

Remarks by
John C. Dugan
Comptroller of the Currency
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It is a pleasure to be with you today, and I want to thank Mike Smith and the New York Bankers Association for arranging this conference. When the bankers of this great state meet, it provides a wonderful opportunity to speak with a uniquely diverse group of institutions about issues that affect the entire banking industry. One of those issues is our recently proposed commercial real estate guidance, which will be the focus of my remarks today.

National Bank Preemption

Before doing that, however, I would be remiss in addressing this audience if I did not briefly discuss national bank preemption. Although this issue has not been as much in the news lately, it remains as important as ever to the national banking system. As you know, recent court decisions have been remarkably consistent in finding that particular types of state laws aimed at national banking activities are preempted. I have been especially pleased with the recognition in a number of these decisions of the reasonableness of the OCC's position in interpreting the authority that Congress has entrusted to the agency in the National Bank Act. Here in New York, the Second Circuit's opinion in *Wachovia v. Burke* is a good example of this, which found that OCC regulations "reflect a consistent and well-reasoned approach to preempting state regulation of operating subsidiaries so as to avoid interference with national banks' exercise of their powers." Likewise, the Southern District of New York in the *OCC v.*

Spitzer case repeatedly described the OCC's positions as reasonable and consistent with the purpose and intent of the National Bank Act.

While this last decision is currently on appeal, I believe that, after a period of intense controversy, the recent chain of court decisions reflects a growing consensus about the uniform federal standards that form the core of the national banking system. The corollary principle, which I fully recognize, is that the OCC shoulders a unique responsibility in implementing a federal regulatory regime that applies credibly and uniformly to national banks operating in every part of the country.

I also recognize that we can and should find more opportunities to work cooperatively with the states to address issues that affect all of the institutions we regulate. One of my priorities since becoming Comptroller has been to engage with state banking regulators, including your own Superintendent of Banking, Diana Taylor, about shared concerns ranging from anti-money laundering practices, to the effective referral and resolution of consumer complaints, to the reach of proposed guidance on non-traditional mortgage products. The Treasury Department has recently established a promising new group called the Consumer Financial Protection Forum, of which both Superintendent Taylor and I are members, whose mission is to find ways to address consumer protection issues at the intersection of state and federal banking. This kind of cooperation in marshaling our resources for our respective institutions is a critical step toward a more constructive and productive working relationship.

The Proposed Commercial Real Estate Guidance

Let me now turn to our proposed new interagency guidance on commercial real estate lending, which is out for public comment until April 14th. Last year, banks made about 1.3 trillion dollars in commercial real estate loans nationwide, with 55 billion dollars of that coming right here in New York State – a 16 percent increase in just one year. So it's not entirely surprising that our proposed guidance has generated an outpouring of comment letters – well over a thousand already. The concerns expressed in these comments have been amplified in many of my face-to-face discussions with bankers, especially mid-size and community bankers.

These bankers point out that commercial real estate has been a very strong business: the underlying collateral is real; demand has remained strong; and smaller banks can compete. In this context, bankers worry that the proposed guidance will cap or restrict their participation in one of their best performing sectors.

That is not what the guidance is intended to do. Concentrations in commercial real estate lending – or in any other type of loan for that matter – do raise safety and soundness concerns. It is our job as regulators to focus institutions on ways to address those concerns. But our message is not, “Cut back on commercial real estate loans.” Instead it is this: “You can have concentrations in commercial real estate loans, but only if you have the risk management and capital you need to address the increased risk.” And in terms of “the risk management and capital you need,” we're not talking about expertise or capital levels that are out of reach or impractical for community and mid-size bankers – because many of you already have both.

So today I would like to address some of the worries and misconceptions I've heard about the proposed guidance by providing more detail about three points: why we're concerned; what the guidance says to address those concerns; and, in practice, what the guidance really means and does not mean.

So let's start with the source of our concerns. Today, 30 percent of national banks hold commercial real estate loans in amounts exceeding 300 percent of capital. Nearly all of these institutions are mid-size or community banks, which in the not-too-distant past rarely exhibited this degree of concentration in this type of lending.

Let me provide some perspective on why these numbers have raised our antennae. Fifteen years ago the OCC defined a concentration of credit as one that exceeded 25 percent of capital. When examiners spotted such a concentration, they were required to flag it on the examination report. And I've been told by our supervisors that, not very long ago, if a national bank held loans of any type exceeding 300 percent of capital, that would have triggered a serious discussion with the board of directors about plans for diversification and possibly more capital.

Obviously, specific supervisory standards change over time. But one thing that hasn't changed is the fundamental principle that loan concentrations require enhanced risk management from bankers and enhanced scrutiny from supervisors.

That's especially true if the concentration is in an asset category as volatile as commercial real estate – a business well known for its sharp and unpredictable turns. We saw this volatility most recently – and, for many bankers, disastrously – in the late 1980s and early 1990s. The degree to which banks participated in the run-up of the commercial real estate market in the early '80s turned out to be one of the best predictors of

subsequent bank failure. On average, banks that failed had nearly three times as many commercial real estate loans as a percentage of their total assets as banks that did not fail. And perhaps even more striking, all but the largest banks in that period had much lower concentrations in commercial real estate than they do today. For example, in 1987 national banks with assets in the 250-million-to-one-billion-dollar range as a group had commercial real estate loan concentrations of approximately 175 percent of capital – compared to nearly 300 percent today.

Thankfully, credit underwriting standards for commercial real estate lending today are much more rigorous than they were in the 1980s. Nevertheless, we have seen slippage at some banks in the last two years that has compounded our concerns with increased concentrations. Beginning in 2003, the OCC conducted a series of “horizontal” examinations – ones that focus on a single line of business across multiple institutions – in order to supplement and deepen our regular examination analysis. We found erosion in key areas: lengthening maturities, increasing policy exceptions, narrowing spreads, and lack of independence and quality control in the appraisal process.

We also found that risk management practices had begun to lag the risks raised by commercial real estate concentrations. Some banks demonstrated weaknesses in the fundamental risk management areas of board and management oversight, sound underwriting and internal controls, risk assessment, and monitoring – especially the type of monitoring that should be taking place through effective management information systems. In other cases, banks were not taking advantage of newer technological tools that help manage concentration risk, including basic risk management models and stress testing methods. These tools do exist; they are more powerful than ever before; and they

are available to community and mid-size banks. But they might as well not exist if banks that need them don't use them.

In short, while we believe that commercial real estate concentrations can be safely managed, they must be effectively managed in order to be safe. And because we were seeing weaknesses in that management, we issued the proposed guidance. So let me talk now about what it says.

The basic premise of the new guidance is unchanged from the 1993 interagency guidance on commercial real estate lending, which the OCC updated and incorporated into a separate examination handbook in 1998. It is this: where commercial real estate loan concentrations exist, banks must have risk management systems and capital appropriate to the risk of those concentrations. Indeed, at its core, the proposed new guidance is simply a restatement and amplification of the supervisory guidance that the agencies developed in the wake of widespread bank failures precipitated by commercial real estate lending less than 20 years ago.

What the new guidance does for the first time is provide a simple definition of what we mean by commercial real estate concentrations. This definition is intended to answer the questions we have received over the years from many bankers frustrated with the ambiguity and lack of clarity of our previous guidance. Specifically, the proposed guidance provides more straightforward concentration thresholds that, once crossed, trigger the need for enhanced risk management and capital levels. The first threshold is defined as those commercial real estate loans made for construction, land development, or other land that in the aggregate exceed 100 percent of capital. The second threshold applies when all commercial real estate loans made by a bank exceed 300 percent of

capital. Importantly, the definitions exclude owner-occupied loans, but they do include unsecured loans to developers and REITs.

Why have we chosen as benchmarks 100 and 300 percent, as opposed to some other figures? The answer is this: these threshold numbers resulted from three years of intensive discussions involving experts from the private ratings agencies, the banking industry, and the regulators. These experts reported on their decades of experience in assessing commercial real estate lending and correlating it with risk. The degree of consensus on what constituted fair and reasonable benchmarks for concentration was striking, and that consensus translated into the benchmarks that the agencies unanimously adopted.

Having defined commercial real estate concentrations, the proposed guidance then sets forth the requirements that will apply to banks that have them, which fall into two categories: risk management and capital. Regarding the former, the guidance elaborates on the principles and components of an effective risk management program. For example, instead of simply invoking the importance of effective board and management oversight, the guidance discusses what that might include, such as timely reports on changes in market conditions and the bank's activity and risk profile. It further discusses the requirements of a solid information system that allows management to better understand risk by tracking property type, geographic area, tenant concentrations, tenant industries, developer concentrations, risk ratings, and the like. And it describes in detail what is meant by enhanced underwriting practices, so banks can take appropriate corrective action before their next examination.

In terms of capital, the proposed guidance is more general: it says simply that banks with commercial real estate concentrations should hold capital higher than regulatory minimums and commensurate with the level of risk in their commercial real estate portfolios. While it's hard to argue with that basic proposition, your comments have indicated considerable uncertainty about what it will mean in practice, just as there have been repeated questions about what we really mean by our discussion of effective risk management practices. So let me turn now to the final part of my remarks, which is our take on what the proposed guidance would mean in practice, and what it would not mean. I would especially like to address a few of the misconceptions that surround the guidance and, hopefully, put some of your concerns to rest.

Probably the most common concern I've heard is that the 100/300 percent thresholds will quickly turn into hard caps – that is, examiners will apply the guidance in a way that will effectively leave banks no choice but to reduce their commercial real estate lending in order to reduce their concentrations to levels below the thresholds. Again, let me say categorically that this is not our intent. Far from being caps, these numbers are simply screens to determine where enhanced risk management and adequate capital is needed, as the guidance makes clear. Of course, those institutions that are unable or unwilling to make such enhancements should reduce or avoid concentrations, but that is a very different point from saying categorically that the thresholds are caps or limits. We are emphasizing this very point – that the thresholds are triggers for better prudential practices, not caps – in discussions with our examiners in every region of the country, including this one, where we just concluded our district staff conference last week.

The other concern I've heard most often involves the capital part of the guidance. Notwithstanding the actual language in the proposal, which is quite general, some bankers are worried that supervisors plan to seize the guidance as an opportunity to increase capital requirements for any institution exceeding the concentration thresholds. Again, that is certainly not the intent of the OCC. It is true that the guidance calls for capital exceeding regulatory minimums for institutions that hold such concentrations. But the simple fact is that the overwhelming majority of such institutions already hold capital cushions that exceed regulatory minimums by more than two hundred basis points, and, as a result, these institutions generally would not be affected by the capital adequacy part of the guidance.

More important, our focus in applying this guidance will be first and foremost on risk management practices. To the extent that an institution with a concentration exceeding one of the thresholds has enhanced risk management practices in place, or is moving in that direction, our concern with increased capital is greatly reduced. By the same token, an institution with a concentration but no prospect of enhancing risk management practices within a reasonable period of time would indeed be a candidate for increased capital requirements.

Finally, there is a certain amount of concern that the guidance will be implemented in an arbitrary and irregular way, disadvantaging some lenders and benefiting others. In truth, one reason we felt it was important to issue the guidance was that, over the decade since similar guidance was last issued, we'd been hearing from bankers about growing variances in interpretation and application across charters and geographic regions. This was not only a source of frustration and confusion for the

industry; it also tended to undermine the credibility of our regulations and supervision.

Our new proposed guidance is intended in part to achieve greater consistency and a more level playing field among all financial institutions.

Just a few final words. Any discussion of the supervisory implications of commercial real estate lending inevitably evokes the banking crisis of more than a decade ago – a crisis in which commercial real estate lending clearly played a critical role and left an indelible mark. It is hard to overstate the impact of that crisis on our economy – or on those who were personally involved in it. I was serving on the staff of the Senate Banking Committee at the time, watching an event unfold that ultimately left more than 1600 banks closed or in need of government assistance, nearly bankrupted the deposit insurance fund, and imposed huge costs on the economy. That experience profoundly affected my own views on banking and bank supervision.

On the other side of the coin, I also have vivid memories of the so-called “credit crunch” of the early 1990s, when credit for commercial real estate became very difficult to find. Some argued that regulators had overreacted to the banking crisis by mandating overly restrictive underwriting policies, while others believed that bankers themselves were overreacting to the problems caused by past credit practices. Either way, it was a painful period from which it took a good bit of time to recover.

Needless to say, when it comes to commercial real estate, we as regulators and you as lenders should be doing all that we can to avoid both increased bank failures and a credit crunch. The best way to do that is to address smaller concerns effectively before they grow into much bigger problems that precipitate more extreme actions and reactions. That’s precisely what the proposed guidance is intended to do. Of course, if you still

think we've got any aspect of the guidance wrong, I encourage you to write us a letter before the comment period closes at the end of next week.

In sum, we recognize that commercial real estate lending has been and will continue to be a very good business for banks – all banks – provided that it is effectively managed. At the end of the day, that is the very essence of the proposed guidance.

Thank you very much.