Remarks by
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Thank you all very much. It's a pleasure to be back at the Exchequer Club. I have been a member for many years, and I've always thought of it as an excellent forum, not just to hear from speakers in the financial services world, but also to catch up with so many friends and colleagues – and friends and colleagues are exactly whom I see as I look around this room. Of course, standards have declined: when I was Chancellor here a number of years ago – during the last century – I had to wear the exceptionally handsome Exchequer ribbon and medal as proof of that exalted position. It was a special pleasure to make fun of each new chancellor who wore it, but obviously someone wisely decided to end that tradition – too bad, because I think the big gold medallion would have truly suited Ron Glancz.

Well, it's hard for me to believe that I'm starting to close in on the end of my third year in office. I was very lucky during my first year, because it was relatively quiet – I testified only once – and I had the luxury of spending lots of down time digging deeply into OCC issues and getting to know my fine staff both here in DC and all over the country. My second year was a lot less quiet: a new Congress changed all that; preemption crested in the Supreme Court decision in the Watters case; and we finally reached an agreement to issue a final rule on Basel II. And my third year – which began last August – has been the opposite of quiet: the credit market disruptions have been with us nearly continuously from then until now, precipitating unprecedented change and regulatory response. On top of that, and related to it, the credit cycle has clearly turned, with loan losses increasing in many classes of assets held on the books of the banks we supervise.

It is this last point that brings me once again to the topic I want to address today. That is the increasing delinquencies and losses we're seeing on commercial real estate loans, especially in CRE related to residential housing. I've spoken a number of times in the past about the need for national banks, particularly community banks, to deal realistically with commercial real estate loans on their books, and this continues to be an area of great concern to us. I don't want to suggest that commercial real estate is our only concern, however. Other types of loans, including home equity and credit card lending, are also under stress today, and we are paying very close attention to troubled credits of all types in our examination of banks, both large and small. But commercial real estate lending played an outsized role in the banking downturn of the late 1980s and early 1990s, and I want to make sure that our examiners don't lose their focus on that product line as we work our way through the current environment.

And that's going to take some time. Given economic trends, it's clear that we're going to see more problem loans and more charge-offs, and addressing these problems is never easy for either banks or their supervisors. In this context, as we stand at the beginning of this part of the credit cycle, I think it's imperative that we as an agency have a consistent, balanced approach to addressing these issues, and that we communicate that approach and our expectations clearly and repeatedly to the banks we supervise. My remarks today are very much intended to help achieve that goal.

Let me start with an acknowledgment. At the OCC, we know that we made some mistakes during the last downturn. We've spent a lot of time reviewing and analyzing what went wrong in that period, and we've learned a lot from our mistakes that we believe will help us in the current environment. Let me highlight some of those "lessons learned."

One of the most controversial issues associated with the last real estate downturn was the tendency for OCC examiners to make unilateral adjustments to real estate appraisals that had become outdated due to clear changes in the markets. We want to minimize the use of this approach during the current cycle. In dealing with a troubled loan that is backed by an outdated appraisal, our preference is to direct management to obtain a new appraisal, and then give the bank a reasonable amount of time to review that new appraisal for appropriateness. Then, it's up to management to make decisions based on that new appraisal – decisions regarding nonaccrural status, charge-off potential, and loan loss provisions, for example.

Because we're still in the early stage of this cycle, we believe there is sufficient time for banks to obtain updated appraisals and use them as appropriate to adjust risk ratings on loans.

Let me add, however, that I will expect examiners to follow up in a timely way. In the event that bank management is unable or unwilling to make adjustments that realistically reflect market conditions, examiners will have no choice but to assess the situation themselves and make adjustments in loan classifications and reserves.

A related lesson involves the early and realistic identification of losses. We expect to see problem credits rise in an environment like the one we're in now. The real question is not whether problem assets are going to increase, but who is going to identify them – bank management or its examiner? I'm less concerned about troubled assets that banks identify and deal with on their own than I am with the loans that – for whatever reason, including slippage in the local economy – aren't being identified by bank management.

Right now, too many community bankers are having too hard a time coming to grips with the problems that have emerged in their commercial real estate portfolios. These bankers are reluctant to charge off obviously troubled loans or even to flag problems to their examiners. While this resistance to recognizing problems at the beginning of an economic downturn may be human nature, it's not healthy, because denial is not a strategy.
It won't serve anyone's interest in the long run. In fact, it only assures that problems get worse and harder to resolve.

The failure by bank management to realistically identify its problems can also strain relations with the bank's examiner. When an examiner has to classify a large number of loans that the bank plainly should have identified on its own, the bank is typically upset at the examiner for classifying the loans, and the examiner is typically unhappy at having to do what should be the bank's job.

That brings me to the issue of two-way communication. Quite honestly, we know we didn't do as good a job as we should have in communicating our expectations to bankers in the late eighties and early nineties. We aim not to repeat that mistake. Our regulatory expectations must be clearly articulated, consistently applied, and effectively enforced. I've heard stories about examination reports that painted a rosy picture at the front of the report, then listed problems in understated terms somewhere in the middle. That doesn't work. We can't soft pedal problems and still expect banks to deal with them effectively.

Of course, it's equally important that banks are open with us. There is a natural tendency for banks experiencing difficulties to regard examiners with trepidation and to say as little as possible. Again, that's human nature. In fact, one classic sign that a bank is getting in trouble is when it stops talking, when the lines of communication begin to fray. I would encourage banks in these circumstances to take exactly the opposite approach – to engage their examiners even more than they might have in good times. Why? Because when problems arise, our examiners need more information, not less, to understand the true dimensions of the bank's problems – rather than assuming the worst.

Now, let me get more specific about our expectations when I say that a bank with a distressed CRE loan portfolio should realistically recognize its problems and deal with them. In particular, we believe it should:

- aggressively identify its problem loans;
- actively stratify its portfolio to identify those borrowers who have a chance to make it, and then engage them in workout strategies;
- realistically identify those borrowers who cannot make it, and actively pursue an exit strategy under the assumption that the first loss is the best loss;
- reward loan officers for bringing problems to the attention of management early; and
- accurately identify losses and non-accruals, and properly classify loans.

For our part, I expect our examiners to engage bank management in a rational discussion on the facts of each distressed credit, such as whether a borrower is "cash flowing." I expect them to share industry knowledge and ensure that sound risk management practices and concentration management are in place for asset classes that are under stress. And I want to know that we are having rational discussions about the adequacy of the loan loss allowance, based on the specific facts of an individual bank's loan portfolio.

This approach ensures that these discussions aren't simply based on individual judgments by our examiners, but instead are based on and supported by specific facts – things like cash flow, debt service coverage, collateral valuation, amortization schedules, and appraisal assumptions. There are underlying facts supporting all of these issues when a banker and an examiner sit across the table from each other. The better developed the relevant facts, the more likely that the banker and the examiner can avoid needless disputes over wholly subjective judgments.

Of course, we recognize that there will still be disputes: ones that can be resolved; ones where there will be a legitimate agreement to disagree; and even ones where, try as we might, bankers will have lingering concerns about unfairness. In this latter case, I'd like to remind our national banks that they have an avenue available to them to appeal regulatory decisions they think are unfair. The OCC's Office of the Ombudsman has independent appellate authority that can be reviewed only by me. I'm pleased to be able to tell you that I recently named Larry Hattix, a long-time examiner who was most recently Assistant Deputy Comptroller for the Cincinnati/Columbus Field Office, to the post of Ombudsman. While I always hope that none of our banks will feel they've been treated unfairly, I want to assure them that they have a fair and independent appellate process available to them, and that we work hard to maintain the integrity of that process.

Moving back to our expectations, we also intend to treat each bank according to its unique financial situation and needs, not according to preplanned cookie cutter rules. I know that in the late 1980s and early 1990s, the regulatory agencies too often lumped problem banks together as though they were all the same. We didn't give enough credit to management teams that were doing the right things. If we had, we might have shown more flexibility in terms of the administrative actions we took.

Let me assure you that we are giving good management its due today. When we see that bank management is realistically recognizing losses and taking tough steps to deal with problems, we are going to give the bank more latitude than we will when we find a management team in denial that forces us to do their work for them. And when we are dealing with bankers that aren't trying to hide problems, but are instead frankly communicating with us every step of the way, we'll be more inclined to trust them to get the job done.

That frank communication begins with bank loan officers. Once they've recognized problems in the loan portfolio, whether they result from poor underwriting or changes in the economy, they need to clearly communicate their conclusions to our examiners so they can make their own realistic assessments based on the merits of each case.

Frank communication should also extend to what our examiners say to bank management. We don't look for timid people when we hire bank examiners. We want them to have the confidence to have direct, candid discussions at the most senior levels of the bank. We also expect them to be able to explain and support every conclusion and value judgment that they make. This is a high standard, and we expect them to meet it.

And the need for frank communication also extends to the board of directors at community banks. As I have talked to board members of banks that got into trouble, or even failed, they frequently tell me that they wish our examiners would have been clearer in board meetings. They say we should have been more direct and provided more explanation as to why something was a problem and what the consequences of board inaction would be. They also tell me that they wish we would have been more specific in our communications with the directors in those instances where the management team didn't seem to get it. I couldn't agree more.

In fact, it reminds me of a story I heard from a veteran of the last down cycle. It involves a banker who told his examiners that they should have told him how bad things were and what needed to be done. When the examiners responded that they did tell him, he had an interesting response. “Well,” he said, “you should have told me again.”

Obviously, there was a failure to communicate. I’m not going to say which side was responsible – whether the breakdown occurred in the telling or the hearing of the issue – because I don’t think it really matters. What does matter is that we need to make sure we keep the lines of communications open. That’s true all the time, but especially now, when the economy is experiencing difficulties.

In closing, let me say that we plan to work with community banks to address problems as they arise. As I’ve tried to convey in my remarks today, that process works best with a combination of early and realistic problem identification by bank management; frequent and robust communication between bankers and examiners; and balanced supervision. If we do all that, I believe we’ll go a long way towards achieving our common goal: to make sure that banks remain safe and sound, and continue to meet the credit needs of a growing and prosperous America.

Thank you very much.

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