Remarks by
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Thank you, Barbara. I'm very pleased to be here and to have this early opportunity to address all of you – the OCC's credit experts. I really enjoyed meeting many of you last night, and I want to thank you for making me feel so welcome. I have to say, the OCC certainly knows how to give a reception! I continue to be struck by the real warmth and camaraderie I've felt at each of the OCC events I've attended over the past three months.

I also have to say that, in my three months here, I've been very impressed with the uniformly high caliber of OCC staff and the clear commitment throughout the agency to our safety and soundness mission. And of course, nothing has more of an impact on safety and soundness than credit – it's at the very core of banking and commands the majority of the OCC's resources. As a result, your expertise in exercising critical judgments on a daily basis is vital to our mission and our reputation, which I believe is second to none.

Despite all the changes in banking over the last 20 years, I hear examiners say that banking is still about blocking and tackling, and I couldn't agree more. The banks that achieve the greatest success are those that excel at the fundamentals. They take care of their customers; they keep a tight rein on expenses; and they set high standards of ethical conduct and accountability. And, in keeping to the basics, they're good lenders: they price for risk; they favor performance over the long haul as opposed to quick income; and they refuse to be stampeded by the latest fads in the marketplace.

That puts a huge premium on the work you do, because your job is to keep national bank lenders on their toes and pull them back when they're headed for trouble. That's especially true when, like today, we're at the top of the credit cycle and banks naturally gravitate towards more risk. So when I tell you what a great pleasure it is to be here with you today, to hear from you, and to learn more about what you do, I mean it.

In one sense, though, this is a bittersweet moment for me and for the OCC. This conference marks something of a send-off for Barbara Grunkemeyer. Barbara has had a remarkable record as Deputy Comptroller for Credit Risk and has made an invaluable contribution to the OCC's supervisory effort. She has represented this agency with great distinction and is deeply respected by her peers, not only at the OCC, but at all of the banking agencies. Her expertise was obvious to me from the very first time I sat in on one of her briefings. I will very much miss her wise and thoughtful counsel, and I wish her the very best in the years to come.

As I said, this conference is certainly timely. Although the national banking system is fundamentally healthy, credit risk is on the rise. It has jumped several places over the last year on our National Risk Committee's radar screen. And the OCC's 2005 Underwriting Survey reported net easing of retail underwriting standards for the first time in 11 years, signifying real changes that are clearly underway. So I would like to take this time to talk to you about the sources of rising credit risk, how we're trying to address them from a policy standpoint, and what the changes in the credit risk environment mean to those of you who work in that environment every day.

There's no question about the fundamental strength of the national banking system. Most of the key indicators are pointing up – asset quality, liquidity, and earnings. And after taking a slight dip last year, capital has resumed its climb to historic highs – and I want to emphasize that, as we go forward with the new Basel capital framework, there will be no erosion of this essential bedrock of a safe and sound national banking system.

But it's at the top of the credit cycle where stresses and weaknesses typically appear, so what we are seeing today should not surprise anyone. With liquidity pouring into the market, we would expect to see increased competition for loan customers – and we are. With competition intensifying, we would expect to see underwriting standards easing – and we are. And we would expect to find emerging concentrations in some loan categories, such as commercial and residential real estate. We are most definitely seeing that.

One of the striking findings in our 2005 underwriting survey was the breadth and extent to which banks had relaxed their lending standards. The easing reported by examiners applied to all commercial products except agricultural loans. Among retail products, only credit cards and other direct consumer loans, such as auto or personal loans, exhibited net tightening.

But while the trend toward increased credit risk is visible across the portfolio and across the country, it really stands out in two product areas. The first is commercial real estate; the second, residential first mortgages.

These are both issues that cut across all areas of the country. Commercial real estate concentrations are everywhere: in large cities and small, on the coasts and in the heartland. Over the past decade, commercial real estate holdings have become an increasing share of total assets, so that about a third of national banks today have commercial real estate holdings equal to 300 percent or more of Tier I capital.

Such concentrations by themselves would warrant supervisory concern under almost any circumstances. But, in order to attract new business and sustain loan volume, banks have also made many compromises and concessions to borrowers along the way, resulting in commercial real estate credits with structural weaknesses that go beyond discounted pricing. It should concern us when we see policies governing such things as loan-to-value standards and debt service coverage being relaxed -- and then an increasing number of exceptions to those more accommodating policies. We should also take notice when we see lenders routinely adjusting covenants, lengthening maturities, and reducing collateral requirements. These signs of lender laxity concern us just as much as the commercial real estate concentrations themselves.

By the end of this year, we expect to issue interagency guidance on commercial real estate that will focus on the need for improved risk management practices for banks with large concentrations. It will clarify supervisory expectations, and emphasize that, when concentrations and more complex transactions exist, banks should take a more pro-active, hands-on approach to their management. A bank with significant concentrations may need to both strengthen its control environment and build capital well above regulatory minimums.

In the meantime, examiners should continue to work at what I know you are doing already with great skill – that is, carefully monitoring banks where these concentrations could become, or already are, significant. One of our primary goals is to ensure that no banker wakes up to discover that there is more commercial real estate credit on its books – or any other asset, for that matter – than the bank can safely handle. Our job is to help prevent such portfolio imbalances by bringing them to the attention of bankers as they develop, and to make certain that, once in place, concentrations receive the appropriate degree of management oversight.

Specifically, examiners should look for an effective control environment in which the bank's policies are consistent with its strategic goals and risk appetite. You should determine that its compensation policies give loan officers appropriate incentives to make high quality loans. You should look for robust information systems that flag material changes in the portfolio and exceptions to policies, and verify that information flows into the hands of responsible officials in a timely way. And finally, you should ensure that lenders maintain a healthy dose of skepticism. Borrowers and portfolios will not always perform as expected. Exercises such as stress testing help identify vulnerabilities before risk levels get out of control. My point here is to emphasize and reaffirm the fundamentals regarding commercial real estate credit, both now and after the interagency guidance is issued.

Let me turn now to an equally important subject: the rapidly changing market for residential mortgages. It seems like only yesterday when a 5/1 ARM was considered a risky mortgage product. And it was – but primarily for borrowers, who, in return for lower initial payments, assumed the interest rate risk that had previously been borne by lenders.

Today's non-traditional mortgage products – interest-only, payment option ARMs, no doc and low-doc, and piggyback mortgages, to name the most prominent examples – are a different species of product, with novel and potentially risky features. I don't have to explain those features to you, because these products have come to dominate the mortgage originations that many of you look at every day.

This dominance is increasingly reflected in the numbers. By some estimates, interest-only products constituted approximately 50 percent of all mortgage originations last year. In the first half of 2005, IOs started to decline in favor of payment-option ARMs, which, according to one source, comprised half of new mortgage originations. And roughly every other mortgage these days is also a "piggyback" or reduced documentation mortgage, which points to another development that concerns us: the trend toward "layering" of multiple risks. There is no doubt that when several risky features are combined in a single loan, the total risk is greater than the sum of the parts.

We can readily understand why these new products have become fixtures in the marketplace in such a short time. One reason is that they have helped sustain loan volume that would otherwise almost certainly be falling, because rising interest rates have brought an end to the refinance boom. More important, lenders have scrambled to find ways to make expensive houses more affordable – although there's now a concern that the very availability of this new type of financing has done its share to help drive up house prices, which in turn stimulates demand for even more non-traditional financing.

Defenders of interest-only ARMs will tell you that they are not much riskier than fixed-rate loans. After all, traditional 30-year mortgages are typically refinanced or prepaid within 7 years, and payments in these early years go almost entirely to interest. And a case can be made that, by giving purchasers a bit more financial flexibility, these loans reflect the realities of demographics and rising house prices. These defenders have a point. On the other hand, the potential "payment shock" of an interest-only loan is greater than it is for a traditional ARM, which raises concerns when IOs are mass marketed, especially to subprime borrowers.

And then there are payment-option ARMs, which take us to another level of risk. They, too, have their defenders, of course, who argue that such mortgages are little more than the combination of a traditional ARM and a home equity line of credit in a single loan. And, borrowers can easily treat payment-option ARMs in the same manner as a traditional mortgage, simply by selecting the fully amortizing option rather than the minimum payment option each month.

In practice, however, few borrowers treat them that way. Recent studies show that a significant number of borrowers are frequently choosing to pay the minimum amount possible, a payment amount that typically falls short of the interest accruing on the loan. Even more disturbing, this choice does not seem limited to high quality, affluent borrowers who may be using the product as a payment flexibility tool. The research indicates that borrowers at both ends of the FICO spectrum make this choice, with riskier borrowers resorting to it most frequently. Because such minimum payments fall considerably short of the total interest accruing each month, the unpaid interest is added to the loan principal, and negative amortization occurs. Thus, it should come as no surprise that, of the least creditworthy holders of payment-option ARMs, nearly 50 percent have current balances above their original loan amount.

Depending on how much negative amortization the borrower opts to incur – and, increasingly, borrowers are incurring as much as their lenders allow – payment-option loans expose borrowers to substantially increased levels of payment shock. For example, take a typical payment option ARM at the conforming loan limit of approximately $360,000, with an initial interest rate of 6 percent**.** If the borrower makes only the minimum payment each month for the first five years – initially $1200 -- the payment shock when the loan begins scheduled amortization will be substantial, even if interest rates remain level. In this example, the minimum payment increases incrementally during the first five years to roughly $1600, and then jumps over <u>50 percent</u> – to $2500 -- when the amortization period starts at the beginning of the sixth year. And that assumes no change in interest rates. If interest rates should increase just two hundred basis points to 8 percent – which is certainly not unreasonable to expect – then the monthly payment would nearly <u>double</u> on the reset date to $3,166. By any measure, <u>that</u> is real payment shock. Of course, the borrower might be able to refinance, but what if interest rates have increased substantially, or house prices have dropped below the value of the loan? That would put the borrower in a far more difficult position.

Some have suggested that payment option ARMs are inherently unsafe and unsound, and that regulators should banish them from reputable banking practice. I would characterize them differently, in this way: They have a legitimate use in the right hands, but they need to be handled with extreme care. They require meticulous underwriting, including a credible analysis of a borrower's payment capacity beyond the period during which minimum payments are artificially reduced. On a portfolio basis, banks must have systems in place to monitor changes in borrower performance and collateral trends for early signs of deterioration. And, given the risks they entail, it is especially important that the bank satisfy both the letter and the spirit of all applicable disclosure requirements. Such disclosures should clearly and reasonably describe the significant potential consequences of the particular product, which in this case would mean the potential payment shock.

You have probably heard about our interagency mortgage guidance project. It began this summer with a survey that targeted payment-option, interest-only, low doc, and piggyback products. This survey, involving six large financial institutions responsible for 40 percent of all 2004 originations, asked bankers to comment on the evolution of underwriting criteria, as well as methodologies used to manage the risk of these products. It also asked for samples of disclosure documents and for copies of reports used by senior management to evaluate loan quality and profitability.

The survey generated the basic data for our interagency discussions to develop guidance relating to these products. This guidance will focus on underwriting standards, appropriate disclosure, and portfolio management concerns. Our current goal is to ready the guidance for release by year's end, although serious interagency discussions about the initial draft have only just begun.

So the question again arises: what should examiners be doing <u>now</u>, before the formal guidance arrives? First, find out if your bank is originating these non-traditional mortgages, and, if so, whether they intend to hold them in their portfolios. If the banks engage in these products, evaluate the quality of loan underwriting, noting any weaknesses and deficiencies in the documentation and decision-making. Look at the quality of the disclosures provided to ensure consumers understand what they have taken on – and that they are receiving loans appropriate to their financial needs and capacities. Be especially sensitive to the problem of "layered" risk that I mentioned earlier. And look at the bank's overall exposure in real estate lending. If you determine that unhealthy concentrations exist, in residential or commercial real estate, take the appropriate steps to ensure that management oversight is adequate to the task.

I know you will carry out your responsibilities with balance, discretion, and good judgment. These are values the OCC has always stood for, and the values that make all of us proud to be part of this great agency.

Let me close by saying that, thanks in part to opportunities like this one, I've been able to talk to a fair number of our people during the nearly three months I've been Comptroller. One of the things I hear most frequently is that the job provides a chance to work closely with bankers to help them identify and solve problems. I hear about the intellectual excitement of helping banks through challenging times. I hear, in short, about how much our people appreciate the opportunity to make a real difference in the national banks we supervise. I want to emphasize to you how pleased I am to be part of that effort.

Now, as we approach 11:30 and stomachs start rumbling, it's obviously time for me to stop and take questions. Thank you very much.