Remarks by
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In the spring of 1991, as a deputy assistant secretary of the Treasury, I spoke at this very conference on a proposal to modernize the regulation of banks. Little did I know that, 15 years later, I would be back – now as the Comptroller, with day-to-day responsibility for carrying out many of the changes that were set in motion way back then. I guess the moral is, be careful what you wish for! One thing that has not changed, however, is the great honor of speaking here, before this conference, on the cutting-edge banking issues of our day. So it is a special pleasure to be here.

The mission of the Office of the Comptroller of the Currency is, and always has been, supervision. We supervise all types of banks in all parts of the country, from the smallest community banks to the trillion dollar "megabanks," from ag banks to credit card banks, and from federal branches of foreign banks to one-branch banks that do their business close to home. Because of this exclusive focus for the last 143 years, the OCC has accumulated a broad base of specialized knowledge and experience in supervising banks as they have changed, expanded, innovated, and failed. Over the years the agency has developed an approach to supervision that is very much tailored to the particular problems at hand.

In short, we like to think we have stayed "on topic" since the Civil War, and I intend to remain true to that tradition today. On the last day of a conference whose theme is "Innovations in Real Estate Markets and the Role of Regulation," it seems appropriate to offer some observations about recent trends in bank real estate lending, the peculiar risks they pose, and the particular supervisory strategies that we are developing to address these risks.

A Changing Business Landscape

Recent changes in the patterns of bank real estate lending are at least partly a response to shifts in the competitive landscape that affect all U.S. businesses. Not very long ago most business transactions were fundamentally local. Nondurable goods were usually produced, distributed, and sold to end users in a geographically constrained marketplace. And durable goods were frequently produced on a regional basis by a few large firms.

In today's marketplace, however, even small businesses directly source product from around the globe. Firms find themselves competing in an expanding universe of markets for the business of customers about whom they may know very little. Their involvement in global markets has produced exposure to fluctuations in commodity prices and foreign exchange rates. And that, in turn, has increased reliance on more comprehensive and integrated analysis of risk and the most sophisticated risk management tools.

Firms have not only learned how to manage this risk, but also to profit from it. Some have carved lucrative niches in the marketing and analysis of information generated to support their own risk management needs. Financial services firms have proved especially adept at using this information to develop a broader range of differentiated financial products and services tailored to their customers' risk profiles. Thus, the risks of the evolving marketplace are paving the way to greater innovation and growth.

In this context, my remarks today will address two basic points: the strategic response of the U.S. banking industry to this new competitive environment, using real estate lending as a prime example; and the particular supervisory approaches that we and the other federal banking regulators are crafting to address the unique supervisory issues raised by this response.

Two Responses from Two Groups of Banks

In very broad terms, there have been two types of responses to the new competitive environment, one from banks that seek new opportunities in evolving markets, and another from those that choose to specialize in markets where they have particular expertise and experience. Banks in the first group – typically larger institutions – have responded by diversifying their revenue streams, developing new products and services, and enhancing the features of existing offerings. They have embraced the world of multiple risks as a way of cushioning themselves against excessive exposure to any one risk. Despite differences of emphasis and image, it is the similarities of these large banks that stand out most, which are the result of their common drive toward product and geographic integration. Once primarily identified in the public mind as commercial lenders, they have expanded to become aggressive players in the retail market, where they have leveraged their brand recognition, extensive infrastructure, and marketing prowess to build national delivery networks. This is especially true for products with commodity-like features, such as credit cards and home mortgages, that are less dependent on customer relationships. They have also become aggressive risk managers, selling many assets that they once held, and carefully calibrating their hedging strategies in an effort to take only those risks that they choose to assume.

Banks in the second group, often midsize and community banks, have chosen a different business strategy to remain viable and competitive. Although their share of the U.S. banking market has been diminishing for some years, these banks continue to wield considerable economic influence in many banking markets. Taking advantage of their strong customer relationships and community-based focus, many of these smaller banks have chosen – or been forced – to recommit themselves to their core competencies. They have made the eminently rational decision that, for them, competitive advantage lies in the superior knowledge, service, and efficiency that accompanies specialization. Accordingly, they have narrowed their arena to regional geographies, to specific products and services, and, often, even to functional segments such as originations, servicing, or interim financing.

Different Approaches to Real Estate Lending

Recent trends in real estate lending provide a salient example of these two quite different approaches to the banking marketplace. Extending credit for the construction and financing of real estate, both commercial and residential, is a core banking activity that plays a critical role in our economy. The credit fundamentals are well understood, and complementary markets that promote efficiency and liquidity at each stage of the development, construction, sale, and financing process have become well established over time.

Significant advances in technology have been important contributing factors in the growth of residential real estate lending, especially at larger institutions. More information is available on the credit history of potential borrowers. Improved computing power allows for more sophisticated estimation of the potential riskiness of these loans by borrower and loan characteristics. And the cost of handling the large volume of transactions associated with retail lending has fallen. These factors have also helped provide greater depth and sophistication to secondary markets for loans, which has been especially important for residential real estate projects. Of course, it takes a considerable investment to take full advantage of these improvements, and a sizeable volume of transactions may be necessary to recover these costs.

Between 1999 and 2005, total real estate loans on the books of national banks doubled, from $800 billion to more than $1.7 trillion, an increase slightly greater than the growth in total loans and assets. More telling, however, was the change in the composition of real estate loan portfolios in our two groups of banks. Larger banks – the "diversifiers," as I have termed them – have come to dominate the national market for home mortgages, while smaller banks have increasingly focused their attention on the localized market for commercial real estate loans.

To illustrate the first trend, in 2001, our larger national banks held 78 percent of all residential mortgage loans on national bank balance sheets. Today, that number is 91 percent, with the share held by the smallest national banks (those with assets under $1 billion) having dropped by about half during the same period. Similarly, in 2001, according to Inside Mortgage Finance, the top five institutions' share of the mortgage origination market was 38 percent. Today it stands at 47 percent, with the top ten originators responsible for three of every five new mortgages, and the top 30 for nearly five of every six.

For our second group, of smaller banks, the trend has been quite different: commercial real estate lending has grown in importance as residential mortgage lending has faded. During the last ten years, while their total real estate loans have held steady, their commercial real estate loans have increased by nearly 50 percent. Clearly, smaller banks are becoming increasingly specialized – and concentrated.

These two very different approaches to real estate lending have resulted in two very different types of risk, which I would like to summarize now, beginning with our smaller banks' concentration in commercial real estate loans.

Commercial Real Estate Lending: Concentration Risk

An undisputed historical fact looms over any discussion of commercial real estate lending: concentrations of these loans contributed in an important way to the wave of bank failures that occurred in the late 1980s and early 1990s. Indeed, banks that failed during that period had nearly three times as many commercial real estate loans as a percentage of their total assets as banks that did not fail.

Commercial real estate markets are inherently cyclical, which adds risk to commercial real estate lending. Real estate markets are subject to periodic overbuilding, and can be affected not only by changing local economic conditions, but also by circumstances in other regions of the country and the world. Construction costs vary from project to project and may be difficult to forecast, yet bankers must evaluate these costs to make prudent lending decisions.

As risk management tools and techniques have improved, so has the quality of commercial real estate lending in the banks the OCC supervises. Although we have seen some slippage of late, driven largely by intensifying competition, credit underwriting standards for commercial real estate lending are generally high today. Our concern, rather, is with rising concentrations and how they're being managed. For a frame of reference, consider that, in 1987 – a year of acute problems for the national banking system – national banks with assets in the mid-size and community bank category as a group had commercial real estate concentrations of approximately 175 percent of capital. Now, for banks of the same size, that concentration ratio has risen sharply, to 270 percent. Moreover, thirty percent of national banks today – nearly all of them mid-size or community banks – hold commercial real estate loans in amounts exceeding 300 percent of their total capital.

I should emphasize that, while concentrations pose a known risk to safety and soundness, this risk can be effectively addressed if properly recognized and actively managed. Of course, banks with real estate lending concentrations must also have adequate capital to address the increased risk, as most of these smaller banks already do. Capital helps to underpin the institution's solvency when, notwithstanding strong underwriting and risk management, the cycle turns and the concentrations result in elevated levels of problem assets.

Residential Mortgage Lending: Payment Shock and Reputation Risk

Now let's shift back to residential mortgage lending, where the risks are quite different. In fact, traditional home mortgage lending has posed far less credit risk for banks than commercial real estate lending. One reason for that is the well-established secondary market that enables lenders to mitigate risk by selling huge volumes of mortgages to third parties. Another is the well-known propensity of borrowers to do just about anything to protect the roofs over their heads. Put another way, when cash is short, it's the mortgage that gets paid first.

That's not to say that mortgage lending is without credit risk – or that the only risks that warrant supervisory action are those that pose a mortal threat to a bank's existence. Indeed, the recent spike in the volume of so-called nontraditional mortgages – primarily interest-only and payment-option mortgages – has increased bank exposure to both credit risk and reputation risk, while at the same time raising important consumer protection issues.

It wasn't the structure of these nontraditional products that caught our attention – after all, they've been around in various forms for 25 years – but, rather, changes in the way they were marketed. Lenders previously limited these products to more creditworthy borrowers for use as a cash-management tool. For example, payment option adjustable rate mortgages allowed borrowers to cushion the blow of a temporary rise in interest rates, which would increase monthly payments, by exercising the option to make a smaller monthly payment than would otherwise be required to cover the full amount of the increased interest accruing on the loan. Of course, any unpaid interest would be added to the underlying principal balance of the mortgage in a process known as negative amortization.

During the recent spike in nontraditional mortgage lending, however, banks and other lenders began selling these new instruments as a type of "affordability product" – that is, as a product that the borrower would use as the only way to qualify for, or afford, a given mortgage. This was accomplished by reducing the almighty monthly payment in the early years of the mortgage. But the trade-off for these much lower monthly payments in the present is the requirement to make much higher monthly payments in the future, typically five years after the beginning of the mortgage.

The risks of a payment option ARM can be masked in a real estate market that experiences rapid home price appreciation. By the time the typical five-year period of lower monthly payments expires, the mortgage can be refinanced and all accumulated charges paid off by extracting the increased equity in the appreciated home. This works for lenders, too, who can book the fully accruing amount of interest and fees as income, regardless of how much revenue has actually been received in cash.

But what happens if rates rise, or house prices fall, or both occur? A borrower could easily be stuck with a mortgage that exceeds the value of his or her home, making it very difficult to refinance or sell that home. That would also mean getting stuck with a much, much higher monthly payment, which might not be one that the borrower could afford, leading to default and foreclosure. And that, in turn, would expose a lender with a portfolio of such loans to very substantial credit risk.

One mitigating factor is that the banks holding the bulk of the system's residential mortgages are the larger, more diversified financial institutions that would be better able to withstand losses from any one business line. Still, lenders with large portfolios of nontraditional mortgages could find themselves in very difficult circumstances indeed if real estate markets were to slump and/or interest rates were to rise substantially. Clearly, these very plausible scenarios could have a significant impact on the quality of bank portfolios, with possible implications for their capital and earnings.

Finally, increased credit risk is not the only concern with the spike in nontraditional mortgage lending. Another is that these products generate increased reputation and compliance risks. With the industry under competitive pressure to maintain loan volume, these products are being down-marketed and mass-marketed to less creditworthy customers who are more vulnerable to the potential payment shock. Already, lenders are facing lawsuits from customers claiming that these products were sold to them without adequate disclosure regarding their risk.

These concerns with nontraditional mortgages products, even if they became a reality, might not result in the failure of a single bank. But in combination they nevertheless have the potential to impair an institution's earnings and capital; sully its reputation; impair its relationship with consumers; and impede its ability to fulfill the public's future need for home loans.

Tailored Supervisory Responses

The peculiar risks generated by these changes in real estate lending clearly warrant supervisory response. But what kind of response? The answer comes from our evolving understanding of the goals and techniques of bank supervision.

More than seventy years ago, in the wake of the Great Depression, Congress and a generation of bank supervisors seemed to adopt as their overriding goal the elimination of bank failures. To achieve that goal, they established strict limits on bank powers and a rigorous regime of bank examinations. But, by discouraging banks from taking appropriate risks to fulfill their fundamental role as financial intermediaries, this myopic focus on preventing bank failure proved counterproductive in some respects. While failures <u>were</u> nearly eradicated, at least for a time, the price was reduced innovation. Banks lost their competitive edge, as well as many of their customers.

Since then, we have come to recognize that the supervisory process must support a competitive banking industry – one that takes risks – as well as a safe and sound one that avoids excessive risk. Our supervision works best when it aids banks in the identification of emerging and growing risks – a process that encourages banks to develop advanced tools and techniques to manage those risks, for their own account and for their customers. Our proposed commercial real estate guidance and our proposed nontraditional mortgage guidance reflect this approach to supervision.

I have already discussed the market conditions and practices that each issuance of our proposed guidance is intended to address. Without going into further detail given the shortness of time, I believe it is as important to recognize what each type of guidance does not say, as much as what it does. Neither is intended to restrict the availability of credit to finance commercial real estate or home sales. To the contrary, each is intended to address concerns early, effectively, and without undue disruption. This, in turn, is intended to foster a climate of stability in which credit remains available on reasonable terms to support developers and homebuyers alike.

Thus, our proposed residential guidance is not intended to ban innovative mortgage products. We believe that financial innovation is vital to promote the national goal of homeownership, and we encourage it. What our proposed guidance seeks to do instead is to ensure that all nontraditional mortgage products are properly underwritten and disclosed. We believe this will help promote sound and sane practices in the mortgage market and thus serve the interests of the banking system and the general public.

Likewise, we have consistently emphasized that our proposed commercial real estate guidance does not seek to curtail commercial real estate lending, which is a strong and vital business for the economy and the banks that specialize in it. Rather, the focus of that guidance is on concentrations and the importance of having risk management and capital equal to the elevated risk those concentrations pose.

In closing, bank supervision will always be as much art as science. Knowing when to intervene in the business of the banking system – and to what degree – will always demand the exercise of subjective judgment. The OCC brings long and specialized experience to this critical mission, and we will continue to work hard to strike the right balance in our guidance on real estate lending.

Thank you very much.