reflect a borrower's historical financial performance but not necessarily his or her ability to handle a material increase in their level of debt.

For these reasons, we have urged bank management to regularly assess the vulnerability of their bank's portfolio to changes in consumers' ability to pay and potential declines in home values. And we have stressed that active portfolio management is especially important for lenders who have experienced or project significant growth, particularly in higher risk products such as higher LTV loans, limited or "no doc" loans, prolonged interest-only repayment products, and loans generated

through third parties. The OCC is watching this area carefully, and we expect to issue guidance on our expectations for home equity lending credit risk management in the future.

Another emerging type of risk for bankers is reputation risk. As a number of companies can now attest, reputation risk can be particularly damaging and expensive, and controlling reputation risk is challenging because it can come from many different sources.

Compliance with the Bank Secrecy Act and anti-money laundering laws is a good example. Without question, banks are now and have been leaders among financial institutions in BSA and anti-money laundering compliance. But in the post- 9/11 world, the stakes, the challenges – and the expectations – are higher. Successfully managing BSA-related reputation and compliance risk in the current environment requires a commitment starting with senior management and the board of directors, extending throughout all levels of the organization. And it requires constant vigilance. For example, it is important that banks periodically take a fresh look at the risks posed by their customers, products and services, assess the adequacy of the bank's systems and controls to identify and manage those risks, and enhance them where appropriate to match the risks presented by their business. Failure to do so can have embarrassing and costly results – financially and legally.

On the retail side, the credit card business presents several dimensions of reputation risk. The industry's evolution has made credit conveniently accessible to millions of consumers – and brought it huge profits. But recently that evolution has included some credit underwriting and marketing practices that brought damaging

notoriety, and generated calls for corrective legislation. I worry that unless these practices are corrected, the credit card industry may wake up one day and find that the goose that's been laying golden eggs has been legislated out of existence.

Many of the practices at issue have both consumer protection and safety and soundness implications, and the OCC has been active in addressing both. For example, we spearheaded the development of account management guidance for credit card issuers, which was issued on an interagency basis in 2003.

This guidance included regulatory expectations for credit line management, workout and forbearance practices, adequate loss allowances for uncollectible interest and fees, control of chronic overlimit accounts, elimination of negative amortization, and minimum payments sufficient to demonstrate the customer's ability to repay the outstanding balance over a reasonable period. National bank credit card issuers came into compliance with most parts of the guidance shortly after it was issued and a significant success of the guidance is the expectation that workout programs be designed to maximize principal reduction. The explicit standard that workout programs should have borrowers repay credit card debt within 60 months has benefited both consumers and lenders.

In three interrelated areas, compliance with the guidance has been occurring on a phased-in basis, an approach dictated by the scope of systems changes needed and the importance of minimizing disruption to customers. These areas are the control of chronic overlimit accounts, elimination of negative amortization, and adjustment of the required minimum payment so that the payment prevents negative amortization, repays balances, and, importantly, demonstrates the ability to repay the outstanding balance over a

reasonable time horizon. Despite the complexity of these issues, significant progress has been achieved, and we expect national bank credit card issuers to fully achieve these goals over a short term. Cumulatively, these changes provide real benefits for customers and to the soundness of national banks' credit card business.

In addition, just this past September, the OCC also issued guidance regarding certain credit card marketing practices. The guidance focused on three specific practices we identified as emerging risks. The first involves what is sometimes called “repricing,” i.e., changing the terms of a customer’s credit. Our concern here is that consumers are being caught by surprise by unexpected rate increases that are triggered by something other than the payment performance on their account, and by unilateral changes in terms.

Our position is that changes in terms generally are acceptable – and legal – ways to manage credit risk. Where a customer’s risk profile increases, it is reasonable for a lender to avail itself of flexibility it has under the credit card agreement to “reprice” to take into account the customer’s increased risk. But changes in terms should not come as a surprise to consumers. When changes in terms can be triggered by various factors, or changed unilaterally in some cases, those possibilities need to be effectively disclosed to consumers. That’s why our guidance stresses that national banks should disclose – fully and prominently – the circumstances under which changes in terms may occur.

Our September advisory also addressed issues we’ve seen with the marketing of teaser-rate balance transfer programs. Our concerns here involve failure to fully and prominently disclose any material limitations on the promotional rate – for example, that it applies only to transferred balances, and that payments will be applied first to pay off the transferred balances that are accruing interest at the low APR.

And the advisory addressed the marketing of programs with maximum credit limits that aren't really available. Problems we've identified here include using a "default" or minimum credit limit that is substantially lower than the "up-to" rate that was advertised; charging fees that substantially reduce the initial credit availability; and making it hard for consumers to cancel their cards without cost if they feel they've been misled about the credit line or other terms.

We are in the process of reviewing the account agreements and disclosures of the largest national bank credit card issuers to see how well they address the issues flagged in the advisory. This is yet another area where prompt, constructive action now, can prevent today's issues from escalating into tomorrow's reputational and financial damage. We will be following up where we conclude that banks need to make changes.

Having said all this, and after having run through this litany of concerns and potential trouble spots, let me stress that it's important that we keep the concerns I've mentioned in context, and in proportion to developments in the industry as a whole.

The fact is that today's banking industry is in excellent health, and its future prospects are as bright as I believe they've ever been. On the whole, consumers are well and conscientiously served, and they have available a greater array of products, which they may obtain more conveniently, than ever before. The challenge is to sustain what has been working well, and address today's issues before they become tomorrow's problems.

At the OCC, we believe an important part of our job is to identify emerging risks and to assess where future problems may arise. We have expert staff and unique perspectives on the banking system that enable us to do this. And, no matter how

prosperous the industry may be, we can't afford to get complacent. We have, and we will, sound the alert when we identify trends that require industry attention, so that banks – and the OCC – can take appropriate measures to address those issues early and effectively. I'm sure you would agree that it is much better to prevent a problem, than it is to have to fix one.

I hope my remarks today have facilitated that goal.