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**TESTIMONY OF  
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BEFORE THE  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
MARCH 4, 2008**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

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### **I. Introduction**

Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to be here today to testify on the condition of the banking system. As you know, the Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks. At the end of 2007, there were 1709 banks in the national banking system, with total assets of \$7.8 trillion; that is about one of every five banks in the United States, with 70 percent of all commercial banking assets. These include the country's largest, most complex banks, as well as many community banks, since almost 90 percent of national banks have less than \$1 billion in assets.

In general, due to a long period of strong economic growth, exceptionally low credit losses, and strong capital ratios, the national banking system has been healthy and vibrant. Indeed, one simple measure of this fact is that we just went through the longest period in the 145-year history of the OCC without a single national bank failing: nearly four years.

Now, however, the system is being tested. Two powerful and related forces are exerting real stress on banks of all sizes and in many different parts of the country. One is the large and unprecedented series of credit market disruptions, still unfolding, that was precipitated by declining house prices and severe problems with subprime mortgages. The other is the slowdown in the economy, which has begun to generate a noticeable decline in credit quality in a number of asset classes. The combination of these forces has strained the resources of many of the national banks we regulate.

Despite these strains, the banking system remains fundamentally sound, in part because it entered this period of stress in such strong condition. Thus far national banks have been able to address a number of significant problems that have arisen while continuing to supply credit and other banking services to the U.S. economy – although there is no doubt that credit standards have tightened. For example, large banks provided liquidity support to asset-backed commercial paper conduits and structured investment vehicles or SIVs – often involving the painful recognition of losses – to restore more normal funding in these markets. Likewise, banks with concentrated positions in collateralized debt obligations backed by subprime asset-backed securities have recognized large losses – but have also raised large amounts of capital to offset these and other losses. And a large national bank holding company entered into an agreement to

purchase the nation's largest mortgage originator, which had been under severe funding stress, and that action had a calming effect on the market.

Despite such efforts, however, significant market disruption issues remain to be addressed, such as the potential downgrades of monoline insurance companies; significant funding problems in the auction rate securities market; and severe constriction in the securitization markets for residential mortgage-backed securities, commercial mortgage-backed securities, and leveraged loans.

Likewise, the economic slowdown and problems in the housing market have caused banks to increase loan loss reserves significantly for such assets as residential construction and development loans; home equity loans; and credit card loans. Indeed, smaller banks that have exceptionally large concentrations in commercial real estate loans – and there are many of them – face real challenges in those parts of the country where real estate markets have slowed significantly. Unlike the unprecedented market disruptions of the last six months, these more traditional credit problems are familiar territory to bankers and supervisors. The key to addressing them is for bankers to recognize problems early and manage through them, and that is exactly what our examiners are working with them to do.

The body of my testimony today describes the current condition of the banking system using some of the traditional measures of condition such as profitability and capital. Because of the influence of a variety of complex forces that have been at work in the domestic and global financial systems over the last few years, I will take some time to describe those forces, to help put the current condition in context. However, a discussion of conditions should not focus solely on where we are, but also on where we are heading.

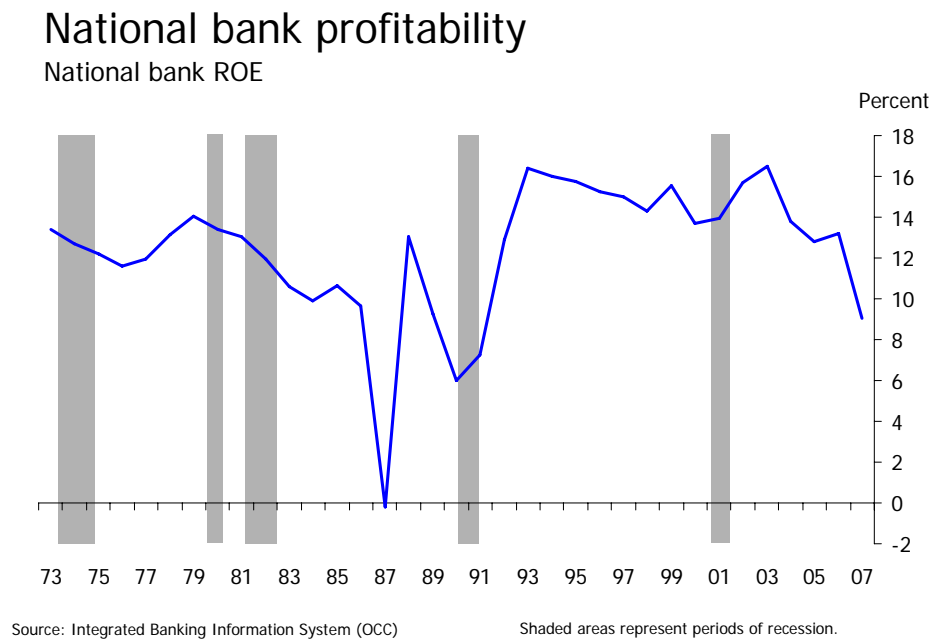
The banking system and its regulators face a number of significant challenges over the near term. The testimony therefore describes several of the more important of those challenges, and concludes with a discussion of how we see banks responding and how we, in turn, are responding.

Finally, your letter of invitation also asked us to describe our current efforts to address foreclosure prevention and mitigation efforts. This is a very important issue for the OCC since the largest national banks that we supervise act as servicers for about 40 percent of all mortgages issued in the United States, including a significant number of subprime mortgages. As the body of my testimony describes in more detail, the OCC has taken a number of steps to encourage national bank lenders and servicers to work constructively with borrowers to avoid foreclosure except when absolutely necessary. We have joined the other banking agencies in issuing guidance to that effect; we have strongly supported the efforts of the HOPE NOW alliance; and we have supported an amendment to the Community Reinvestment Act regulations that would provide CRA credit for foreclosure prevention activities in distressed middle-income neighborhoods. We also announced last week a significant new effort regarding the reporting of key data on mortgages, including mortgage modifications and restructurings: we are requiring our largest national bank servicers to provide standardized reports on a range of mortgage metrics, not just for subprime adjustable rate mortgages, but for *all* mortgages. These data, which are consistent with the HOPE NOW metrics, will provide an important way to track mortgage performance against a broad range of indicators.

## II. Condition of the National Banking System

### A. A Period of Strength and Growth

Until very recently, favorable economic conditions helped banks generate solid profits and consistent growth. The U.S. economy was performing well, the global economy was growing as fast as it had since the end of World War II, inflation remained under control, and liquidity was abundant. Between 1993 and 2007, annual return on equity for the national banking system averaged over 14 percent. To put that performance in perspective, the average for the twenty preceding years (1973 to 1992) was around 11 percent, with annual return on equity reaching 14 percent in only one of those earlier years.

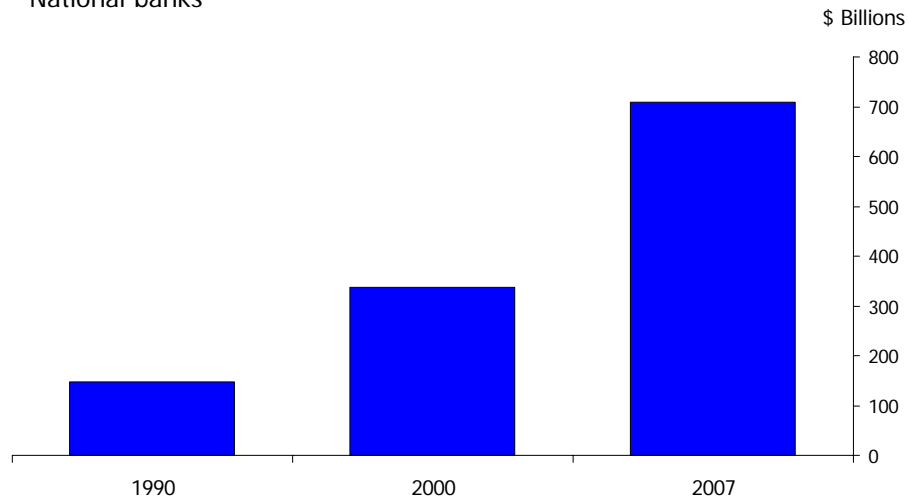


Other measures showed the same favorable trends. Total assets in the national banking system have risen steadily for more than two decades, even as the number of banks has declined. And total capital has more than tripled over the last seventeen years,

to roughly \$700 billion, making the national banking system better-positioned to absorb shocks and losses. With the exception of a handful of relatively small banks, all national banks currently meet the regulatory definition of “well capitalized.”

## Total risk-based capital

National banks

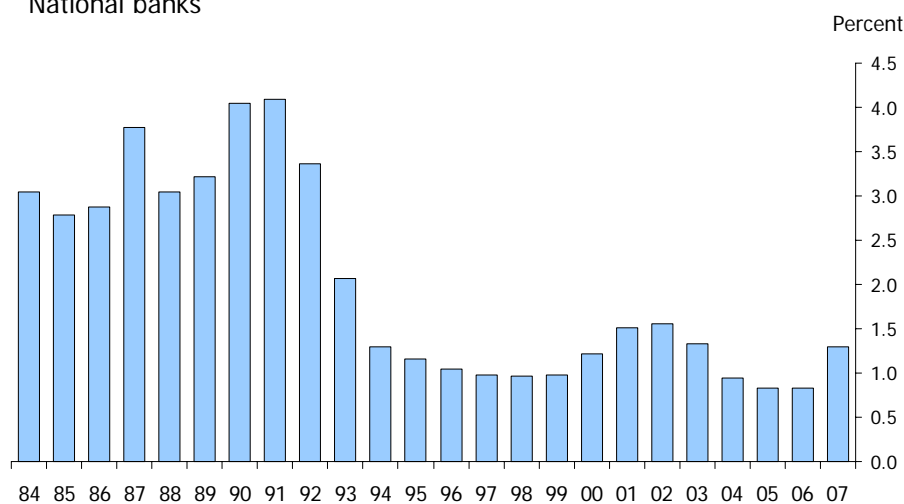


Source: Integrated Banking Information System (OCC)

An exceptionally benign credit environment in recent years also contributed significantly to earnings. Problem loans in the national banking system fell for a decade, reaching historic lows, as illustrated in the accompanying chart. Although the share of noncurrent loans – the percentage of bank loans that were 90 days or more past due and on nonaccrual – has risen recently, it remains very low by historical standards. The low level of problem loans held down credit losses for national banks and contributed importantly to their earnings.

## Noncurrent loan rate

National banks



Source: Integrated Banking Information System (OCC)

### *B. The Changing Financial Sector*

While favorable economic trends helped produce a sound and healthy banking system, their influence on elements of the broader financial sector also helped set the stage for problems to follow. The combination of steady growth, abundant liquidity, and minimal losses led to relatively low yields on safe assets, and reduced the spreads on riskier assets as investor demand for new products that could deliver higher returns far outstripped supply. Increasingly, investors accepted greater risk in pursuit of their earnings goals. Hedge funds and private equity funds became more prominent during this period, expanding the range of activities and risk-taking in financial markets.

Concurrent with these developments, and to some degree fostered by them, the U.S. and many other countries experienced rapid home price appreciation. Liquidity provided by investors searching for high-yielding financial instruments helped support



expanded use of various non-traditional mortgages. The securitization market helped facilitate strong mortgage loan growth, as nonconforming loans, including jumbo and subprime mortgages, came to account for an ever larger share of the market, with private issuers claiming more than half of the mortgage securitization market. Many of these same factors helped extend the market for U.S. assets to overseas investors.

These factors clearly affected the operations of national banks. Sustained economic expansion, particularly strength in housing, contributed to an acceleration of asset growth and to growth in bank earnings. Bank holdings of first mortgage, home equity, and construction loans all rose significantly. Other categories of lending also grew more rapidly to support business activity associated with the housing industry.

The impact of these developments varied across different segments of the banking industry. Larger banks had the capacity and supporting technologies for packaging pools of residential loans into mortgage-backed securities for sale to the investment community, and for managing the interest-rate risk of holding longer-term assets. As a result, residential mortgage loans at national banks with assets over \$10 billion grew rapidly, reaching 36 percent of total loans by December 31, 2007, up from 22 percent in late 2000. Larger banks also experienced strong gains in noninterest income from residential mortgage securitization and servicing.

In contrast, residential mortgage lending declined as a share of loans at smaller banks. Smaller banks found it more and more difficult to compete with their larger counterparts in residential lending, and shifted toward lending for construction and commercial real estate. This was especially true in areas with vibrant housing markets, where home building was a key part of the regional economy. Construction and

commercial real estate lending puts more of a premium on knowledge of individual borrowers and local market conditions; this tends to be a strong suit of smaller institutions. In addition, many large and small banks significantly increased their home equity loan portfolios, as consumers took advantage of home price appreciation to finance property improvements, purchase big-ticket durable goods, and pay down other forms of debt.

But banks also faced greater competition in lending, especially for home mortgages, as less risk-averse and less regulated players moved into residential lending. Increased competition and abundant liquidity kept pressure on risk spreads, squeezing banks' net interest margins to historic lows in 2007. These pressures led to loosened underwriting standards, as loan growth became ever more critical to earnings. This slippage in lending standards, while making credit much more widely available, ultimately resulted in over-leveraged borrowers, particularly in the area of subprime residential mortgages. When borrowers were unable or unwilling to perform, this led to substantial losses for lenders and investors and turmoil in the markets.

By 2005, as interest rates rose and affordability deteriorated, the housing sector began to show signs of weakness. Home price appreciation slowed, causing some speculative investors to sell, which put further pressure on home prices. By 2006, national average home prices had leveled off. Home building and sales, however, remained at very high levels through the first part of 2007. During this period, subprime mortgages, mostly originated by nonbanks, were a very important share of the total market. Many subprime mortgages were bundled into residential mortgage-backed securities (RMBS), and many of these RMBS were then repackaged into collateralized

debt obligations (CDOs). Both subprime RMBS and CDOs backed by subprime RMBS were sold to a broad range of investors.

### *C. Recent Turmoil*

In 2007, national median home prices fell for the first time in many decades. Many homeowners found themselves overextended, and foreclosures jumped to record levels. The effects were most pronounced and immediate in the subprime market, and resulted in numerous nonbank lenders being sold or forced out of business. The rapid expansion of the housing market had attracted new mortgage lenders and brokers, many of whom had only limited business experience or financial strength and operated with little regulatory oversight. Nonbanks were particularly active in subprime lending; indeed, national banks and their subsidiaries originated only about 10 percent of all subprime mortgages in 2006 (when underwriting standards were weakest).<sup>1</sup> Nonbanks expanded their market share in part by extending credit on considerably less stringent terms. They also popularized more risky types of mortgage instruments, which had the effect of expanding the pool of qualifying home buyers, but also reflected an abandonment of more traditional underwriting criteria. Loans originated by national banks tended to be more conservatively underwritten and structured, and their delinquency rates tend to be well below the national average.

Nonetheless, banks have not been immune to housing market forces. The impact of falling home prices and struggling borrowers has been evident in deterioration in the

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<sup>1</sup> Although national banks were not dominant originators at the height of the subprime mortgage market, some continue to serve this segment of borrowers; with the exodus of many nonbank lenders and overall contraction of this market segment, it is likely that national banks' share of subprime mortgage originations is increasing.

residential real estate loans on the books of national banks. Noncurrent loan ratios increased in 2007 for each of the major categories of housing-related loans: one-to-four family residential mortgages, multifamily residential mortgages, and home equity loans.<sup>2</sup> National bank losses on home equity loans, for example, were more than three times higher in 2007 versus 2006, with most of it recognized in the fourth quarter; we expect bank losses from home equity loans to continue to escalate as, unlike first mortgages, these assets are predominantly held on banks' balance sheets.

States that saw a boom in home prices followed by a sudden slowdown have seen more rapid deterioration in loan quality, reflecting, perhaps, the significant role that speculators played in these markets. Among community banks supervised by the OCC, the noncurrent loan ratio for banks in the "boom-bust" states more than doubled to 1.4 percent last year, compared to 1.3 percent in economically stressed Midwest states, and 1.0 percent in the rest of the U.S.<sup>3</sup> The deterioration is now spreading to other nonresidential loan products like credit cards and auto loans.

The impact of these events in housing markets was rapidly transmitted to broader financial markets because many of the subprime mortgage loans have been securitized into the secondary market. Revelations about losses on subprime-related securities jolted investors during the second half of 2007. Several large financial institutions, including some with considerable experience in complex instruments, began reporting losses on CDOs and other securities backed by subprime mortgages, at the same time that more

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<sup>2</sup> Noncurrent loan ratios increased by 83 basis points to 2.07 percent for one-to-four family; by 37 basis points to 1.03 percent for multifamily; and by 39 basis points to 0.80 percent for home equity loans. Noncurrent loans include those 90 days past due or on nonaccrual; ratios are stated as a percent of the dollar value of loans in each respective loan category.

<sup>3</sup> Data are for national banks with assets less than \$1 billion, excluding credit card and trust banks. "Boom-bust states" for this purpose are Arizona, California, Nevada, Florida, the District of Columbia, Maryland, and Virginia; "economically stressed" Midwest states for this purpose are Illinois, Indiana, Michigan, Minnesota, North Dakota, Ohio, South Dakota, and Wisconsin.

analysts were projecting sharp increases in mortgage defaults. Subprime-related losses have appeared in places market participants did not anticipate, including at foreign financial institutions. Lack of transparency has made it difficult to distinguish differences in risk among mortgage-related securities, and illiquid markets for many of these securities have made valuation difficult. Credit derivatives included in these products add leverage and amplify the risks.

One notable and unusual development has been the speed and extent of the fall in credit ratings for some previously highly rated subprime-linked securities. These declines have no precedent in recent history. For example, prior to 2007 no Aaa-rated corporate bond had been downgraded below A (a maximum of 6 notches) in a single step by Moody's. In contrast, among 198 Aaa-rated ABS CDO tranches downgraded by Moody's in October and early November, more than half of the downgrades exceeded 7 notches (Aaa to Baa1), and 30 were downgraded 10 or more notches to below-investment grade. One was downgraded 16 notches from Aaa to Caa1. As a result, the market value of these securities has dropped sharply and unexpectedly. These developments added to market uncertainty about mortgage-related assets, securitizations, and other structured products.

That market uncertainty has fed a general reduction in market liquidity. Liquidity problems particularly affected off-balance sheet conduits funded by short-term asset-backed commercial paper (ABCP), where the conduit held any kind of subprime mortgage-related asset (such as triple A-rated RMBS or CDOs). Due to the uncertain value of these assets, commercial paper investors began to lose confidence in the conduits and increasingly chose not to "roll over" maturing notes into new notes issued by the

conduit. Bank sponsors of these conduits that were contractually bound to provide back-up liquidity were forced to take back on their balance sheets the subprime mortgage assets and sometimes other assets as well. The reduction in liquidity also had an even more pronounced effect on structured investment vehicles (SIVs) that held any subprime-related assets. Unlike traditional ABCP conduits, SIVs had very limited back-up liquidity contracts with their sponsoring banks. As investors became increasingly reluctant to fund these vehicles, some were liquidated, and in other cases, bank sponsors, even though they had no legal obligation to do so, absorbed SIV assets back on their balance sheets to avoid reputational damage.

In addition, turmoil in credit markets followed on the heels of a surge in leveraged buyout activity in early 2007. That resulted in a number of large banks keeping on their balance sheets leveraged loans that they originated with the intent to sell to investors; the banks also had a large volume of commitments that could not clear the market at prices they were willing to accept. Bankers made some progress in reducing the commitment pipeline; the largest national banks were able to reduce their volume of commitments awaiting syndication from \$217 billion in July to \$90 billion at the end of the year. However, as these commitments became funded and investor demand remained weak, banks ended up taking onto their books an additional \$62 billion from the \$127 billion funded during the second half of 2007, with a corresponding requirement for funding.

Late last year, liquidity pressures from all these events began to make some banks reluctant to lend to other banks, out of a desire to retain liquidity in such an uncertain environment. Lending terms shortened as the premium for longer-term debt rose substantially. To address this concern, the Federal Reserve and other central banks

responded by injecting large amounts of liquidity into the global monetary system, restoring operations in key short-term markets and contributing to improvements in other markets as well.

Market liquidity for certain types of assets remains very constrained, however. For example, securitization channels for residential mortgages remain largely closed except for conforming mortgages sold to Fannie Mae and Freddie Mac. Banks have an additional significant source for mortgage funding liquidity in the Federal Home Loan Banks, which have substantially increased their advances, but overall there is clearly reduced liquidity in the nonconforming mortgage market. Similarly, the securitization channel has largely closed for commercial real estate loans that larger banks were packaging and distributing as commercial mortgage-backed securities (CMBS).

As recent earnings reports have shown, these factors significantly reduced bank earnings in the last half of the year. In fact, 2007 marked the first year-over-year drop in net income for the national banking system since 2000. The biggest single factor depressing bank earnings in the second half of 2007 was the recognition of large mark-to-market subprime-related losses on holdings of super-senior tranches of CDOs at some of the largest banks. As discussed above, these super-senior securities carried ratings that were widely understood to indicate very low risk. It is now clear that overreliance on these ratings provided by the major credit rating agencies played a significant role in lulling bank management, regulators, and others into a false sense of security. Some banks held large amounts of these assets on their books, in most cases regarding them as being nearly as safe as U.S. government debt for purposes of risk management. The large

size of these positions – believed to be nearly risk-free – resulted in exceptionally large losses.

Larger banks also took significant write-downs on other assets on their books because of the financial market disruptions in the fourth quarter, including marks on the large pipeline of leveraged loans and loan commitments that were “stuck” on bank balance sheets. In addition, banks substantially increased provisioning for loan losses to reflect deterioration in credit quality in several categories of assets, including home equity loans and credit card loans.

Smaller banks also have been subject to earnings pressure. This has particularly been the case in areas where housing markets had seen rapid growth but are now experiencing a sharp drop-off. These problems have been compounded in some parts of the country by a weakening local economy and depressed loan demand. Many smaller banks also have experienced sharp increases in noncurrent loans, leading them to increase provisions for losses.

#### *D. Banking System Response*

Given this challenging environment, it is perhaps remarkable that banks have been able to expand lending even while absorbing additional assets and recognizing sizable losses. Lending growth has slowed, but not contracted, as some had feared. Some portion of the growth stems from dysfunction in other parts of the credit markets that has forced banks to take back on their balance sheets loans that they thought they had sold, or to keep on their balance sheet loans that they hoped to sell but could not. It is clear, however, that this is not the whole story, and that banks continue to perform in



their key role as intermediaries. As of the end of 2007, growth has continued in most categories of lending, and loans have been growing at both small and large banks, even those that have had to unexpectedly fund additional assets as a result of financial market disruptions. There is also evidence that for most creditworthy borrowers the cost of funding has declined, as the sharp decline in the general level of interest rates has more than offset any increases due to heightened risk premiums. For example the prime rate, now at six percent, has fallen more than two full percentage points since early September.

Banks have been able to absorb financial shocks for a number of reasons. The first and most important is that, because they entered this period in overall good health, banks have had the earnings and capital to weather market downturns thus far. Despite large write-downs and a drop in income in the fourth quarter, the national banking system still generated almost \$65 billion in net income in 2007. Capital levels well in excess of regulatory minimums gave banks the flexibility to add sizable quantities of assets to their balance sheets.

Banks have further strengthened their position by reducing dividends and issuing capital and debt in both public and private offerings. For example, nine of the largest banks regulated by the OCC (or their holding companies) have raised over \$65 billion in capital in the last few months. Their ability to do this speaks to the underlying long-term viability that investors see in these franchises. The additional capital supports these banks' ability to continue providing credit to U.S. borrowers even if other sources of credit remain constrained. While some of the capital was raised at the bank level, most companies kept the capital at the holding company level for greater flexibility.

It is also important to recognize that there are pockets of strength within the banking system. Banks, especially larger institutions, conduct a wide range of activities, and weakness in some lines of business often can be offset by strength elsewhere. In the fourth quarter, while banks were recognizing losses from residential real estate activities, other business lines were generating offsetting income. In addition, banks have diverse funding sources. As a result, despite the difficulties in securitizing nonconforming mortgages, banks continue making mortgage loans, including loans to subprime but still creditworthy borrowers – albeit with underwriting standards that have become more prudent. In contrast, some nonbank mortgage lenders had no fall-back options for funding, and a number of them withdrew from the business.

Another positive factor for bank profitability has been the general widening of risk premiums across a broad range of loans and securities to what are, in our view, levels more appropriate for the risks assumed. Similarly, as interest rates have come down the Treasury yield curve has steepened; in the past, a steeper yield curve has often contributed to higher bank margins. And while credit-quality concerns cannot be easily dismissed, delinquency rates on consumer loans are starting from record-low levels, and surveys show that banks have taken steps to limit risk by appropriately tightening loan standards over the last year for credit cards and other non-mortgage consumer credit.

At this point, it is fair to say that the banking system has substantially addressed some – but by no means all – of the problems discussed above. For example:

- Banks have largely taken back on their balance sheet or otherwise addressed the issues arising from subprime mortgage assets that were sold to ABCP conduits and SIVs. Although SIVs that lack bank liquidity

support have declined significantly in importance, traditional ABCP conduits have resumed funding at more normal levels.

- Thanks to proactive liquidity actions by central banks, earlier problems in interbank markets have receded, at least for the time-being.
- Banks have made significant progress in recognizing large and concentrated losses caused by subprime mortgage CDOs and other asset deterioration. Even more important, they have succeeded in raising large amounts of capital to restore strength to their balance sheets to offset these losses.
- The purchase of the country's largest mortgage originator by one of the biggest national bank holding companies helped to calm credit markets.
- And banks have reduced their exposure to the combined volume of leveraged loans and pipeline commitments, even though a significant amount of funded loans remains on their books.

### **III. Near-Term Challenges**

Despite this progress, banks still face significant hurdles on several fronts. This period of market turmoil has not run its full course, and a number of critical financial markets remain fragile. Restoring confidence in financial markets has proven more challenging than in other recent periods of market turmoil, such as the late 1990s, for several reasons. Participation in financial markets has broadened, with large numbers of unregulated or lightly regulated entities engaged in financial intermediation and trading activities. Various structured financial products, many of which evolved only recently,

can now transfer credit risk among market participants in ways that are not necessarily transparent. This particular market disruption also has highlighted the global nature of financial markets and the ability of market participants to use technology to alter risk profiles quickly. Interconnection among key markets and market participants has fueled worries about contagion. Taken together, these factors complicate current problems and lengthen the road to full recovery.

Continuing market turmoil presents a variety of issues for banks and for regulators. Although as noted earlier many larger banks have revalued their mortgage-related CDO exposures to recognize losses, it is entirely possible that, as housing markets continue to weaken, there will be additional write-downs on these securities. Similarly, although banks have made progress in reducing their exposure to leveraged loans, they remain exposed to potential losses in this area; this is also a line of business that has come to depend heavily on liquid markets for funding, and liquidity risk management remains a challenge as the cost and tenors of available funding options remain volatile.

Recent problems among monoline bond insurers, who insure municipal bonds and provide credit protection on structured securities such as ABS CDOs, also pose problems for banks. National banks have relatively moderate direct exposure to these companies in the form of direct credit obligations. In addition, national banks' indirect risks from exposure to insured municipal bond holdings in investment portfolios are relatively modest; the underlying bonds tend to be highly rated on their own, which should minimize the effect of monoline downgrades. However, a more significant concern is that banks may be obligated as part of their municipal remarketing activities to repurchase securities from investors. Downgrades of the monoline insurers would make

it more likely that policy constrained investors would “put” these securities back to the remarketing banks. If this happens in large volumes, banks would incur price and liquidity risks, and would face increased strain on their capital ratios.

Most recently, problems with auction-rate securities have received considerable attention. This is a market in which some of the larger national banks are involved through their broker-dealers. Investor concerns linked in part to the weakening financial condition of monoline bond insurers has in some cases disrupted the normal functioning of the periodic auctions that are used to set interest rates on these types of securities. In the past, when there was insufficient investor demand in the auctions, dealers have purchased securities to assure a successful auction. However, given current liquidity and balance sheet constraints, and the absence of a contractual requirement for dealers to purchase securities in the auction, many auctions are now failing. The result is that issuers of these securities, such as municipalities and universities, are scrambling to find alternative ways to borrow funds.

The weak financial condition of some monoline insurers, and the disruption created by uncertainty and investor concerns regarding that condition, not only creates various risks for banks, but likely delays a return to normalcy. On the other hand, if recent efforts to recapitalize monoline insurers successfully restore their triple-A ratings, or allow them to retain those ratings, the corresponding risks to banks will be mitigated.

Looking beyond the immediate fallout of financial market disruption, deteriorating credit quality is likely to remain a big issue across the national banking system in the near term. Housing markets continue to slide in much of the country; analysts generally expect at least another year before the housing sector turns around, and

banks will continue to feel the impact. Slower economic growth and the sharp fall-off in home building are reducing loan demand and restraining revenue growth for banks.

General economic weakness implies more losses to come on home equity loans, credit card loans, and auto loans, as consumers face a softer job market along with near-record debt service burdens.

Commercial real estate (CRE) will be an area of challenge for bankers and bank supervisors, and its impact could be quite broad. During the prolonged period of exceptionally benign credit conditions that I discussed earlier, many community bankers became complacent about the potential for significant stresses in these markets. Lending growth was historically high in commercial real estate, especially in regions of the country that enjoyed an extraordinary boom in the housing markets. CRE concentrations rose around the country, and in some cases risk management failed to keep pace.

Approximately a quarter of the community banks supervised by the OCC now have CRE-related concentrations exceeding one or both of the thresholds contained in the interagency CRE guidance issued in December 2006.<sup>4</sup> The share is even higher in the former housing boom regions. Credit quality is now declining for many of these loans, especially those related to residential construction and development (C&D). For example, at the end of 2007, nonperforming C&D loans at national community banks amounted to 2.7 percent of the total, more than triple the rate of a year earlier. This trend is particularly pronounced in the former housing boom states.

CRE exposures are smaller relative to capital at the largest national banks than at community and mid-size banks, because larger banks have tended to originate CRE

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<sup>4</sup> The concentration thresholds articulated in the guidance are commercial real estate loans (excluding owner-occupied real estate) exceeding 300 percent of risk-based capital, or construction and development loans exceeding 100 percent of risk-based capital.

exposures for distribution via commercial mortgage-backed securities (CMBS). As seems to have been the case for other loans originated with the intent to distribute, underwriting standards for CRE loans deteriorated over the past several years. Interest-only structures, fewer covenants, and financing based upon optimistic projections of cash flows rather than actual in-place cash flows are examples of the more aggressive underwriting terms. As risk appetites of investors have changed in the wake of market disruptions, securitization of CRE has become very difficult as well. As a result, several of the largest national banks experienced some losses when warehoused loans and security exposures declined in value. The banks also retain significant exposures to residential builders, many of which have struggled under recent market conditions, and to income-producing CRE loans.

#### **IV. Supervisory Responses**

As the supervisor of national banks, the OCC has various ways to influence the national banking system: policy guidance and regulations that set forth standards for sound banking practices; on-site examinations and ongoing off-site monitoring that enable us to assess compliance with those standards and identify emerging risks or trends; and a variety of supervisory and enforcement tools – ranging from reports of examination that highlight matters requiring attention to informal and formal enforcement actions – that are used to obtain corrective action to remedy weaknesses, deficiencies, or violations.

Current market and economic conditions highlight the importance of appropriately identifying, measuring, managing, and controlling risk. Based on what we

have observed so far in this period of market turmoil, there is a need to restore several fundamental banking precepts: first, sound underwriting and robust credit administration practices; second, diversified funding sources supplemented with realistic contingency funding plans; third, strong internal controls and risk management systems, including stress-testing, valuations, and disclosures; and fourth, timely recognition of losses coupled with adequate loan loss reserves and strong capital cushions. In each of these four areas – asset quality, liquidity, risk management, and reserves and capital – we remain alert to emerging trends and to findings that may trigger additional supervisory action.

A. *Asset Quality*

1. Monitoring and reviews

A core component of our supervision is monitoring and assessing the quality of national banks' loan portfolios. Our assessments of individual bank risks are supplemented by a variety of mechanisms to determine potential risks, including on-site loan reviews at individual banks; horizontal reviews of particular portfolios or operational areas across a group of banks; an annual credit underwriting survey; and the agencies' Shared National Credit Program. Through these mechanisms we look for trends that may signal systemic weaknesses or increases in risk that warrant supervisory responses. Responses may take the form of more targeted supervisory examinations or additional policy guidance.

Our annual credit underwriting survey that is currently underway, and the agencies' Shared National Credit reviews that will commence in April, will provide us



with an updated picture of the aggregate level of credit risk in the banking system.

Findings from these reviews will help identify areas where we may need further targeted examinations or additional supervisory guidance to bankers and examiners.

The OCC's underwriting survey covers the largest 64 national banks, whose combined loan portfolios represent approximately 94 percent of all outstanding loans in the national banking system. The survey provides information on how national banks are responding to recent developments and adjusting their underwriting standards across 18 major retail and commercial loan products. It also provides examiners' assessments on trends in the aggregate credit risks for each of these product categories. In the 2008 survey, we are specifically asking about deviations from sound underwriting, and about any differences in the diligence of underwriting by product or intended hold positions.

The agencies' Shared National Credit Program will provide detailed on-site reviews of large syndicated credits that are shared by two or more banks. This program typically involves reviewing over 7,000 individual credits that total in excess of \$2 trillion in credit commitments. During the 2008 Shared National Credit review, the agencies will focus on credits extended to the residential homebuilding industry, other commercial real estate construction loans, loans to mortgage and consumer finance companies, merger and acquisition loans, and loans to monoline insurance and subprime lending companies. A key focus of examiners' evaluations will be whether banks' internal credit review processes are proactively identifying and classifying credits that are showing inherent weaknesses. Banks that have failed to take appropriate charge-offs or provisions for probable losses will be directed to do so and to take concrete action to strengthen their credit administration.

Examiners also will continue to evaluate differences in underwriting between extensions of credit originated to hold for investment, versus originated with the intent to distribute. In the past, we issued guidance to our examiners stressing the importance of sound underwriting and the need to have distributed credit underwritten with control and structures that are reasonably consistent with credit exposure held in the bank. We also previously issued guidance requiring examiners to continue to ensure that appropriate risk management systems are in place to effectively measure, monitor, and control risks with leveraged lending activities in banks; examiners will continue to assess and document compliance with guidance regarding leveraged finance and participations purchased when conducting reviews of leveraged lending.

More generally, during our on-site reviews at individual banks, examiners will be conducting portfolio and transaction-level testing tailored to each bank's risk profile to determine the level of credit risk and the adequacy of the bank's credit risk management processes. A particular focus in the coming months will be to ensure that banks are holding adequate reserves for estimated loan losses, and that problem credits are being identified and dealt with in a timely manner. Actual credit losses on individual credits are to be recorded when the bank becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in the agencies' credit classification policies.<sup>5</sup>

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<sup>5</sup> For closed-end retail loans, such as auto loans, charge offs are to be taken when loans are 120 days past due; for open-end retail loans, such as credit card loans, charge offs should occur once the loan is 180 days past due. For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due and any outstanding balance in excess of the value of the property, less cost to sell, should be classified as loss and charged off. For commercial credits, nonaccrual loans are maintained on a cash basis due to a deterioration in the financial position of the borrower, where payment in full of interest or principal is not expected, or principal or interest has been in default for 90 days or longer, unless the obligation is both well secured and in the process of collection. Proper loan loss provisions are also expected to be taken and losses recognized if appropriate.

## 2. Supervisory initiatives and guidance

In recent years the OCC has issued more targeted, detailed guidance that is directly applicable to some of the specific portfolios that are of current heightened concern, including certain residential mortgage, home equity, and credit card loans; commercial real estate loans; and leveraged corporate loans. Examiners are assessing banks' compliance with these guidelines as part of their examinations.

### *a) Residential mortgages*

With respect to residential mortgage loans, the OCC alerted national banks to slippage in underwriting standards after our 2003 annual survey of underwriting practices. In 2004, we took further steps to assess the risks associated with these activities, including a survey of national bank originations of interest-only and payment-option adjustable-rate mortgages (ARMs) and the underwriting and marketing practices associated with such products. As a result of our findings, the OCC instructed our examiners to address the risk of products that carry the potential for significant "payment shock" even though home prices were continuing to escalate. We also issued strong standards on predatory lending, and initiated an interagency process to develop policy guidelines to address the safety and soundness and consumer protection concerns that we were seeing in these products. This latter effort culminated with the September 2006 Interagency Guidance on Nontraditional Mortgage Product Risks, which was followed by the June 2007 Interagency Statement on Subprime Lending. Both statements emphasize that loan terms and underwriting standards for such products must be consistent with prudent lending practices, including a credible analysis of a borrower's repayment

capacity based on a loan's fully indexed rate, assuming a fully amortizing repayment schedule. The statements also stress the need for consumers to have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. Our examiners will continue to assess national banks' compliance with these guidelines as part of our 2008 supervisory activities.

(1) Foreclosure prevention

We also recognize, however, the need for banks to work constructively with borrowers who may be facing difficulties with their current mortgage obligations. As a result, we continue to support various private sector and public sector initiatives and programs that seek to assist these borrowers. In particular, the OCC supports the use of the streamlined modification framework for securitized subprime ARMs as outlined by the American Securitization Forum (ASF) and HOPE NOW alliance in December 2007. We also have instructed our examiners to permit banks to apply a similar streamlined approach more broadly, including for loans that have not been securitized, provided that performance and occupancy criteria are no less stringent than those of the ASF plan. In both instances, we believe it is critical that banks construct loan modifications in such a way as to ensure that a borrower has a reasonable prospect of performing under the new terms. Simply shifting a borrower from one unaffordable mortgage to another serves neither the borrower's nor the bank's interest. Through our ongoing supervision and fair lending processes, we will continue to be alert to, and pursue any evidence of, unfair or deceptive or unlawful discriminatory lending practices.

I share the Committee's concern about the effect that current market conditions may have on individual homeowners who face sharply escalating mortgage payments and the possibility of foreclosure. While foreclosures obviously can have devastating effects on borrowers, it is less obvious but no less true that it can also result in steep losses for lenders. As a result, it is very often a "win-win" for both borrowers and lenders to take alternative courses of action to avoid foreclosure, including through loan modifications.

As a result, the OCC has stressed the importance of national banks prudently working with residential loan borrowers facing difficulties in meeting their contractual payment obligations. The OCC is using all available tools to encourage lenders and borrowers to work together, facilitated by supportive organizations such as counseling agencies, to maintain the smooth functioning of the residential lending industry and to help keep borrowers in their homes except where foreclosure is the only prudent course of action. To this end, we are co-hosting forums in parts of the country hard hit by foreclosures to introduce banks to the range of delinquency intervention services that community-based counseling organizations can provide.

In April and again in September of last year, the OCC and other regulatory agencies disseminated guidance to encourage national banks to work with borrowers in these unfortunate circumstances and to remind them of the regulatory incentives to do so. We recognize that many national banks are working with community partners to develop and implement strategies to help identify financially stressed borrowers, pursue workouts, and avoid foreclosure, and we support and publicize these efforts so that they may be replicated and enhanced as much as possible. For example, in June of last year, the OCC published the report, "Foreclosure Prevention: Improving Contact with Borrowers,"

which sets forth a variety of strategies lenders can use to reach borrowers for whom loan workouts may be necessary and appropriate. In 2006, we dedicated an issue of the OCC's Community Developments newsletter to focus on successful foreclosure prevention partnerships between banks and non-profit organizations and to summarize how CRA credit is available for these activities. This newsletter, and the April 2007 workout guidance, identifies ways that lenders may receive favorable CRA consideration for foreclosure prevention activities, including programs that transition low- and moderate-income borrowers from higher-cost loans to lower-cost loans provided that the loans are made in a safe and sound manner. Consistent with this guidance, the banking agencies have proposed revisions to the CRA Questions and Answers, which provide additional clarification regarding when foreclosure prevention activities may be eligible for favorable CRA consideration. The agencies expect to issue the final revised CRA Q&As in the upcoming weeks.

I have recently visited neighborhoods that have been hard hit by foreclosures, and have spoken with community organizations seeking to mitigate the economic effects of high foreclosure rates. From these visits, it is becoming increasingly apparent to me that a broad range of communities across our nation, including neighborhoods classified as "middle income" in the 2000 Census, are suffering the adverse consequences of rising mortgage delinquencies and foreclosures. I believe that Congress can, and should, do more to provide the statutory authority to ensure that, in addition to low- and moderate-income communities, certain stressed middle-income communities can benefit from bank investments to help alleviate the disastrous effects of rapidly escalating foreclosures. The Senate is now considering S. 2487 to restore the original scope of national banks' public

welfare investment authority, which would give banks an important tool to help foreclosure-plagued urban and suburban middle-income areas. A companion bill, H.R. 1066, has unanimously passed the House. I would hope the Senate would move quickly to pass this legislation so that this important bill can go to conference with the House and ultimately to enactment.

In order to ensure that banks receive appropriate CRA consideration for these investments, I have proposed an amendment to the CRA regulations that would provide an incentive for community development investments that revitalize and stabilize middle-income urban and suburban areas that are “distressed” based on unprecedented levels of foreclosures and related economic factors. With this change, the banking agencies could give favorable CRA consideration for – and thereby encourage – loans, services, and investments in more communities suffering from the consequences of foreclosures.

(2) New mortgage reporting metrics

To improve our ability to monitor the quality of banks’ residential mortgage portfolios, including modifications of existing mortgage loans, the banking agencies recently announced the addition of new items to the quarterly Consolidated Report of Condition and Income (Call Report) and Thrift Financial Report filed by banks and savings associations. Specifically, beginning with the March 31 reports, institutions will report the total dollar value of one-to-four family residential mortgage loans owned or serviced by them that are in the process of foreclosure as of the quarter-end date, and also will report restructured loans secured by one-to-four family residential properties. These amounts will be broken into two categories: loans that are in compliance with their

modified terms, and loans that under their modified terms are past due 30 days or more or in nonaccrual status.

In addition, we are requiring the largest national bank mortgage servicers to submit comprehensive mortgage data to the OCC on a monthly basis. We expect the data will cover more than 95 percent of the mortgage servicing activity in the national banking system. The OCC is requiring this comprehensive mortgage data in order to ensure that we have a detailed picture of the activities of national bank servicers and the performance of loans serviced by them.

The scope of the mortgage data we are requiring is not limited to subprime mortgages or to mortgages serviced in securitization pools. We believe it is important to obtain key mortgage performance metrics across a broader base, and therefore, our data collection covers all mortgages held on the books of national banks and their subsidiaries, as well as loans serviced for others. The data will use common definitions and data elements for asset quality metrics (delinquency measures, foreclosures, and so on), loss and foreclosure mitigation actions taken, and credit risk indicators (such as credit bureau scores). With this approach, we will have data that is consistent, comparable, and reliable.

We also believe that it is important to build upon, and not conflict with, the mortgage data collection efforts of the HOPE NOW Alliance. Thus, in designing our data collection, the OCC has been coordinating with participants in the HOPE NOW Alliance in order to coordinate data collection efforts and minimize burden. We understand that as a result of their review of the information sought by the OCC, the HOPE NOW Alliance decided to revise and expand its subprime mortgage metrics to be more consistent with



the enhanced metrics to be used by the OCC. Similarly, we have revised our OCC mortgage metrics and definitions in some respects so they are compatible with the HOPE NOW data collection. I have been pleased that the banks we are requiring to submit mortgage data recognize the importance of this effort and have committed to prompt fulfillment of the OCC's requirements. Our aim is to have the largest national bank mortgage servicers begin submitting reliable data as soon as March 31.

*b) Home equity*

National banks' home equity portfolios grew considerably over the last several years, fueled by the low interest rates, rising home prices, and relaxed underwriting standards discussed earlier in this testimony; growth averaged 29 percent per year from 2001 to 2006. National banks have about half of this market, and almost all of the exposure is held on the banks' balance sheets.

In our 2003 targeted reviews of home equity lending, we identified changes in the product structure and underwriting that were increasing the risk inherent in these portfolios. These changes included extended draw periods with interest-only payments, acceptance of higher debt-to-income and loan-to-value ratios, and greater use of stated-income and other reduced documentation products. As result of these findings, we advised bankers to strengthen their credit risk management practices, and the OCC worked with the other FFIEC-member agencies to issue the 2005 guidance on Credit Risk Management for Home Equity Lending. The guidance sets forth sound credit risk management practices for nine key areas including marketing, underwriting, collateral valuation management, individual account and portfolio management, and servicing.

While national banks have taken steps to strengthen their underwriting and risk management practices in response to our guidance, losses have recently accelerated from a low base. Losses reflect the increased risk that accumulated in these portfolios over the last several years through gradual loosening of underwriting standards and increased risk layering – especially with respect to loans purchased from third party brokers or correspondents. These built-up structural weaknesses, together with the spreading weakness in home prices, lead us to expect higher losses in these portfolios in the months to come. Despite the higher losses and the likely need for additional provisions, problems are likely to be manageable for national banks; home equity loans account for less than 5 percent of national bank assets.

*c) Credit cards*

The OCC also regulates institutions that account for approximately 75 percent of the credit card industry. The 2003 interagency guidance on Credit Card Account Management and Loss Allowance Practices addressed a number of inappropriate account management, risk management, and loss allowance practices identified through our examinations. These practices, which often increased credit risk and masked portfolio quality, included increased negative amortization, liberal credit line management, certain overlimit practices, and a general easing of minimum payment requirements.

Although we faced considerable criticism by some that our guidance and actions could have negative repercussions on bank profitability and consumer spending, we thought it was critical to curtail the continuing liberalization that we were seeing with regard to minimum payments. At the OCC, we directed all national bank credit card

issuers to revise their minimum payment policies to ensure that those payments were sufficient to cover, at a minimum, all accrued interest and late fees plus at least one percent of the principal balance outstanding. In addition, we required banks either to include other recurring fees (such as overlimit fees) in the minimum payment, or to waive them after three consecutive months.

Although credit card earnings have been fairly robust and portfolios are currently strong, we have a heightened level of concern in this area, even before the numbers confirm any significant deterioration. This is unsecured credit, and is very susceptible to a mortgage spillover effect. National bank credit card delinquency and loss rates are on the rise, although from exceptionally low levels as noted above. Industry losses are running approximately 5 percent; this is currently below the long-term industry average of 5.5 percent, but losses may migrate to that rate or higher in 2008. These trends require that we continue to devote attention to this type of credit; however, the number of affected national banks is relatively small, and the potential problems, taking into account the possibility of some further decline in economic growth, appear manageable within the broader spectrum of current issues.

*d) Commercial real estate and construction*

Because of the growing CRE concentrations of community banks described earlier in this testimony, the OCC started conducting horizontal reviews of national banks with higher CRE concentrations about four years ago. These reviews, which brought together teams of highly experienced examiners, allowed the OCC to identify and convey best practices more effectively, and provide consistent advice on any additional measures

that we believed should be taken. As a result of these reviews, we provided guidance to national banks on areas that needed improvement, and used our findings to help formulate guidance that the agencies issued in December 2006 on sound risk management practices for concentrations in commercial real estate lending. That guidance is intended to help ensure that institutions pursuing a significant commercial real estate lending strategy remain healthy and profitable while continuing to serve the credit needs of their communities. It reminds bankers of the increased risk that arises from these concentrations, and sets forth our expectations for evaluating this risk.

But results from our more recent horizontal reviews have continued to show a number of risk management deficiencies that cause us concern. For example, despite our previous guidance, a number of banks with CRE concentrations have not extended their stress testing of income-producing properties beyond interest rates to other business variables that affect risk, such as vacancy rates, lease rates, and expense scenarios – not only at the time the loan is made, but also periodically throughout the life of the credit relationship. The potential for rapid deterioration in this business is simply too great not to conduct such testing on an ongoing basis.

Another issue that has surfaced in horizontal reviews involves real estate appraisals. We have seen an increasing number of instances in which appraisals on file have become outdated with respect to current market conditions, making it very difficult to assess the true credit quality of these loans. In these cases, we will require bank management to obtain new appraisals, thoroughly review those appraisals, and take any action necessary should these loans no longer be adequately supported by collateral values.

Our horizontal reviews have definitely revealed a significant increase in the number of problem loans related to residential construction and development in community banks across the country, especially in the “boom-bust” areas that experienced rapid appreciation followed by downward pressures on home prices. In the coming months we will continue focusing our supervisory efforts in these geographic areas and on banks with greater concentrations in this segment of CRE; many of these banks are already seeing an increase in their problem loans and loan loss provisions for this part of their portfolios. We believe that our “supervision by risk” approach works well in these situations, as we can tailor our work to the specific facts and circumstances of individual banks without having to adopt a “one size fits all” solution.

The trend of increasing problem assets is unmistakable, and the potential consequences are magnified in this credit cycle by the fact that so many community banks have CRE concentrations that are so much higher than has ever been the case in the past. While we fully expect to see further increases in problem assets, increases to loss reserves, more problem banks, and some bank failures, this progression is not inevitable just because a bank has a commercial real estate concentration. It remains imperative, as we enter this more stressful period for community banks with concentrations in commercial real estate lending, for bank management to be realistic about identifying problem assets themselves, so that our examiners are not forced into the position of having to do it for them. The idea is to recognize problems early and manage through them, with good and continual communications between examiners and bankers.

Although the larger banks generally have lower concentrations of CRE credits on their books, some have large dollar volumes of CRE exposure. As with community

banks, CRE exposures related to residential construction and development present particular concerns. Housing-related CRE outstandings comprise only 1.6 percent of large bank loans, but a number of them have experienced significant deterioration. We recently subjected these portfolios to a horizontal analysis and are targeting them in our supervisory strategies and in the Shared National Credit review. We also continue to ensure that banks maintain adequate reserves against these portfolios.

At larger banks CRE weakness takes on a different character, as noted earlier in this testimony. For the large banks, disruption in CMBS markets and securitization activities has led us to monitor the actions, such as write-downs and whole-loan sales, that banks are taking to reduce warehouse exposures. However, the absence of a functioning securitization market likely will make progress slow. As a result, we may see additional losses at banks that hold the underlying CRE loans and securities.

*e) Leveraged lending*

As noted earlier, market disruptions last summer delayed completion of long-term financing for some leveraged loans that banks had not expected to hold on their books. We continue to closely monitor the inventory of these loans held at the larger national banks and the potential adverse affects such holdings may have on those banks' asset quality and balance sheet capacity. As warranted, we will direct banks to take appropriate write-downs on these holdings to reflect current market conditions. Last week we issued a Leveraged Lending handbook that consolidates and supplements existing guidance to bankers and examiners on the risks associated with leveraged lending and the risk management systems and controls needed to mitigate those risks.

These systems and controls include sound underwriting standards; appropriate concentration limits; robust problem loan management; and clear policies and procedures on loan acquisition and distribution, including procedures for defining, managing, and accounting for distribution failures and methodologies for determining market values and promptly recognizing losses for loans classified as held-for-sale.

Leveraged lending has been and will remain a supervisory focus. We are in process of conducting leveraged lending target reviews in our top syndication banks, with a focus on syndication pipeline management, stress testing, and limit setting. Similar to the 2007 Shared National Credit review, we will be completing underwriting analysis questionnaires on selected new leveraged loan syndications in our upcoming shared credit examinations. As before, this work will allow us to identify and quantify the volume of weakly underwritten credits.

#### *B. Liquidity and Funding*

As part of our supervision of bank safety and soundness, we require national banks to carefully monitor their liquidity and funding levels and to have contingency plans in place that contemplate a potential disruption to their normal funding activities and market access. As we have seen, market liquidity can change rapidly and unpredictably. However, these changes in market liquidity need not unduly threaten the health of the banking system, provided banks take responsible steps to manage their own institutional liquidity. And in general, national banks have been able to maintain adequate funding for loans and other credit activities throughout this period of market turmoil.

Although most national banks continue to have sufficient funding to meet loan demand, unprecedented dislocations within the secondary mortgage, leveraged loan, and asset-backed commercial paper markets have posed challenges for banks active in these markets. Our examiners at these institutions continue to monitor market conditions, deal flow, and funding availability. We are also working with other U.S. and international supervisors to assess the effectiveness of existing liquidity risk management practices and to identify areas where practices must be strengthened. One specific focus is the likely need for banks to enhance the identification and mitigation of contingent funding risks, such as those associated with loan syndication and off-balance sheet structures and commitments.

### *C. Risk Management Systems and Controls*

The events of the past few months have exposed a number of areas where we will be directing banks to improve their risk management systems and controls. A key area of supervisory attention in the coming year will be the need for enhanced stress testing to improve the evaluation of potential so-called “tail events” or extreme market movements, particularly those in which markets that in normal times appear quite independent suddenly move more in tandem. Model validation processes, methodologies used to value complex or illiquid instruments, counterparty credit risk management, and credit risk mitigation tools are other areas where we will be working with other supervisors to determine whether additional standards or guidance are needed.

While these efforts related to modeling and stress testing primarily focus on larger institutions, we expect smaller banks that have significant portfolio concentrations to



have adequate systems and processes in place to manage these concentrations, whether they are tied to commercial real estate or to any other type of lending. Banks' processes should include assessing how changing market conditions may affect their borrowers' ability to repay their loans, and the impact on the bank's asset quality, earnings, and capital.

The goal of OCC supervision is to identify and correct potential problems at an early stage, before they adversely affect the safety and soundness of the banking system or the viability of any individual bank. We use our various tools – supervisory policy guidance, on-site examinations and communications between bankers and examiners, and where needed, informal and formal enforcement actions – to achieve such changes. Notwithstanding these efforts, we fully expect given current market conditions that we will see an increase in problem banks that will require more in-depth supervisory attention. As a bank reaches this stage, our efforts focus on developing a specific plan that takes into consideration the ability and willingness of management and the board to correct deficiencies in a timely manner and return the bank to a safe and sound condition. In most instances our efforts, coupled with the commitment of bank management, result in a successful rehabilitation of the bank. There will be cases, however, where the situation is of such significance that we will require the sale, merger, or liquidation of the bank. In rare cases where that is not possible, we may appoint the FDIC as receiver, such as occurred in one instance this January. We work closely with the FDIC in these cases to effect early and least-cost-resolution, consistent with the provisions of the Federal Deposit Insurance Corporation Improvement Act.

#### *D. Reserving and Capital Standards*

Prompt recognition of losses and the maintenance of strong loan loss reserves and capital buffers are essential in preparing for, and responding to, periods of economic stress. Failure to recognize losses erodes investor confidence and impedes the ultimate resolution of problem credits. To provide for estimated credit losses, banks must employ a robust methodology for determining and maintaining an adequate allowance for loan and lease losses (ALLL). As we have seen in the fourth quarter, many banks are increasing their loan loss reserves – a development that we believe is both warranted and prudent in the current environment. We will continue to direct banks to maintain adequate reserves to cover their estimated credit losses.

In December 2006, the banking agencies issued guidance and supplemental frequently asked questions that set forth supervisory expectations and generally accepted accounting principles for the ALLL. At the OCC we followed up with a 2007 ALLL training initiative that provided training sessions for over 1,200 examiners on key ALLL concepts and practical case studies that address many of the current issues examiners are facing in their credit examinations.

U.S. banks entered the recent market upheaval with strong levels of capital, as noted earlier. This period has been a useful reminder, if we needed one, that capital standards are a crucial line of defense against problems that might threaten the stability of the banking system. To strengthen that crucial element of our prudential regulations, the U.S. banking agencies recently adopted a final rule that implements the advanced approaches for risk-based capital established under the Basel II Framework. Specifically, for the largest U.S. banking organizations the rule establishes regulatory and supervisory

expectations for credit risk, through the Internal Ratings-Based Approach (IRB), and for operational risk through the Advanced Measurement Approaches (AMA), and articulates enhanced standards for the supervisory review of capital adequacy and for public disclosures related to risk and capital adequacy.

The IRB and AMA frameworks represent a more risk-sensitive and comprehensive regulatory capital regime than our existing risk-based capital rules, and establish capital requirements and risk management expectations that are better aligned with the risks assumed by these institutions. The IRB framework provides a more granular assessment of the capital needed to support both on- and off-balance sheet credit risk exposures of banks; this increased granularity should help address some of the shortcomings in the current risk-based framework that often provided incentives for institutions to take on more risky exposures. Under the AMA framework, banking organizations will be required to have systems in place to measure and hold capital explicitly for potential operational risk losses.

Our implementation of the advanced approaches of Basel II incorporate a number of transitional arrangements and prudential safeguards designed to ensure that the new framework is working as anticipated. These safeguards include a parallel run period that will last at least four quarters but could be longer for individual institutions, which will provide the basis for the OCC's initial Basel II qualification determination. During this period, banks will be required to demonstrate adherence to stringent qualification requirements on all aspects of their credit and operational risk measurement and management process. Following initial qualification, a minimum three-year transition period would apply, permitting supervisors to observe and scrutinize Basel II systems

while strictly limiting, through a system of simple and conservative capital floors, any potential reductions in capital requirements. In addition, banks operating under the advanced approaches will continue to be subject to the agencies' leverage capital and Prompt Corrective Action requirements.

We believe that the advanced approaches final rule is an important step forward in improving our risk-based capital requirements. But as I have noted throughout the development of Basel II, if results from the parallel run or transition periods are unacceptable, I am committed to addressing the shortcomings. In fact, the structure of the Basel II rule was designed to allow us to make adjustments to regulatory requirements on the basis of bank implementation activities and to make informed changes while prudential transition safeguards are still in effect. In this regard, the U.S. agencies, independently and in conjunction with the Basel Committee on Banking Supervision, are reviewing the treatment of certain CDOs and securitizations in the Basel II Framework to determine if further enhancements are warranted.

## **V. Conclusion**

In conclusion, while the condition of the national banking system remains fundamentally solid, the challenges of the last few months are undeniable, as are the likely challenges that remain. As I have described in my testimony today, the OCC is carefully monitoring the credit, market, and liquidity risk management activities at national banks. We also are working with large banks to identify and evaluate critical risk management pressure points, and are assessing more broadly the potential for the current economic downturn to have negative consequences in the wider population of

national banks. In addition, the OCC is leading or participating in work being conducted by broader groups of policymakers such as the President's Working Group domestically, and the Basel Committee on Banking Supervision, the Joint Forum, and the Financial Stability Forum Working Group internationally.

Without a doubt there are more challenges to come, many of which I have touched on in this testimony. However, virtually all national banks remain well capitalized. Many of the specific concerns I have discussed today may reduce income for banks, but they are considerably less likely to lead to any widespread threats to their viability. Indeed, the resilience of the banking system has allowed banks to at least partially step into the breach and continue to provide needed credit as nonbank sources have been forced to pull back.

But as I hope I have made clear, this is a storm that was years in the making: the problems we are now facing are the result of a complex set of forces and market developments that have been building for some time. It is simply not realistic to expect that every problem can be fixed overnight, or that all damage can be avoided. We have made some encouraging progress, but it will take diligence, patience, and hard work to ensure that we continue to have the kind of strong, healthy banking system that Americans expect and deserve.



**Comptroller of the Currency  
Administrator of National Banks**

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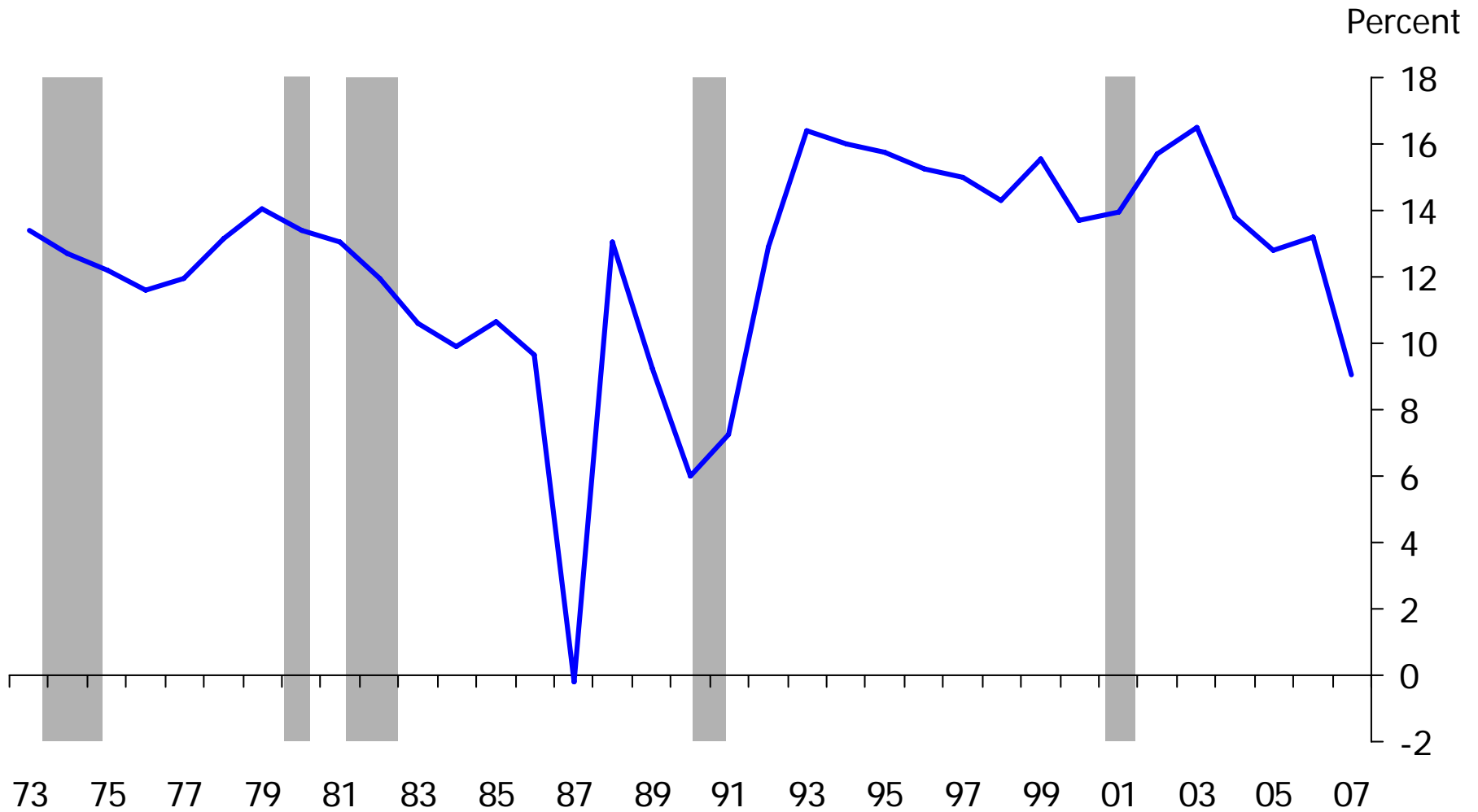
# **Condition of the National Banking System**

**March 4, 2008**

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# National bank profitability

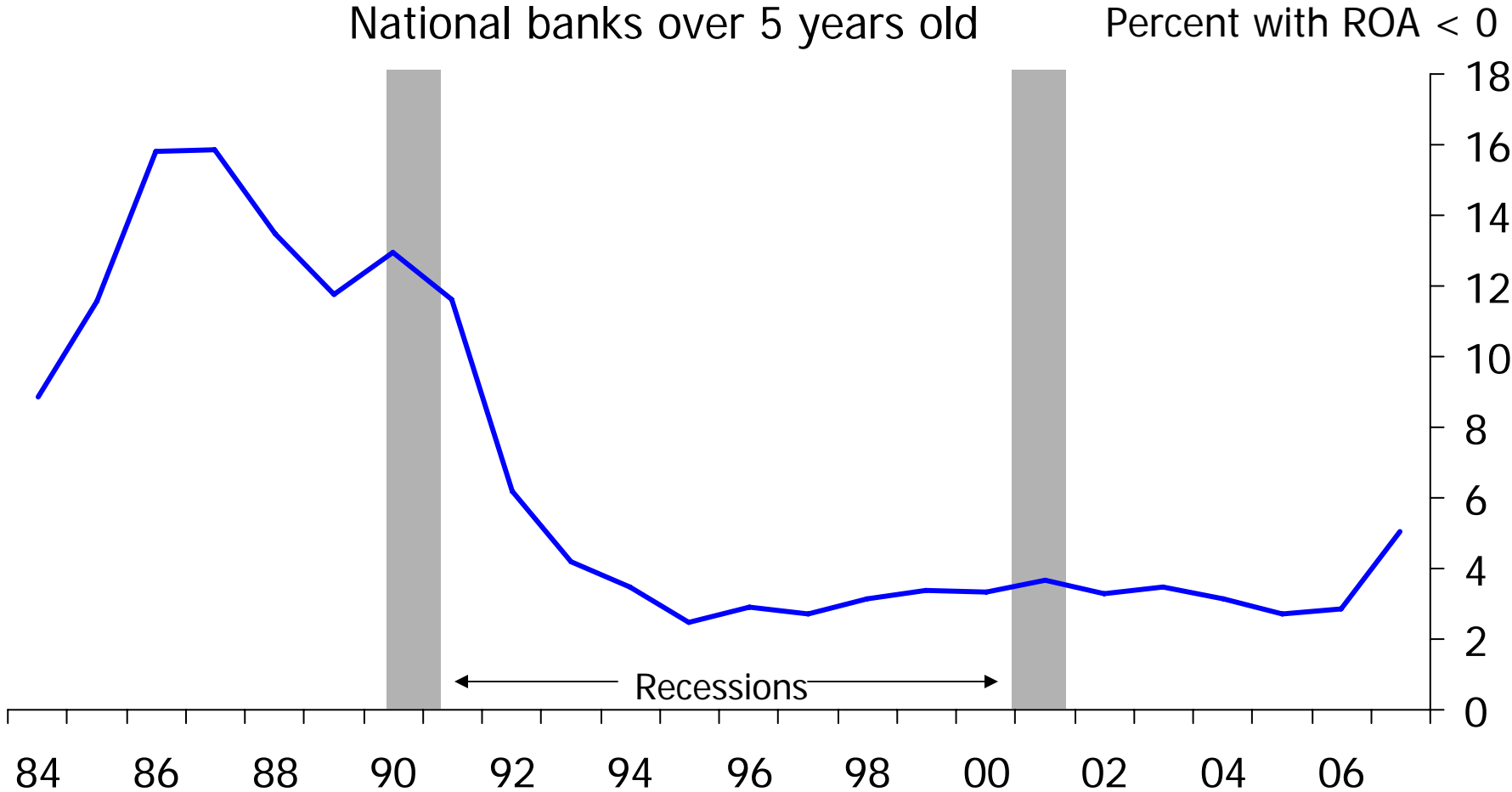
National bank ROE



Source: Integrated Banking Information System (OCC)

Shaded areas represent periods of recession.

# Share of unprofitable national banks is highest since the early 1990s



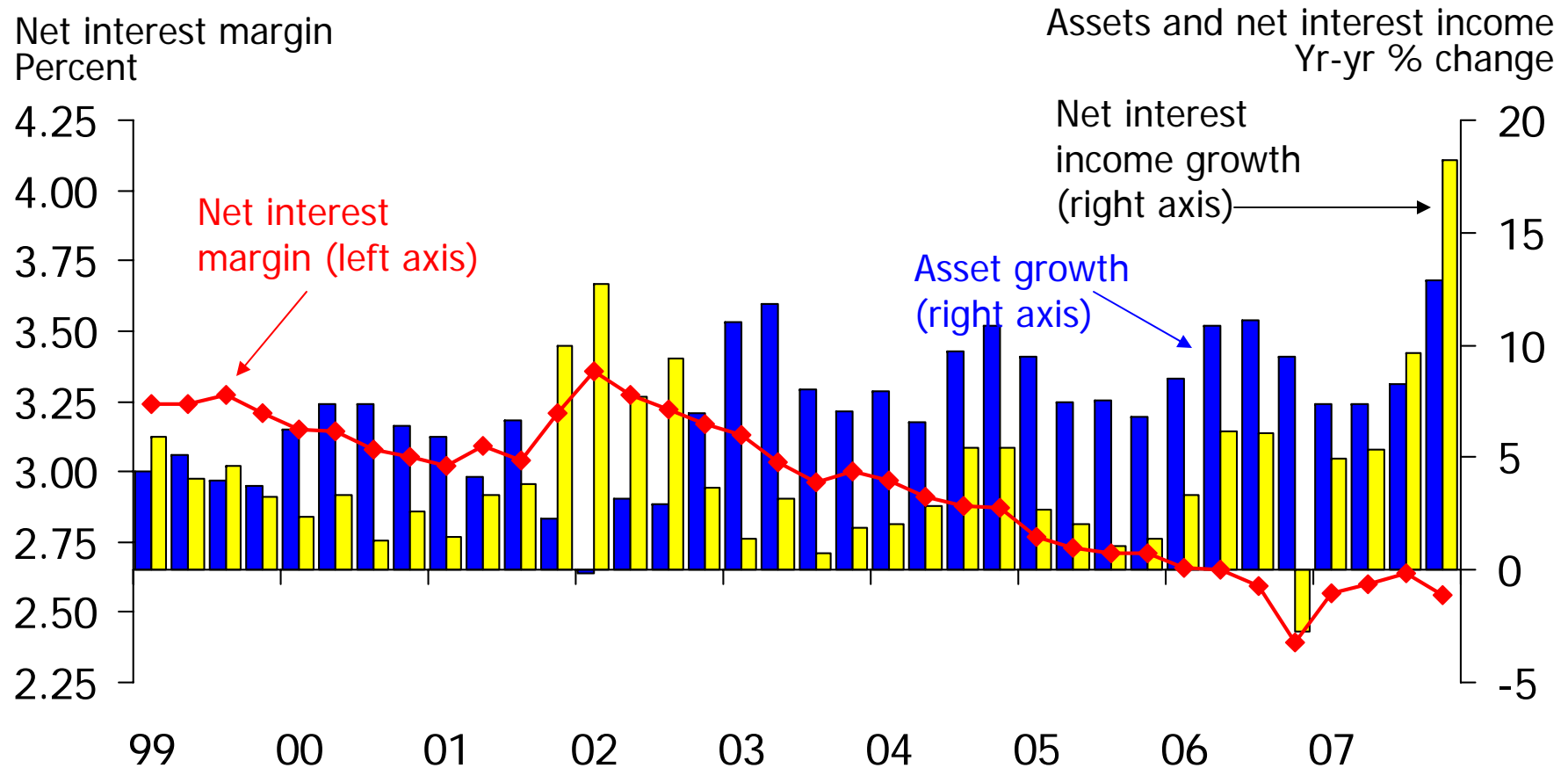
Source: Integrated Banking Information System (OCC)

NOTE: the average bank is not profitable until its 3<sup>rd</sup> or 4<sup>th</sup> full year of operation.



# Large bank interest income benefiting both from increased assets and modestly higher margin

National banks with assets over \$1 billion

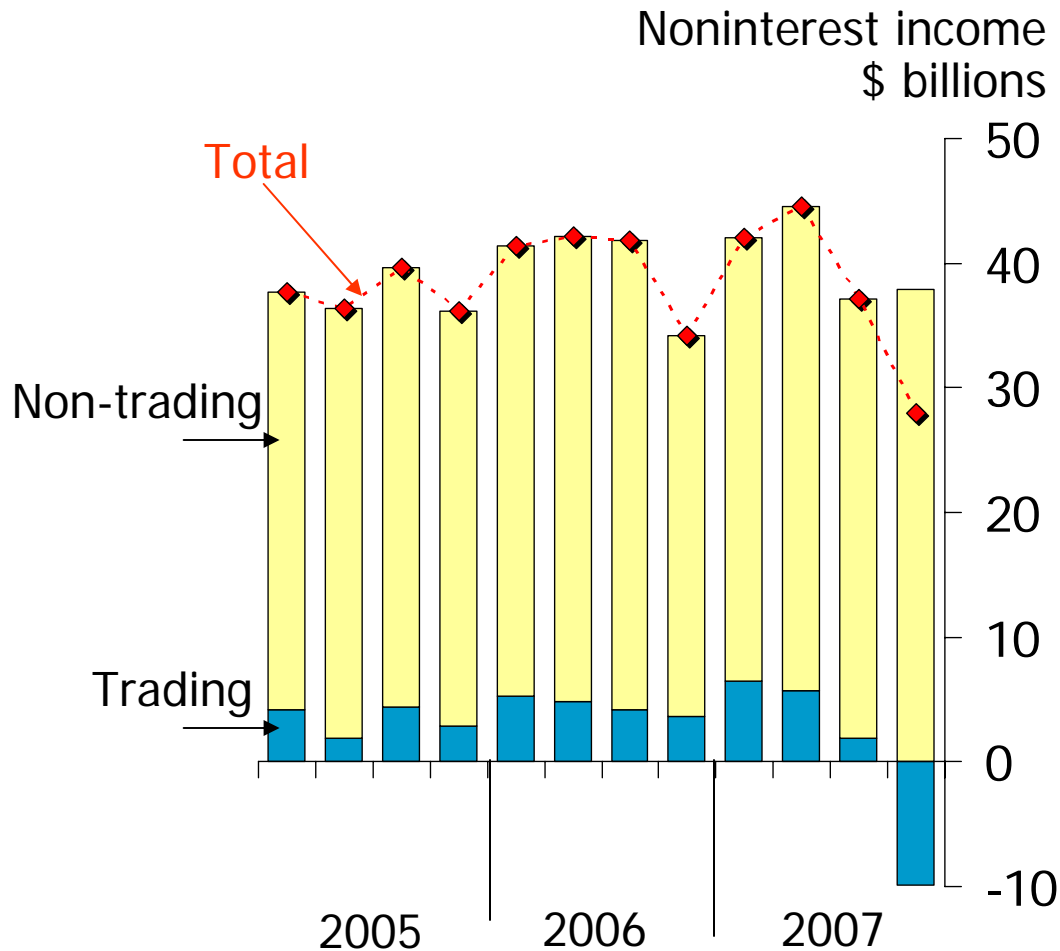


Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007.

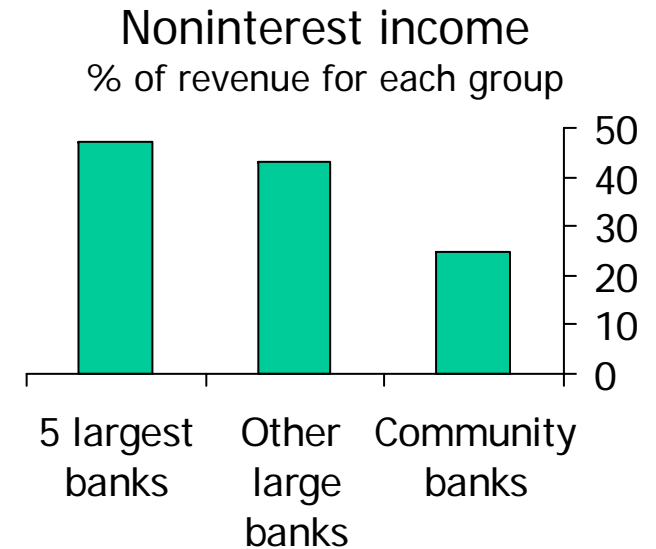
# Trading losses at a few large banks cut heavily into noninterest income

National banks



5 largest banks account for:

- 89% of system trading income
- 73% of system non-trading income
- 74% of system noninterest income

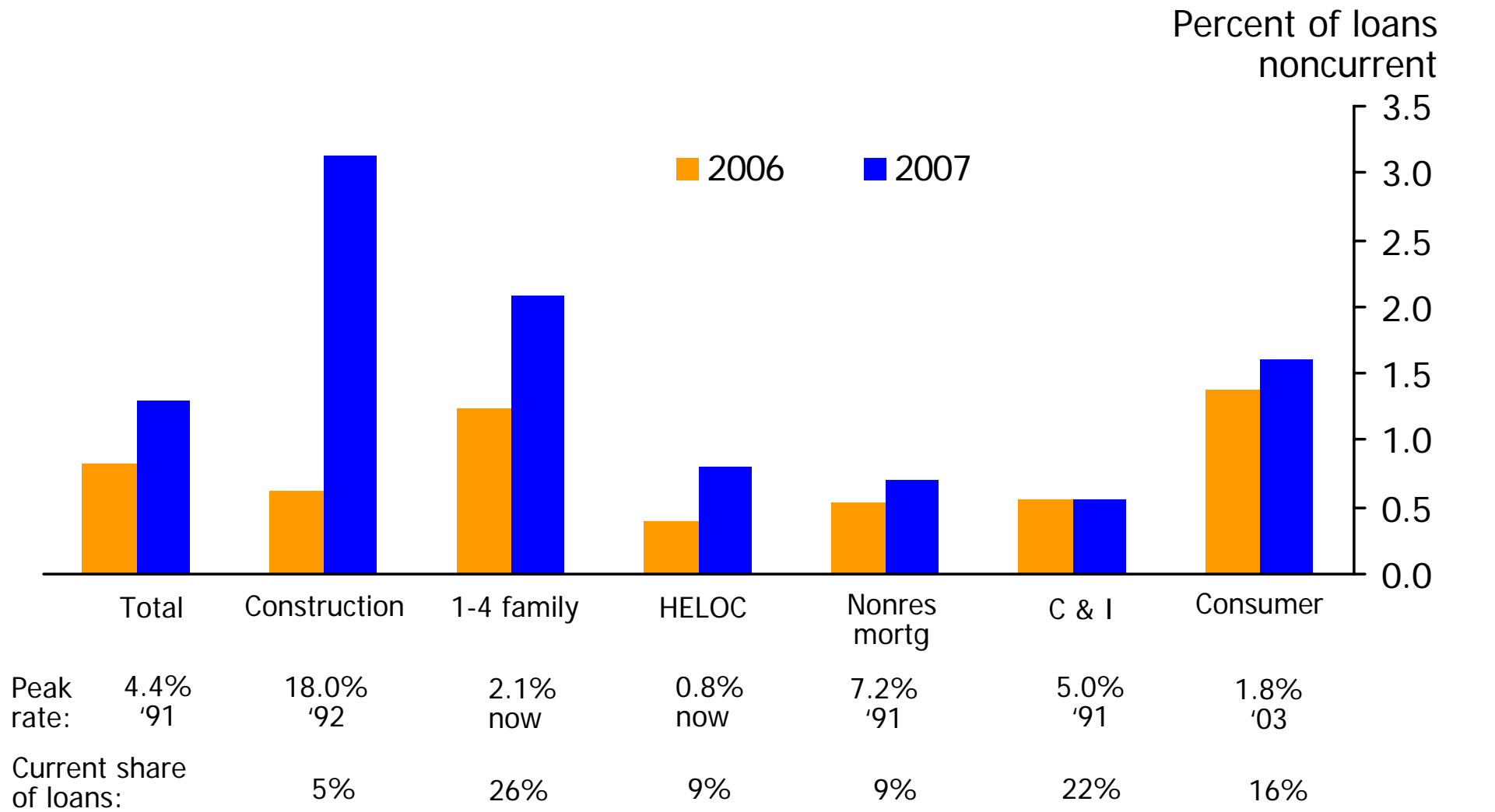


Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007. Large banks are those identified as supervised by the OCC Large bank program; community banks are under \$1 billion in assets.

# Noncurrent construction and residential mortgage loans have risen sharply

National banks



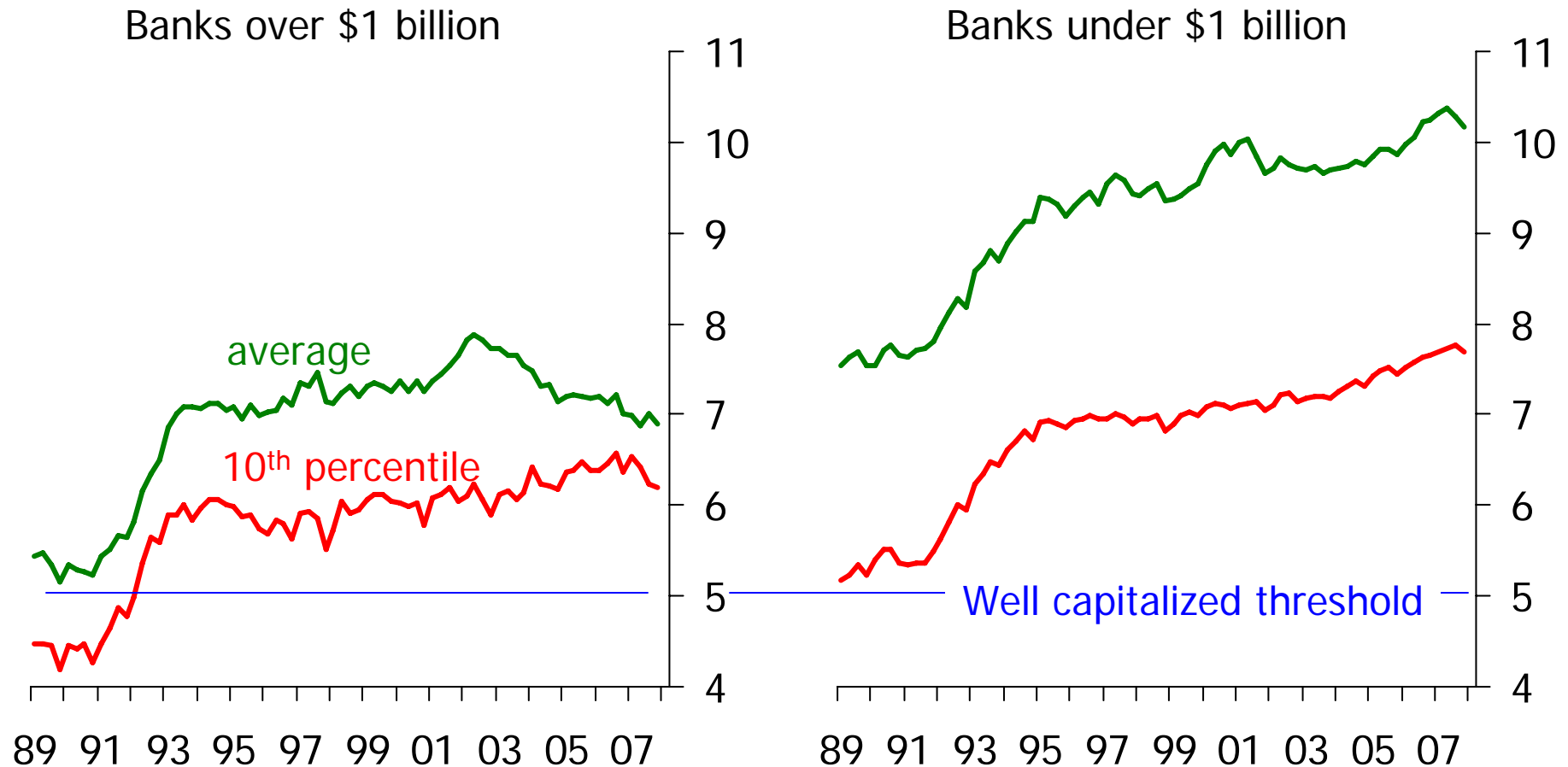
Source: Integrated Banking Information System (OCC)

Noncurrent loans as a percent of loans in respective category.

# Capital ratios remain well above their late 1980s levels

National banks

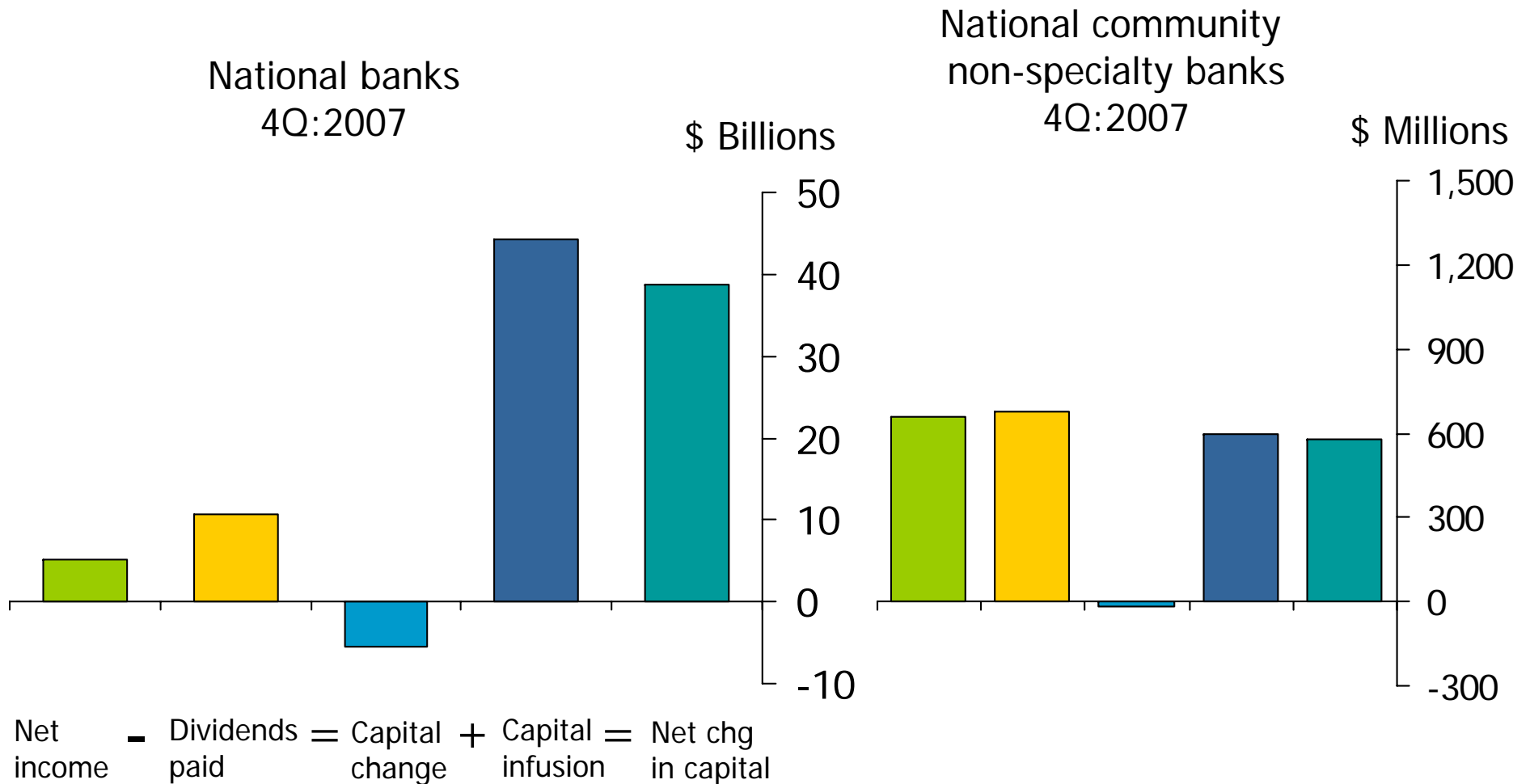
T1 leverage ratio



Source: Integrated Banking Information System (OCC)

T1 leverage ratio is Tier 1 capital as a share of average assets, less disallowed intangible assets.

# Dividend payouts exceeded 4Q net income, but capital infusions more than offset this deficit

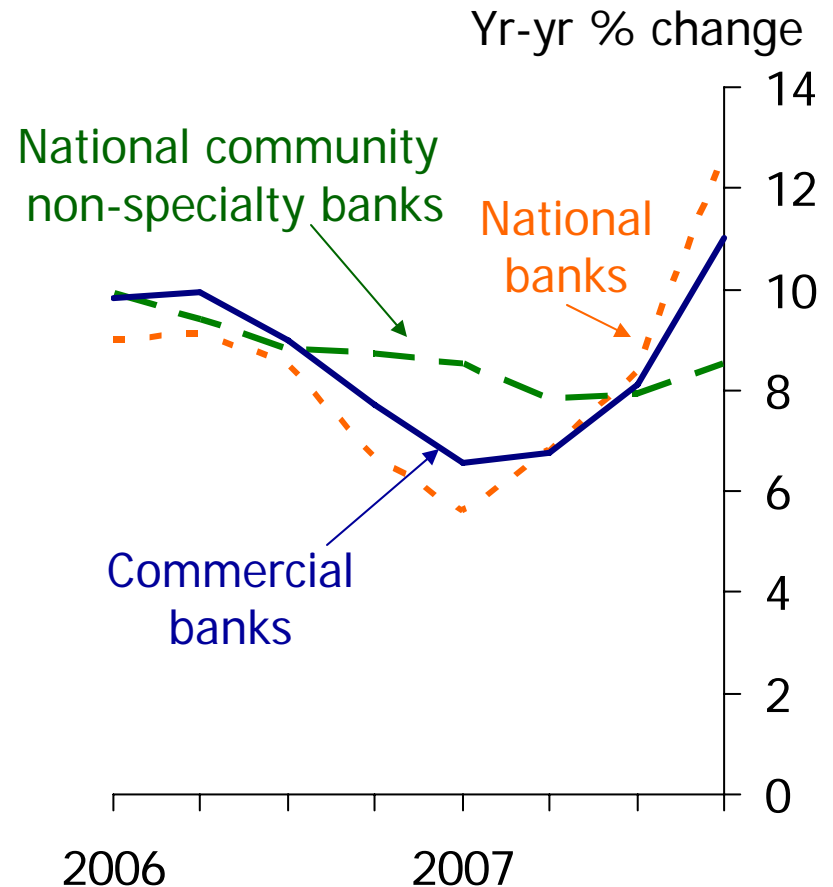
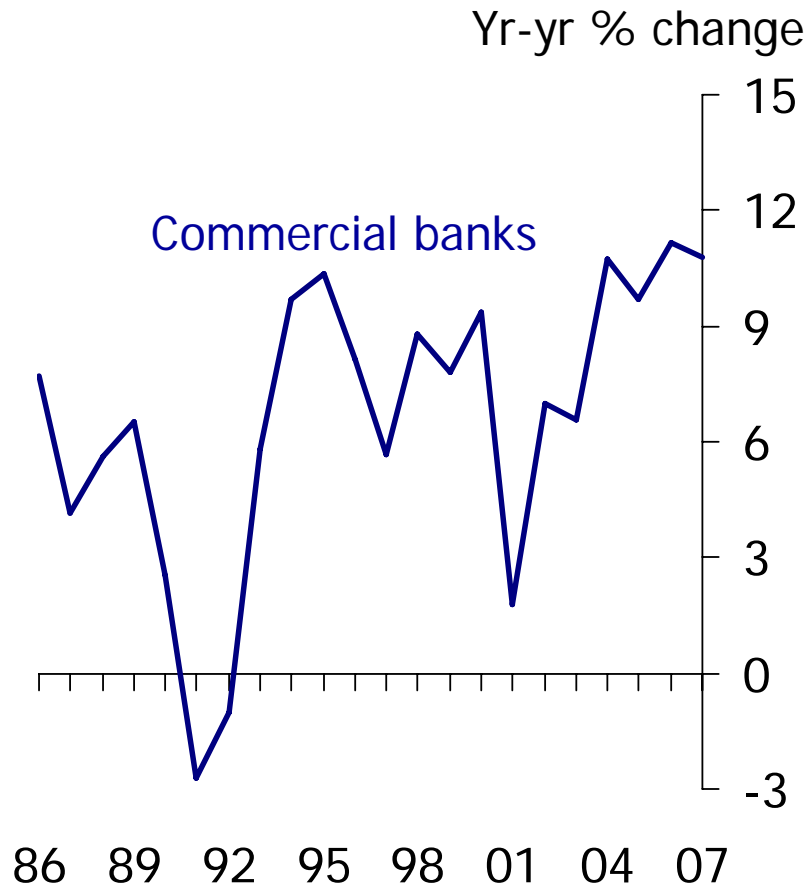


Source: Integrated Banking Information System (OCC)

National community non-specialty banks have assets under \$1 billion and exclude credit card and trust banks. "Capital" defined here as total equity capital. 4Q:07 capital change equaled 5% of total equity as of 9/30/07 for all national banks and 2% for community banks.

# Small and large national banks continued to expand loan book in the fourth quarter

Total loans



Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007. National community non-specialty banks have assets under \$1 billion and exclude credit card and trust banks.