Remarks by
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Before the
Canisius College School of Business
Buffalo, New York
September 14, 2005

It is a pleasure to be here with you, especially so because I'm honored to have been invited by Congressman LaFalce – native of this great city, proud Canisius alumnus, and proud 28-year veteran of the House of Representatives. Members of the bank regulatory community remember the Congressman with respect and affection, as someone who cares deeply about the interests of American consumers and who had a great influence on much of the key banking legislation of recent times. I can say from personal experience that he was always constructive, always fair, and always determined to do his best for his constituents and for American consumers at large.

A century and a half or so ago, lawmakers sensitive to national as well as local constituent needs – statesmen like John LaFalce – created a system of nationally-chartered banks and a new agency, the Office of the Comptroller of the Currency (OCC), to regulate it. No account of this country's extraordinary rise to economic greatness after the Civil War can fail to take note of the vital role of the national banking system. The new system was a unifying force that drew together, with economic laces, the splintered, spreading nation. National banks issued the notes that were the new national currency, they were a robust new source of credit and capital for economic growth and opportunity, and, as a result of the uniform standards and oversight applied to their operations by the OCC, they constituted a network of financially stable and operationally trustworthy financial repositories and intermediaries for customers of all types.

While the currency issuance function of national banks (hence the "Comptroller of the Currency" name of the agency) was long ago superceded when the Federal Reserve was established as our nation's central bank, the other responsibilities of the OCC remain as vital today as they were when the national banking system was first created: Assuring that national banks are safe and sound, that their operations are conducted with integrity, that they are able to evolve and develop the business of banking to serve the ever changing needs of their customers, and that, collectively, they serve as the backbone of a strong national economy. The job of the OCC was – and is today – to ensure, through examination and supervision and regulation, that national banks meet those standards, consistent with the vision that launched the national banking system.

We do this through careful and continual external monitoring of the industry's condition and practices; through evaluation and assessment of each bank's operations through the examination process; and, when we find it necessary, through intervention to correct deficiencies and excesses and, in some cases, to impose sanctions for violations of applicable standards.

I offer this perspective on our history and mission because some say that we, as bank regulators, "only" care about banks' safety and soundness, and safety and soundness is just about how much capital a bank has and how much money it makes. Let me be very clear: The integrity of a bank's operations, including how well and effectively it serves its customers is, inextricably, part of its safety and soundness. A bank is not operating safely and soundly, regardless of how profitable it may be, if its revenues or capital are the product of deception, or discrimination, or other activities that are illegal or illicit.

To illustrate this is very practical and concrete terms, current developments in bank retail credit products, particularly with respect to mortgages, provide excellent examples.

First, some background is helpful. For the past eleven years, the OCC has been polling its examiners on national banks' credit underwriting practices. The most recent of these surveys, which was released just this past Summer, reported a distinct shift in the market for bank loans, with credit terms easing for both commercial and retail borrowers. In light of the overall condition of the banking system and other factors I'll go into momentarily, we find this development worthy of note and careful monitoring, but not overly worrisome. Indeed, as this is the first time for several years running that banks have markedly trended toward easing rather than tightening underwriting standards, the 2005 results could be viewed as a predictable recalibration of the balance between prudence and accommodation in the industry's credit posture.

The 2005 survey included the 71 largest national banks, holding $2.9 trillion in loans – over 90 percent of all outstanding loans in national banks. The survey showed that credit became easier for almost all products within the commercial and retail categories, with only agricultural loans on the commercial side, and credit cards and other direct consumer loans, exhibiting net tightening.

In retail lending, OCC examiners reported that 28 percent of the banks had eased standards, 10 percent tightened, and 52 percent made no change. This was up considerably from 2004, when 13 percent of banks eased retail standards and 13 percent tightened. It was also the first time in the survey's eleven-year history that examiners reported net easing of retail underwriting standards.

Examiners found a number of explanations behind this shift. Overwhelmingly, the most frequently cited reason, in both commercial and retail lending, was competition. These competitive pressures have diverse sources: the end of the housing refinance boom, which has left mortgage bankers scrambling after a shrinking pool of borrowers; ambitious corporate growth goals; and rising interest rates, which have driven banks to seek asset growth to sustain net interest income. Some banks have deliberately shifted toward a more accommodating stance on loan terms as part of strategy to win market share. Their competitors have had to match or exceed these concessions.

But the easing of retail credit standards may reflect something more profound than the customary short-term fluctuations in the credit cycle. It is also a reflection of secular changes both in the way Americans use and think about debt – and in the ways bankers market and manage their retail lending business.

That a shift is underway in the philosophy of retail lending has long been apparent. The change is reflected in the growing focus in banking circles on the income-generating potential of the loan rather than on its repayment. It's reflected in the focus on the ability of households to meet their current, periodic obligations, without regard to amortizing principal. Indeed, judging by some of the loan terms now in vogue, one might conclude that it's quite acceptable – and even desirable -- from the banker's standpoint if the principle balance of consumer loans were <u>never</u> retired.

We've referred to that approach to credit as equivalent to "renting money." And it not only reflects a change in the way households manage their finances; it can also give rise to misconceptions about the level of risk in the banking system and the economy as a whole.

The change in Americans' approach to credit that I'm referring to can be found in the terms available in virtually every stratum of the retail banking market – in auto loans, credit cards, overdraft lines of credit, and more.

But developments in the residential mortgage business deserve special attention. First, mortgage lending, including both first and second liens, represents far and away the largest single item in national banks' retail loan portfolio, amounting to nearly a quarter of all national bank assets and a third of all loans, *and* far and away the biggest debt for consumers. Second, because housing is so bound up with our goals and aspirations as a people, it is an area is of great public policy interest.

The mortgage market has been the scene of extraordinary innovation, driven by industry competition and soaring housing prices. Recently introduced flexible financing options and relaxed terms have enabled many Americans to purchase homes they could not otherwise afford. But these non-traditional mortgage products also have raised concerns – about increased risks for borrowers and lenders and how well those risks are understood; about the extent to which banks' lending practices are fueling real estate speculation and unsustainable housing price appreciation; and about the marketing and disclosure practices spawned by the new practices and whether consumers fully understand the products they are selecting.

Some of the mortgage products that have recently been introduced carry novel and worrisome risks. For example, interest-only mortgages, which allow borrowers to defer principal payments for a certain period, eventually require principal to be repaid at an accelerated pace, meaning much higher monthly payments, especially for adjustable-rate products, once the principal repayment period begins.

Consider the case of a $300,000, 3/1 adjustable rate mortgage (ARM) with a three year interest-only period, initially priced at 4.25 percent. If the loan is repriced by a modest 200 basis points in year four, the monthly payment would go up 81 percent – from just over $1000 to $1900 a month. If the borrower opted for a five-year interest-only period and rates increased 500 basis points – not a far-fetched scenario in the current climate – the mortgage payment could triple.

Even more issues are raised by the new so-called “payment option” adjustable-rate mortgages, which offer not only an interest-only option, but also a “minimum payment” option that does not even cover all of the interest due – in other words, where the mortgage *negatively amortizes.* The unpaid interest is added to the principal, which is usually capped at 115 to 125 percent of the original loan amount.

One could argue – and some do – that interest only mortgages aren’t much different in practice from a traditional mortgage, where payments in the early years are virtually all for interest, and the loan principal doesn’t begin to amortize significantly until several years into the mortgage. Today’s housing ownership trends also reflect an increasing mobile population, where many homebuyers do not plan to stay in a particular home for more than a limited number of years. Viewed from that perspective, an interest only loan might look not much different than a traditional mortgage.

But traditional mortgages, even ARMs, do not have the magnitude of payment shock that an interest-only or payment option ARMs can have. Do customers understand this? And from the lender perspective, what standards do they apply to underwrite these loans? Are customers qualified solely on the basis of their ability to repay the initial amount due in the interest-only period? Does the bank also gauge the customer’s ability to handle the increased obligation that will exist when the adjustable rate begins to increase, and increments of principal payments are added?

And if housing prices enter a period of decline, borrowers could a wind up with a depreciating asset backing a rising loan balance – a recipe for potential trouble for them and their lenders. If home values decline during the interest-only period, owners could find themselves “upside down” that is, owing more on the loan than the property is worth, and potentially unable to refinance when payment obligations are scheduled to increase.

Should this situation lead to default, it is much more likely to result in a loss to the bank than if a conventional mortgage product were involved. Surveys show that banks are significantly less likely to securitize these non-traditional mortgage products than their conventional cousins.

And even traditional mortgage products are being offered on terms that are far more generous – making them riskier – than ever before. For some customers, lenders are dropping income, employment, and asset verification requirements and relying entirely on credit scores. Qualifying credit scores have been creeping downward, and the usual ratios of debt-to-household income used to qualify borrowers have been creeping upward, but there's growing evidence that customers who can't meet even these relaxed standards are being steered into interest-only products whose artificially low monthly payments ensure that they can meet them. And it was not long ago that borrowers needed to come up with at least 25 percent of the appraised value of investment and vacation homes; today, loan-to-value ratios of 90 percent or more on such properties are not uncommon.

As a result of these products and practices, there is today growing credit risk embedded in the banking system – even before we factor in the possibility of softening real estate markets and rising mortgage rates.

Some would dispute that assessment by pointing to the low level of mortgage delinquencies -- lower today, in fact, than they were five years ago -- as evidence of continued strength in the housing markets, prudent and skillful credit risk management on the part of lenders, and responsible financial management on the part of American households. It also has been pointed out that while interest-only mortgages are growing in popularity, especially with larger lenders and in the strongest real estate markets, such loans still amount to only a small fraction of all newly-originated mortgages loans – 11 percent in the second half of 2004.

But these statistics don't tell the whole story. We need to be wary of lagging indicators, such as delinquencies and losses, to gauge credit risk when it is now so much easier for consumers to avoid delinquencies by stretching out the life of the loan and reducing regular payments to a minimum. Today loans are routinely structured so that a borrower can be "current" while doing little or nothing toward erasing his debt. But while risk may be building silently, it is still building nonetheless; and it is incumbent upon lenders to monitor and measure that risk with extreme care, keeping a careful eye on the borrower's financial situation and the condition of local housing markets, to determine whether the loan could be paid off if it needed to be.

Monitoring these sorts of changes in credit products and changes in lending behavior and responding in a measured way is one of the essential challenges facing the OCC as a supervisor. In the past, when we have determined that the critical balance between innovation and calibrated risk-taking, on the one hand, and sound and responsible banking practices, on the other, was askew – we have taken what we believed were timely and prudent actions to restore that balance before more serious problems developed.

In February of this year, for example, the OCC spearheaded the development of interagency supervisory guidance on home equity lending. The guidance flagged issues presented by interest-only products that require no amortization; the appearance of loan-to-value ratios in excess of 100%; growing reliance on automated valuation models instead of full appraisals; and higher loan-to-value and debt-to-income ratios, among others. The guidance outlined expectations regarding the need for heightened vigilance in dealing with the rising credit risk presented by products with these features, and for commensurate increases in banks' credit risk and compliance risk management.

Later this year, we expect to issue similar interagency supervisory guidance to cover first mortgages. Let me quickly review the issues that we see in this arena because they further illustrate how credit risk issues are inextricably linked with consumer risk issues in a bank's overall safety and soundness:

- What standards does a bank use to qualify borrowers? To what extent does the bank look at a borrower's ability to handle rate increases and principal payments? Is the bank looking at income and repayment capacity, or relying a credit score? To what extent does the bank take account of the possibility that the value of credit scores as credit quality indicators may be diminishing?

- Do consumers understand what they are getting into? Interest-only and payment-option ARMs can be complicated products, do consumers receive good disclosure about how these non-traditional mortgage products work and how their payment obligations could increase? Do they understand how interest rate risk is being shifted to them? Are marketing practices employed that help, or hinder, consumers' ability to understand the obligations they are taking on?

- Does the bank recognize and take account of property value inflation affecting the property? If it uses automated valuation models for appraisals, how does it validate that system?

- Is the bank underwriting loans based on its own prudent underwriting standards, or simply underwriting to investor standards and figuring it can later sell the loan? Is it applying different standards for loans it plans to sell than for loans it plans to keep?

- Is the bank watching its overall concentrations of non-traditional mortgage products? Is it tracking the *increases* in indebtedness in those portfolios resulting from negative amortization of option ARMs? In evaluating the quality of its loan portfolio, does the bank recognize that their traditional credit quality indicators, such as loan delinquencies, may be less useful than in the past?

It's too early to say how the agencies will answer these questions, or whether others may arise. But what we can say is that these questions tellingly illustrate how *credit* risks and *consumer* risks presented by today's non-traditional mortgage products have converged. Together, they present important safety and soundness considerations. And together, they are part of the many dimensions of the responsibilities of the OCC as the supervisor of the national banking system.

Thank you.