

Statement of
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Comptroller of the Currency
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
April 20, 2004

Chairman Shelby, Senator Sarbanes, and members of the Committee, I appreciate this opportunity to review the condition of the national banking system and its supervision by the Office of the Comptroller of the Currency.

I would like to make two key points in my remarks this afternoon. These points receive much fuller treatment in my written statement.

First, by virtually every measure, the national banking system – consisting today of about 2100 financial institutions -- is in excellent health. Earnings have been at historically high levels for a decade. In 2003, national banks set records for both return on equity and return on assets.

Loan growth has also been strong overall: in 2002 and 2003, total loans grew by 7.8 and 7.6 percent, respectively. These are truly impressive numbers when one considers that, at a comparable point in the last economic cycle, total loans held by national banks were in the midst of a prolonged decline.

The rise in bank assets has been fueled by the growth in bank deposits that one might expect to see in a low interest rate environment. Deposits at national banks grew at an average 7.4 percent over the past three years. But asset growth has not come at the expense of asset quality. The noncurrent loan ratio for national banks in the second

quarter of 2002 was 1.6 percent; at a comparable point in the last economic cycle, it was 4.4 percent.

Data on failure and new entrants similarly reflects the banking system's health and dynamism. In 2003, only two banks failed – one national and one State-chartered institution. By contrast, 100 commercial banks – including 33 national banks and 67 state banks – failed in 1992, the first year of recovery after the 1990 to 1991 recession. Last year also saw 111 new commercial bank entrants.

By historical standards, the system is also exceedingly well capitalized: today all national banks, with minor exceptions, have risk-based capital above eight percent, and less than one percent of national banks have risk-based capital below 10 percent.

Capital provides a crucial cushion against uncertainty, and that brings me to my second point. Even today's recovering economy poses elements of uncertainty for financial institutions. The high level of liquidity in the banking system could fall rapidly if the relative yield on alternative investments increased sharply. Similarly, concerns have been expressed about declining demand for consumer loans and loans backed by commercial and residential real estate in a rising interest rate environment, as well as the impact of such a development on bank earnings, to which they have made such an important contribution. And, as recent events have taught us, operational, strategic, and reputational risks posed by bank activities can have just as serious an impact on bank soundness as changes in banks' financial condition.

Yet I am optimistic about the ability of the banking system to overcome these challenges, just as it overcame the challenges of the recent recession. Our optimism is based on two factors. The first is the dramatic improvement in the tools, techniques, and

processes available to financial institutions to manage just such risks. Banks increasingly look at risk in more comprehensive terms rather than on a transaction-by-transaction basis. Advances in technology, including sophisticated computer models that enable banks to conduct scenario analysis, permit risk to be managed proactively. Many financial institutions have formed independent risk-management units that are endowed with responsibility for managing enterprise-wide risk. These units typically are responsible for ensuring that business units and the bank as a whole comply with established risk tolerances and limits.

Risk management has also benefited from the use of tools that enable banks to better adjust and manage their risk profiles. The growth of the syndicated loan market has enabled banks to more broadly distribute credit exposures within the banking system, as well as to foreign banking organizations and non-banks. The expanding asset securitization market has provided banks with a way of managing concentration risk and diversifying funding sources. And growth in the derivatives markets has endowed banks with additional tools to manage their credit and interest rate risk exposure.

OCC supervision provides the national banking system with a second layer of protection against the challenges posed by our changing economy – and provides a second reason for optimism. Our risk-based approach involves supervisory policies and processes that tailor OCC oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's appetite for risk. This results in a customized approach that reflects each bank's underlying risk characteristics. It also provides an effective means for the OCC to

allocate resources and to communicate with senior management about areas in need of attention.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we divided our day-to-day supervisory operations into two lines of business: our Community and Mid-Size Bank program and our Large Bank program. The first covers over 2000 national banks and Federal branches and agencies through our network of district, field, and satellite offices.

Our Large Bank program involves the 24 largest national banks. Each is staffed by a resident examiner-in-charge and a on-site team of examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, asset management, and compliance.

Whether attached to the Community and Mid-Size or Large Bank program, OCC examiners are supported by an extensive team of analysts, accountants, economists, and attorneys in our district and headquarters offices, who monitor industry, market, and economic trends, provide technical expertise, and develop analytical tools and models to support our examination functions. This depth of talent assures that the OCC is able to adjust to emerging risks and issues that may arise at individual institutions, within business segments or across the banking industry as a whole.

In response to the growing importance of non-financial risks, we have strengthened our supervision in critical areas of audit and corporate governance. New supervisory guidance, developed both in conjunction with the other U.S. banking agencies and independently by the OCC for national banks, set forth our expectations that

well planned, properly structured, and independent auditing programs are essential to effective risk management and internal control systems.

Finally, I would like to comment briefly on developments relating to the Basel II process. This is an enormously complex and important project in which the OCC has been deeply involved for more than five years. Even so, some important substantive issues have not yet been resolved, and we continue to work hard on those issues.

The important thing to understand is that the Basel process is far from over. Before we adopt final implementing regulations for national banks, a number of important domestic processes will need to be completed. We will need a new Quantitative Impact Study to provide good estimates of what the actual impact of Basel II will be on the capital of our banks. The economic impact analysis required by Executive Order will give us a better idea of the implications of Basel II for our economy. And of course, we will need to continue the dialogue with this Committee and its House counterpart on the progress of the process. Only when all of these steps have been completed will we be in a position to draft and then put out for comment our final implementing regulations.

Clearly it will be a major -- if not impossible -- challenge to get all this done in time to meet the current implementing date of year-end 2006.

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change and improving our approach to

supervision. We look forward to working productively with you, with the members of this Committee, and with state officials as we pursue our efforts to achieve that goal.