Remarks by

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Thank you. It's a pleasure to be here today and to have this opportunity to discuss the OCC's perspectives on commercial credit risk issues. I recently spoke about the emergence of operational risk as a key risk area for banks and thrifts of all sizes. That development doesn't diminish the significance of credit risk as a core risk that is always significant for banking institutions. There are few concerns more central to the safety and soundness of the overwhelming majority of the banks and thrifts that are supervised by the Office of the Comptroller of the Currency than credit risk -- particularly commercial real estate credit.

You can see the reason for that in the numbers. National banks and federally chartered thrifts hold over $700 billion in total commercial real estate loans, or CRE, which amount to 14 percent of their aggregate loan portfolios. That's a big share of loans, but those numbers don't begin to describe the extent of CRE concentrations for community banks and thrifts, which tend to have much larger relative exposures. For banks and thrifts in the OCC's Community Bank Supervision program, CRE accounts for 37 percent of the total loan portfolio.

Of course, concentrations are a fact of life for small banks and thrifts, who serve local communities that may lack the economic diversity of larger markets. The fortunes

of a community institution in the farm belt might depend almost entirely on the price of corn, for example, no matter what kinds of loans it makes, and that's just a reflection of where it does business. Thus, concentrations have to be evaluated in context, and a vital element of that context is how institutions manage these concentrations, and the capital they retain as a buffer against losses.

At the OCC, we recognize that CRE is a bread-and-butter product for community banks and thrifts that became even more important as increased competition from large institutions and nonbanks constrained fee and interest income. For many community banks and thrifts, a well-managed portfolio of commercial real estate is central to their continued long-term health.

On the other hand, however, it is also true that, in too many cases, concentrations in commercial real estate have led to significant losses and failures of community banks. The vast majority of community bank failures over the past three years involved commercial real estate to some degree, and in most of these cases, that exposure was the primary reason for failure.

Our assessment of commercial credit risk takes into account the performance of different types of commercial loans. Construction and development loans were by far the worst performers in the crisis, and concentrations in C&D proved to be a reliable indicator of the likelihood of failure for both national and state community banks. In March of 2007, nearly 2,000 of these banks held C&D loans that exceeded their capital. By September of last year, 13 percent of them had failed. If you expand the view to look at excessive real estate lending, look through the lens of the real estate guidance the regulatory agencies jointly issued in 2006. That guidance set thresholds of 100 percent of

capital for construction lending and 300 percent of capital for total CRE. Where banks were in excess of those concentration thresholds, 23 percent failed. Where banks were within those thresholds only about one-half of one percent failed. That is a stark difference: one-half of one percent versus 23 percent.

That's not to say that CRE concentrations threaten the viability of all community institutions. Far from it. The overwhelming majority of the banks and thrifts we supervise are managing their CRE exposures very well. Our message to these institutions is clear and consistent: continue to work with borrowers who face difficulties, but also recognize and address problem credits by maintaining appropriate loan loss reserves and taking appropriate charge-offs when repayment is unlikely.

Among large banks, there is good news and bad news. The bad news is that large bank CRE portfolios performed worse than those of smaller institutions. The good news is that their exposures were much lower as a percentage of total loans or capital. That's not a new story. Large banks by their nature should have greater diversity both in product lines and market areas. Community banks, on the other hand, don't always have the same opportunities to diversify. They simply have to be more nimble in their management of concentrations in both good times and bad.

And today, there's both good and bad news in the outlook for commercial real estate. We see real and tangible signs of improvement in CRE markets and CRE loan performance, and that gives us a reason for cautious optimism. However, as a supervisor, I have to be more concerned about the very strong headwinds these markets and their lenders still face. In fact, while we are seeing improvements in some of the fundamentals, even the positive trends come with qualifications and risks.

On the positive side, demand for multifamily housing is picking up, in no small part because homeownership rates dropped as the economy turned down, but supply is growing as well. Demand for office buildings is growing steadily, but moderately, reflecting the slow growth in employment. Demand for retail and warehouse space is also improving, due to increased consumption, but weakness in the housing market and technological advances that favor internet sales over retail stores are hurting some segments of the market.

Although demand for CRE space is increasing, it remains soft relative to historical norms. Thus while vacancy rates have improved, they are likely to remain elevated in many markets over the next couple of years. Rental rates and net operating income are well below peak levels, and net operating income is expected to continue to decline nationally for the next year or two for warehouse, office, and retail space. Many leases signed during the boom will be renewed with lower rents, and that will continue to put downward pressure on net operating income.

Thus far, loans from the 2007 and earlier vintages have generally been extended or refinanced on a short-term basis as they matured. Up to half of all outstanding CRE loans will need to be rolled over by 2014, and many of these have been on interest-only terms or required only minimal amortization. Given the large volume of CRE loans maturing in the next one to two years, banks and CRE investors will have to resolve repayment issues, such as declining net operating income and underwater mortgages, while dealing with difficult economic conditions. I can assure you that this is one of the issues we will be monitoring closely over time.

Commercial mortgage loans have performed better than construction and development loans, but we should keep in mind that they are benefiting greatly from very low interest rates, and these loans will suffer if rates rise. While property valuations are no longer declining rapidly, they remain well below peak levels for many segments of the market and are projected to recover slowly, which will make it difficult for many existing loans to be refinanced if net operating income does not improve.

While we continue to see modest improvement in banks' loan portfolios, it's important to put that trend in context. For CRE specifically, current non-performing and loss rates continue to significantly exceed historical averages. For commercial mortgages specifically, non-performing and loss rate levels have improved but continue to exceed historical averages significantly. The nonperforming rate for commercial mortgages decreased from 4.7 percent in 2010 to 3.5 percent as of the first quarter of 2012. That's still almost two-times the average rate over the previous 10 years. The net charge-off rate for commercial mortgages has also sharply declined from the 2009 highs and is approaching its 10-year average. However, some of the improvement that we have observed is the result of significant charge-offs taken earlier in the cycle, and commercial mortgage performance has improved more quickly at large banks than at our community banks. Although the trend has been positive for several months, clearly there are still significant obstacles to overcome and portfolios remain vulnerable.

Despite the remaining obstacles, we know the environment will eventually improve, and it's important that we learn from the mistakes of the financial crisis and the recent recession <u>before</u> it does. Booms don't last, and bubbles inevitably burst. When the economy is growing, demand for all kinds of commercial real estate, from office

buildings to warehouses, increases quickly, and rental income begins to grow rapidly. At that point, it will be tempting for lenders to grow their CRE portfolios. Again, this is an essential product for community banks, and CRE growth can lead to very healthy-looking profits in the short run.

But the short run is, well, short. Sooner or later, the market turns, and when it does, lenders with outsized concentrations, particularly those who grew their portfolios rapidly, will experience the same painful adjustments and losses that we are working our way through right now. It does lenders little good to rack up record profits during the boom if they have to give them all back and more during the bust.

And that's where we as an agency will be focused as we move forward. Credit concentrations have fallen, but they are still evident at most banks and thrifts. Again, we aren't saying that financial institutions can't have concentrations, but we are saying concentrations have to be managed, and supported by appropriate capital. That is why we released an updated concentration handbook to provide further guidance on this topic in December 2011. The new handbook focuses on concentration risk management. In particular, it encourages banks to recognize correlations between concentrated loan pools. The handbook also points out that different pools of the same size may represent different levels of risk, as shown by the uneven loss and non-performing levels for different types and locations of CRE during the downturn.

We are also closely focused on the appraisal process. We continue to expect banks to obtain appraisals from competent and qualified professional appraisers who will provide unbiased market value conclusions. Appraiser competence should be the focus of a bank's appraiser selection process. Certification and licensure are necessary

prerequisites, but are not sufficient to determine competency for a particular appraisal assignment. In addition to appraiser selection, we expect banks to document a review and acceptance of all of the appraisals that are obtained.

We have also directed banks with significant CRE concentrations to develop more rigorous scenario analyses that consider the effect of multiple variables, including changes in interest rates, vacancy rates, and capitalization rates. For national banks and federal thrifts, we have developed and will be providing at no cost a tool that they can use to assess how their CRE portfolios may perform in a downturn or market disturbance.

Let me say in closing that while there are hopeful signs that commercial real estate markets are improving, we have to be vigilant in focusing on the obstacles and challenges that remain. We at the OCC will continue to take a balanced approach in our supervision of CRE that encourages banks and thrifts to make prudent loans and work with troubled borrowers, while recognizing losses and maintaining appropriate reserves and capital.

Thank you for your time. I would be happy to take your questions.