Remarks by

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Thank you for that introduction, Sal. It's a pleasure to be here today to discuss the fast-paced, sometimes rewarding, sometimes frustrating world of Dodd-Frank implementation. Since the unexpected moment when I was asked to serve as Acting Comptroller of the Currency, life has been a good deal more challenging than anything I had experienced before. The Chairman of the ICBA can probably appreciate what I am talking about better than most, laboring alongside Cam during this first year of Dodd-Frank implementation: dealing with Congress, the new consumer bureau, the GSEs, and on the receiving end of the host of rules the regulators have been tasked with writing. We are all experiencing the Chinese curse – may you live in interesting times – and I wish you the best of luck. I am confident that your end-of-year report to the ICBA membership at the 2012 Convention will be a very interesting tale.

This is my first appearance before the ICBA's national convention, but I have already spent a great deal of time as acting Comptroller, and in my prior role as Chief of Staff and Public Affairs, visiting with community national banks. I find those meetings to be tremendously useful, providing insights into the problems and concerns of Main Street bankers. And our extensive program of outreach to community bankers also helps inform our decision-making process when we consider regulations and guidance that affect community institutions.

When preparing to address audiences that extend beyond the national banking system, I'm always reminded to discuss how community banks figure into the work of the OCC. For whatever reasons, many people remain unaware that the vast majority of our time and resources are devoted to community institutions, and I'd like to offer a brief overview of that work.

It's true, of course, that we supervise most of the nation's large banks. But only 15 of our banks are in the large bank program, and the bulk of our resources, including 75 percent of our examination staff, are devoted to community institutions. The OCC supervises over 1,200 community banks with assets under $1 billion, and in fact, more than 800 of those banks have less than $250 million in assets. The ranks of community institutions supervised by the OCC will grow dramatically in July, when we complete the transfer of staff and supervisory responsibilities from the Office of Thrift Supervision to OCC. We expect that about 670 federal savings associations, with total assets of just over $900 billion, will come under OCC supervision and the overwhelming majority of those thrifts are community institutions. So, in July, the ranks of community institutions we supervise will increase by more than half, and an even greater proportion of the banks we supervise will be community institutions.

Most of our examiners are based in offices around the country, some 70 altogether, near the banks they supervise. And most supervisory decisions are made at the local level. In fact, our Assistant Deputy Comptrollers who manage those local offices are not just empowered to make decisions locally, it is something we expect of them. Very little needs to be kicked up to Washington. And when we complete the transfer of OTS responsibilities, the number of Assistant Deputy Comptrollers will expand by more than 20, and new offices will be opened in Des Moines and Seattle.

One additional resource of particular significance for community banks is our Office of the Ombudsman. We know that there will be times when bankers disagree with exam findings, and it's important that you have an independent avenue of appeal available to you in those cases. Larry Hattix, our Ombudsman, is fully independent of the supervisory process, and he reports directly to me. The results show that bankers who appeal decisions don't always win, but neither does the supervisory office. Last year, of the 11 appeals decided by the Ombudsman, two decisions upheld the bank, two were split decisions, and seven upheld the supervisory office. The Ombudsman provides an important check on the supervisory process. While I would hope you would first try to work out disagreements through discussions with the supervisory office, you should not hesitate to file an appeal with the Ombudsman if you still have concerns.

Given the extent of our commitment to community banking, it's a matter of great concern to me when I hear, as I sometimes do, that community bankers feel the business is no longer sustainable, or – worse – that regulators, including the OCC, agree and are encouraging community banks to exit the business. This latter point is both completely untrue, and particularly troubling. While I won't try to minimize the very significant challenges facing smaller institutions, I can assure you that we at the OCC believe very strongly in the future of community banks. America has long had a diverse banking system, and there is no reason to believe that will change.

More fundamentally, the OCC recognizes that community banks play a special role in the economy and society of cities, towns, and rural areas across the country. They provide essential financial services to small businesses, from lock boxes to cash management to checking accounts. And, of course, they provide the credit which is so critical to job creation. At a more personal level, one need only read the minutes of the boards of directors meetings of community banks – as OCC examiners do – to get a feel for the contributions banks make to the local way of life. It's the small, often unpublicized, actions of community bankers – from sponsoring a charitable fund-raising drive to underwriting a meals-on-wheels program to contributing to the re-sodding of the local high school football field – that contributes so much to the quality of life in a community.

So, it's important that we address the challenges community banks face today. I'll offer a list of my major concerns, but with the caveat that this list is by no means exhaustive. Let's start with commercial real estate or CRE. Commercial real estate lending is a bread-and-butter product that is important to both small banks and the communities they serve, but CRE concentrations have played a major role in almost every bank failure this year.

Unfortunately, though, many other credit products have been commoditized to the point that a bank needs considerable scale to make money in those areas. Auto loans, fixed-rate mortgages, and education loans might once have seemed like solid bets, but today they provide thin margins that require large volumes to be profitable.

At the same time, net interest margins are under severe pressure. This is the case industry wide, but it is a more difficult challenge for small institutions than for large banks that have more diverse revenue streams and economies of scale. When margins are under pressure, other sources of revenue take on greater prominence. But those other sources of income are also under pressure right now.

The limits on interchange fees mandated by Dodd-Frank are an example of a possible new constraint on fee income. It's worth noting that Congress intended to exclude community banks from this provision of Dodd-Frank but community banks recognize that the exemption granted has little practical benefit because the price the Fed sets for large banks will end up being the price smaller banks can charge. That said, we believe that the Federal Reserve's proposal crimps income more than necessary by taking a very narrow view of costs the law permits, and we've provided our views to the Fed in a comment letter.

Income generated by overdraft protection programs is also coming under increasing scrutiny. We believe that this is a legitimate product if it is used properly. By "properly," I mean that it should be offered as a convenience to customers that is used sparingly, not operate as a thinly disguised credit product that consumers use routinely as an alternative to payday loans or other such products. The bottom line here is that community banks that have encouraged customers to become overly reliant on this product to manage their cash flow will need to find other sources of revenue to offset an almost certain decline in the income they have been generating from overdraft protection fees.

Layered onto these specific challenges is the simple accretion of new regulations that limit profitability and increase compliance costs for the industry. It's not that any one requirement is a bad idea, but it's hard to judge the cumulative effect when so many changes are made at once. I worry there could be "drug interactions:" one pill that's good for the heart, one for the head, but taken together they're dangerous. Neither is any one requirement so hard to implement, but the cumulative effect can be punishing, particularly for small banks that don't have spare resources to deal with the expanded compliance burden.

Sometimes new requirements have unforeseen consequences, such as the unanticipated impact of interchange limits on small banks I just discussed. Another example is the restrictions written into Dodd-Frank on the use of credit ratings. Unlike interchange, this prohibition on the use of ratings in bank regulations was <u>intended</u> to apply to all banks, but the burden will fall disproportionately on small institutions. The burden shows up in a number of ways, but to cite just one: our regulations rely on credit ratings to determine which investments are permissible for national banks. If the regulators have to rewrite the rules to require banks to do their own due diligence for each investment prior to purchase, community institutions will have a very hard time doing this analysis and may be forced to forego some sound investments.

Serious errors by the rating agencies in rating structured financial products contributed directly to the financial crisis, but the solution mandated by Congress is overbroad and is proving unworkable. I have argued for greater flexibility to use traditional ratings several times in testimony, as well as in meetings with lawmakers and their staff, and this is an area where I believe Congressional action is essential.

Looking ahead, the industry will have a new rule-writing agency come July 21 in the form of the Consumer Financial Protection Bureau. OCC will continue to provide consumer compliance supervision for smaller banks, but we will be enforcing regulations written by the CFPB. We are assured that the CFPB will use its authority to set nationwide standards that will apply to the tens of thousands of nonbank financial services providers that have been at best lightly regulated, and this should help even the playing field. But the Bureau is a new agency; it may have a different approach to consumer rules than the banking agencies; and it remains to be seen how conflicts between safety and soundness and consumer protection will be addressed in rulemaking. I believe it will be important for all of us – banking regulators and the consumer bureau – to establish and maintain a constructive dialogue, which we are already doing.

The same obligation applies to all of the rule writing under Dodd-Frank. There are a number of important new authorities in this law that we need to get in place, but there are always issues and errors in such a large, complex law. Normally Congress would go back and fix obvious problems, but the current political climate offers little hope of that. So we will pursue the art of the possible in rulemaking. At the OCC, we are taking a balanced approach that is sensitive to congressional intent and mindful of safety and soundness. But let me assure you that we are conscious of the fundamental role that banks play as engines for a healthy economy by taking on and managing risk, and we will do our best to limit unnecessary burden.

All of these forces – economic and legislative – combine to make the current environment very challenging for community banks. That shows up in the numbers: the number of banks on our problem list – those rated 3, 4, or 5 on the CAMELS scale – account for 27 percent of the banks we supervise. I hope that's a peak, and that the number of problem banks will soon begin working its way down. But the good news in that number is that as big as the problem bank list has grown, three-quarters of the banks we supervise are still rated 1 or 2. As we think about the industry's future, we ought to focus on these banks and ask what it was that they did right. How did they successfully navigate through the worst economic environment of our lifetime? That is the theme I want to explore in the remainder of my remarks today.

First, I think, 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. That's something that local companies just can't get from large financial institutions.

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: 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.

I've mentioned the problems that stem from credit concentrations, 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. They made effective use of local knowledge as community bankers. 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 big banks can't match, and 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'd be happy to answer your questions.