The L. William Seidman Lecture Series

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during the

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I'm delighted to have this opportunity to be here with you today to talk about both the challenges facing the banking industry, and the OCC's expectations for national banks and federal thrifts, and especially for the outside directors of these institutions. I am also pleased to speak as part of the L. William Seidman Lecture Series. Bill Seidman played a major role in bringing the banking system out of its last major crisis 20 years ago, and it is fitting to honor his memory as we consider the path to recovery from this one.

I understand that about a quarter of those present at this conference are directors at banks and thrifts, and the presence of so many outside directors is one of the things that I think is most useful about this conference. While my remarks today are directed toward community banks generally, I will focus on the role of independent directors.

For those of you who are directors, I doubt that the public at large understands how important your job is, or for that matter, how difficult it is. An active and engaged board is essential, not just to the effective oversight of institutions of all sizes, but to the stability of our increasingly interconnected financial system as a whole.

That is a lofty mandate, and accomplishing it is no easy task. We expect directors to challenge management; to understand the bank's risk appetite, internal controls, and strategy; and, more generally, to question the direction management is taking. That's a lot to ask, I know, and it must seem like a thankless job at times. But your willingness and ability to perform it is vital, and all of us, from regulators to bank management to the public, owe you a debt of gratitude when you do it well.

For our part, we at the OCC devote a great deal of time and resources to industry outreach and, in particular, to educational programs for bank directors. One of our most important educational efforts is the program of workshops we hold specifically for bank directors. They cover a range of topics, generally related to the board's responsibilities relating to risk, including basic risk assessment, credit risk, and compliance risk. Additionally we offer a comprehensive workshop on "mastering the basics" for new directors. If you are a director at an OCC-supervised institution and you haven't attended one yet, I hope you'll take advantage of this program soon. This year, we have planned 33 workshops, scheduled in cities around the country. We also have a number of publications, including the OCC's Director's Handbook, part of our Directors Toolkit, which can arm you with the resources you need to perform your responsibilities.

And of course, at the conclusion of each exam, our findings are presented by the Examiner in Charge, along with the Assistant Deputy Comptroller responsible for your bank, at a meeting of the board of directors. You should take advantage of that opportunity to ask questions. Our examiners are expected to challenge management, and you should challenge our examiners. If they haven't explained themselves clearly, ask questions. If you don't think the conclusions are properly backed up, ask more questions.

The more information you have, the better you can do your job, and I can assure you that we see our job as helping you get that information.

With the integration of the thrift industry into our regulatory portfolio, we now supervise just over 2,000 institutions, most of which are community institutions: 87 percent of the charters we supervise have assets under $1 billion; nearly two-thirds have less than $250 million in assets. We recognize the significant contribution that these institutions make, not only to their communities, but to the national economy as well. Community banks are important lenders to small businesses, which are vital contributors to job creation. I don't think I need to say just how important that function is today. Every small business that succeeds adds badly-needed jobs to the nation's economy, and many small businesses that succeed do so in no small part because of a community bank that provided it credit. It's not easy to make the credit decisions involved in small business lending, but your banks do it every day, and it's one of the reasons that we can be hopeful about the future.

That future, of course, is full of challenges, and I want to spend some time today discussing them. First, though, I'd like to recognize the very substantial progress the industry, and particularly the community banking segment, has made since the dark days of the financial crisis. The economic meltdown and the resulting recession took a heavy toll on community banks, slowing loan growth and impairing the quality of your portfolios, particularly in the area of commercial real estate. Lending activity, which is the primary revenue source for community banks, continues to be hampered by the overall economic downturn, and net interest margins continue to be strained.

Still, in the last year, we have seen improvements in financial conditions among community banks and thrifts. Through the third quarter of last year, noncurrent loan levels for most loan types have begun to stabilize or decline, and returns on assets and equity for many banks have improved.

This is a solid basis from which to tackle new challenges, which is good because there is considerably more to do, and quite frankly the expectations for banks are higher than they have ever been. No one should be surprised that supervisory expectations have ramped up in the wake of the financial crisis, and there's no point in belaboring or bemoaning the fact that there are more supervisory eyes on you than ever before. It's what happens after a financial crisis, when so many people have suffered so much economic pain, and public funds have been placed at risk. In the wake of a financial crisis, the markets expect more of you; the public expects more of you; politicians expect more of you; and so do we. And I would guess that many of the directors in this audience have conveyed that very message to management—expectations have changed, and standards that might have been acceptable a few years ago just won't cut it today. As directors, you have to expect more of bank management, and as bank management, you have to deliver.

While our expectations have grown, we also recognize that you face pressures on your bottom line wherever you look. In addition to dealing with a challenging economic landscape, you are also dealing with a regulatory environment that is being reshaped by the Dodd-Frank Act. In this regard, believe me when I tell you that we feel your pain. Congress assigned responsibility for implementing Dodd-Frank to the regulatory agencies, and it is taking an enormous amount of energy to get new rules written.

Without question, Dodd-Frank resulted in the most comprehensive reform of the U.S. financial system in decades, probably in our lifetimes. Some of the best-known changes will primarily affect the largest banking institutions, including enhanced capital and risk-management requirements for systemically important institutions, and the shift in the cost of the insurance fund toward large banks. But other mandates within the Act broadly amend banking and financial laws in ways that affect the entire banking sector, including community banks—in some ways that may surprise you.

For example, the Dodd-Frank Act imposes a range of new requirements on the retail businesses that are "bread-and-butter" for many community banks. The compliance requirements for small business lending will increase when new HMDA-style reporting requirements become effective. Longstanding advisory and service relationships with municipalities may cause the bank to be deemed a "municipal advisor" subject to registration with the Securities and Exchange Commission (SEC) and rules issued by the SEC and the Municipal Securities Rulemaking Board. Checking account relationships with customers are likely to be re-shaped to recover the costs associated with providing debit cards as debit interchange fees fall, even though small banks are exempted from the rule. Even the regulations implementing the "Volcker Rule" that were recently proposed by the banking agencies, the SEC, and the Commodities Futures Trading Commission have compliance implications for community and regional banks.

The Consumer Financial Protection Bureau (CFPB) is charged with implementing new requirements that will affect banks of all sizes. These include new standards for mortgage loan originators; minimum standards for mortgages themselves; limits on charges for mortgage prepayments; new disclosure requirements required at mortgage

origination and in monthly statements; a new regime of standards and oversight for appraisers; and a significant expansion of the current HMDA requirements for mortgage lenders to report and publicly disclose detailed information about mortgage loans they originate.

The CFPB is also authorized to set additional disclosure requirements for all consumer financial products and services and to promulgate regulations defining and banning unfair, deceptive, or abusive practices.

These are all worthy goals, but every change that is mandated and its associated costs will have a proportionately larger impact on community banks due to their smaller revenue base. The ultimate cost to community banks will depend on how the CFPB implements its new mandate and the extent it exercises its exemptive authority for community banks.

Community banks also may be particularly affected by the Dodd-Frank Act's directive that federal agencies modify their regulations to remove references to credit ratings as standards for determining creditworthiness. The practical result of this requirement will be that institutions will have to do more independent analysis in categorizing assets for the purpose of determining applicable capital requirements and whether certain types of debt securities are permissible investments.

In all areas of rulemaking, we and the other regulators are committed to making clear which rules, and which parts of rules, apply to community banks so that management is not faced with trying to understand which of the large volume of rules coming out of Washington will apply to community banks. But of course, many of the

new rules will apply, and that will affect costs and revenues. The effect will vary for different banks and thrifts, depending on their current mix of activities.

In the longer term, we expect to see banks adjust their business models in a variety of ways. Some will exit businesses where they find that associated regulatory costs cut too deeply into profitability, and the prices charged for services will change as banks decide to pass added costs along to customers. Others will focus on providing products and services to certain customers over others as a way to manage their regulatory costs. Some will elect to concentrate more heavily in niche businesses that increase revenues but could concentrate risk and heighten their risk profile.

What is clear is that there will be a process of adaptation. It is equally clear that these are issues each of you needs to keep in mind as you evaluate the strategic direction your institution will take. Bank and thrift directors should be spending time with senior management to understand your bank's internal standards for capital and liquidity management, its plans for growing the loan portfolio in an economic environment that will continue to be challenging, and its plans for ensuring an effective compliance function.

This last point is particularly important. In a financial crisis, survival becomes the immediate focus and compliance tends to become a secondary concern. But this tendency must be resisted because compliance is always important, and compliance failures can do major damage to a bank—especially when they compound credit problems. You need look no farther than the foreclosure processing mess, often referred to as the "robo-signing" scandal, to see its impact. While none of the banks in this room were part of that problem, it illustrates well the consequences of taking compliance too

lightly. Massive screw ups in routine back office operations have caused serious reputational damage that will not only be costly to fix, but will absorb huge amounts of management time and resources that would be better spent on improving service to customers and building a sound foundation of profitability.

Overdraft protection is another example of a product that can cause problems if not managed well. When it's done right, it can be a good product that provides substantial benefits to a segment of your customer population. Done wrong, it's an invitation to a front-page article in your local paper about customer abuse that will leave your reputation in shreds. Overreliance on fees based on the premise that customers will regularly spend beyond the funds they have available in their account is not a sound foundation for a banking business.

That brings me to my final theme—the future of community banks in our national economy. I won't repeat why I think your banks are so important to the communities they serve but I'd like to emphasize that, for as long and difficult as the economic downturn has been, roughly three-quarters of the banks we supervise are still rated 1 or 2. They have come through the battle with their flags flying.

That is important to bear in mind because there is a great deal of discussion in Washington these days about the level of conflict in the supervisory process, and the steps industry associations are pushing to address it. It is certainly true at this stage of the economic cycle that the number of matters requiring attention, enforcement orders, problem banks, and bank failures are all elevated. We share with you the goal of identifying and working through problems as quickly as possible to keep your bank healthy or return a problem bank to financial health.

At the OCC, we strive to achieve this outcome through frank discussion with the bank board. In those situations where the board has concerns about the exam process or the validity of the exam conclusions, we want to know about it—either by surfacing issues up our chain of command or going through our independent Ombudsman. For nearly 20 years, we have maintained a robust review process that has been singled out for praise by the industry. So it worries me greatly when legislation like the "Financial Institutions Examination Fairness and Reform Act" attempts to dictate outcomes in key areas of accounting, management, and supervisory judgment, and layers on bureaucracy in the name of due process.

We are all for a robust process to ensure that the actions of examiners in the field reflect fair application of the interagency policies developed in Washington, and to provide an independent review when a bank challenges the result. In fact, finding such problems and fixing them is a major focus of our supervisory approach. Our Ombudsman is a seasoned examiner and field manager who reports directly to me, not through the supervisory chain. He calls 'em like he sees 'em: some for the examiners, some for the bankers, and some split decisions. Our process is completely transparent, and we are happy to engage the industry and work with Congress to find ways to make it work better. Nonetheless, we will testify on the proposed legislation before the House Financial Services Committee later this week, and we will oppose the proposals in that bill. We've been down the path of legislating regulatory outcomes and forbearance on problem loans, and it ended very badly for all concerned.

Rather than end my remarks on the fallout from the financial crisis and recession, I'd like to return to the three banks in four that have maintained their footing through the

crisis and recession. What did this solid majority of community banks do to navigate successfully through the worst economic environment of our lifetimes?

First, successful banks played to their strengths. There's a reason why we use the term community banks, and it's because you serve communities, not big regions or the nation as a whole. You know your customers, both businesses and consumers. You shop in the same stores, send your children to the same schools, and participate in the same community activities. When a small business needs a quick decision, you can evaluate its proposal quickly because you know them and their local market, and you know the character of the men and women who stand behind the business.

In that regard, your reputation is a very important asset, and good banks have maintained their standing in the community. We hear time and again that while people are mad at banks generally, they like and respect their local banker.

But the best community banks, the ones that did not lose their bearings during the financial crisis or the downturn that followed, took care of the basics of banking: they recognized problem loans that are inevitable in a downturn, addressed them early, and made sure they did not grow into a threat to the overall financial health of the bank.

Credit concentrations are always a matter for concern, but I recognize that concentrations are a fact of life for community banks. However, the banks that maintained 1 or 2 ratings through the downturn were the ones that understood and managed the concentrations on their balance sheets. They developed prudent limits and stuck to them, despite tempting returns when times were good. They also engaged in careful underwriting and structured loans appropriately to limit risk to the bank in the event of unexpected declines in the borrowers' performance. And as good community

bankers, they made effective use of local knowledge. The fact is, you know which builders manage costs, maintain quality, and pick marketable sites for residential or commercial developments. You know which ones have a bankable track record and which ones do not. You also know when problems are developing in your local market and which businesses are struggling. That allows you to respond proactively to work with those borrowers while protecting the bank's interests.

That's a skill that your communities can't do without, and that's why we will always have a diverse and vibrant banking system with a broad base of local community institutions. I can assure you that the OCC remains deeply committed to community banks, and that the goal of our supervision is to ensure that your banks remain safe and sound, and able to serve your communities.

Thank you for your attention. I am happy to take your questions.