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Testimony of
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Before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 25, 2009

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Timothy Long, and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner for the Office of the Comptroller of the Currency. I appreciate the opportunity to describe the OCC's role in ensuring that banks remain safe and sound, while at the same time meet the credit needs of their communities and customers. This is our core mission, and we recognize it is a balance: supervise too lightly, and some banks will use federally insured deposits to make unsafe loans that can ultimately cause them to fail; supervise too strictly, and some banks will become too conservative and not make loans to creditworthy borrowers. The OCC strives every day to get this balance right through strong, thoughtful and consistent supervision that reflects constant interaction with and feedback from the banks that we supervise.

All of us – supervisors, bankers, and members of this Committee – recognize the important role that credit availability and prudent lending plays in our nation's economy and we all share the goal of ensuring that banks can continue to meet the credit needs of their customers. The actions undertaken over the past few months – providing facilities and programs to help banks strengthen their balance sheets, restoring liquidity to various credit segments, including small business owners, and promoting supportable residential loan modifications – are important steps in restoring our banking system and economy.

The OCC fully supports these initiatives and we believe they will have a positive impact on banks' ability and willingness to lend. We must recognize, however, that banks are operating in an economic environment that continues to pose significant challenges to them and their loan customers. The sharp decline in fourth quarter gross domestic product and increasing unemployment levels are placing strains on borrowers' ability to service their loan obligations and is contributing to the tighter loan underwriting standards we are seeing at many banks. Notwithstanding these challenges, bankers *are* making loans to credit worthy borrowers. For example, as the Treasury Department has reported, over $800 billion of new loans – in the form of new originations, renewals, and refinancings – have been generated in the four month period from October 2008 through January 2009 by the nine large national banking organizations that have received funds from the Capital Purchase Program. Moreover, every banker I have talked to reiterates that lending is the backbone of their business and that they are committed to meeting the credit needs of their customers through this economic cycle. Our examiners, who are in the banks, also confirm that bankers are continuing to make loans to creditworthy customers.

I understand that some bankers believe they are receiving mixed messages from regulators about the need to make loans to creditworthy customers while at the same time being subject to what some have termed as "overzealous" regulatory examinations. We believe we are striking the right balance in encouraging bankers to make loans to creditworthy borrowers, but always consistent with safe and sound banking practices – and to the extent we're not, we are continually prodding bankers to let us know, both directly to our examiners and indirectly through our Ombudsman. Our message to bankers is straightforward:

- Do make loans that you believe will be repaid;
- Do not make loans that are unlikely to be repaid; and
- Continue to work constructively with troubled borrowers, but recognize repayment problems in loans when you see them, because delay and denial makes things worse.

OCC examiners do not and will not criticize bankers for making loans that are prudently underwritten and appropriately managed. This does not mean that every person or company that wants credit will receive a loan. The simple truth is that, given the economic conditions facing our country today, there are borrowers that simply cannot afford or manage new or existing debt obligations – borrowers and companies that find themselves overleveraged. In these cases, we encourage bankers to work with the borrower, to the extent possible, to restructure or modify the loan so that repossession of collateral or foreclosure is avoided wherever possible.

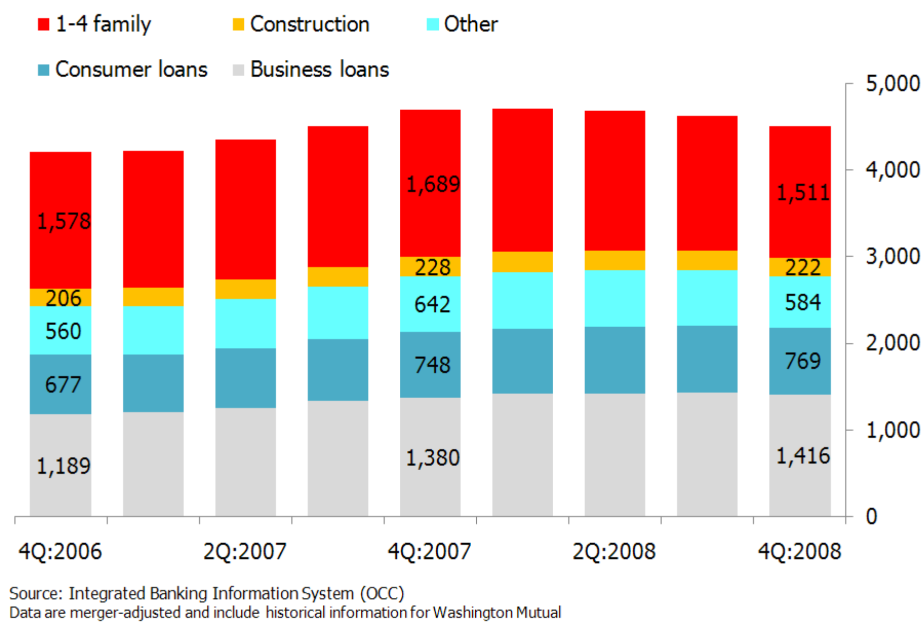
But for some borrowers, a workout is not feasible and the bank is unlikely to be fully repaid. In these cases our goal is to ensure that the bank has adequate reserves and capital to absorb its loan losses. In this regard, we have and will continue to be forceful in telling bankers that they need to be realistic in their evaluations of a borrower's condition and to take appropriate actions, including charge-offs, when warranted. Likewise, there are some community banks that find themselves overextended in relation to their capital and loan loss reserves. In most cases, these institutions will need to reduce their exposures – sometimes by raising more capital, but often by cutting back on loans – to survive. While this is not always an easy step for management to take, in these circumstances we believe it is both prudent and necessary.

National Banks are Making Loans, but Loan Demand and Some Loan Volumes are Down

Before discussing our supervisory approaches in the current environment, it is useful to begin with some facts about current credit conditions. There have been clear signs of weakness, especially since last summer. As Chart 1 shows, the total dollar volume of loans on the books of national banks declined four percent over the course of 2008, with the deceleration picking up in the fourth quarter. Naturally, some categories of lending were weaker than others. Examples include 1-4 family residential mortgages and construction lending. But these examples are hardly surprising, given the significant contraction in these sectors during 2008 that sharply curtailed the demand for new loans.[1] Outside of the real estate realm, business loans increased slightly in 2008, as did non-mortgage consumer lending (see Chart 1).[2]

Chart 1

Loans on balance sheets of national banks ($ billions)



There are also some technical reasons for a portion of the decline that shows up in the data. We have traced a sizable share of the reported reduction in bank loan volume – approximately $56 billion – to accounting adjustments that were made in connection with mergers and acquisitions. The loans moved onto the acquiring bank's books at a lower

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[1] During 2008, the value of residential construction put in place fell by 27 percent. Existing home sales fell by 13 percent and new single family home sales declined by 38 percent. The Federal Reserves' Senior Loan Officer Survey reported 14 straight quarters of net decline in demand for home mortgage loans and the Mortgage Bankers Association's weekly mortgage application survey saw a 19 percent drop in new purchase applications for 2008.

[2] Commercial/industrial and commercial mortgage loans increased by 2.6% in 2008. Consumer loans (credit card and installment) rose by 3%. 1-4 family mortgages dropped by 11% and construction by 2.6%.

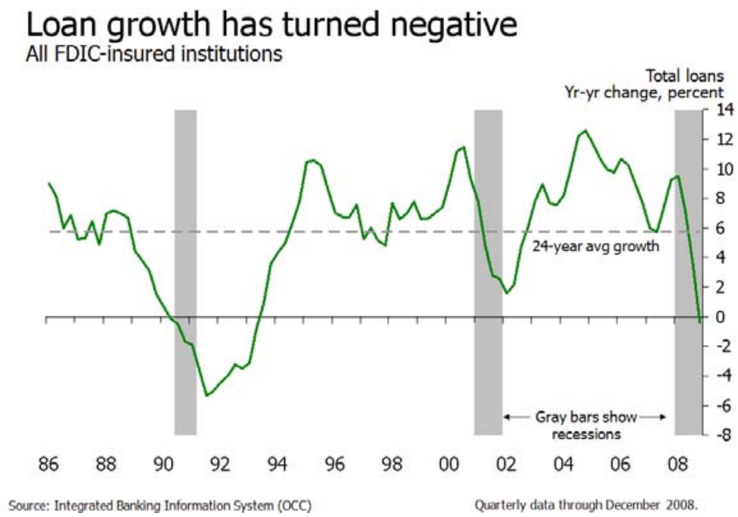
value and were correctly reported at that lower value which can make it look like lending has fallen, when in fact, there may have been no change at all.[3] While we will not have first quarter data until mid-May, recent data suggests that there has been further contraction in commercial and industrial (C&I) and commercial real estate (CRE) lending, whereas residential mortgage loan balances have increased.

Looking solely at the outstanding volume of loans held by national banks, however, does not give a complete picture of the amount of *new* loan dollars that banks are extending, because it only captures the net change in loan volume. Because some portion of loans amortize or payoff each month and banks appropriately are charging off loans deemed uncollectible, the actual volume of new loans that banks are generating is higher than what is suggested by the level of outstanding balances. As noted in the U.S. Treasury's recent "January Monthly Lending and Intermediation Snapshot" report for the 21 largest Capital Purchase Program recipients, "the nation's largest banks continued to originate, refinance, and renew loans in January 2009 in the face of a worsening economic downturn."[4] The report notes that most institutions had higher originations across consumer lending categories than in December 2008, whereas C&I and CRE lending decreased due to weakening demand. Nonetheless, looking over the fourth month period, from October 2008 through January 2009, these financial institutions on a combined basis reported nearly $960 billion in loan originations, renewals, and refinancings. National banking organizations accounted for more than 80 percent of that total.

[3] Includes accounting adjustments related to Washington Mutual, but excludes those related to acquired thrift loans at Wachovia/Wells Fargo.
[4] *See* "Treasury Department January Monthly Lending and Intermediation Snapshot" at http://www.treas.gov/press/releases/tg59.htm and "Treasury Department Monthly Lending and Intermediation Snapshot" at http://www.treas.gov/press/releases/reports/tg30-2-122008.pdf.

But a recitation of figures on short-term fluctuations in bank lending makes it possible to lose perspective. While concerns about recent softening should not be minimized, as Chart 2 illustrates, this pattern is consistent with the experience of all insured depository institutions in past recessions.

Chart 2



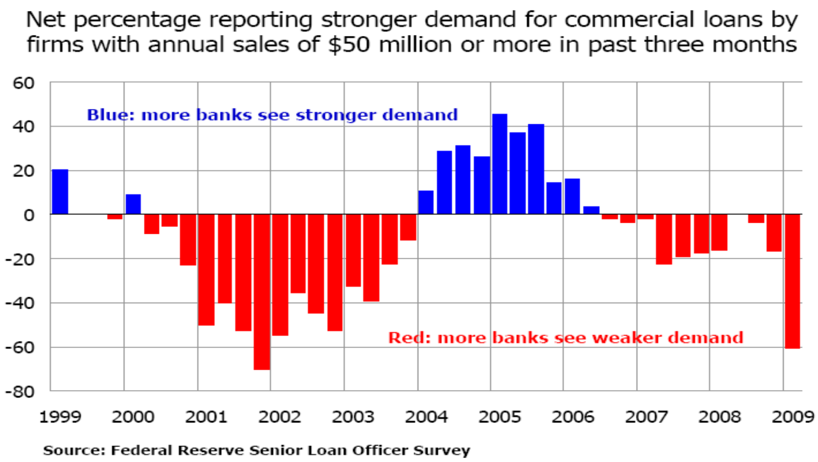
A number of supply and demand-related factors are having a direct bearing on loan growth:

- Reduction in loan demand, as reductions in consumer spending lead businesses to cut back on inventory and other investments;
- Reductions in the demand for consumer and other credit from borrowers who may have been able to afford or repay a loan when the economy was expanding, but now face constrained income or cash flow and debt service capacity;
- Self-corrective actions taken by bankers to scale back risk exposures in the face of declining collateral values, and to strengthen underwriting standards and loan terms that had become, in retrospect, too relaxed; and finally,
- The absence of a normally functioning loan securitization market.

This interplay of factors and their effect on lending is consistent with a variety of recent reports and surveys. For example, as shown in Chart 3, data from the Federal

Reserve's quarterly Senior Loan Officer Survey illustrates that as the economy weakened, demand for bank loans waned.

Chart 3



This trend has continued in 2009. The Federal Reserve's January survey results show that nearly 70 percent of bank respondents reported the demand for C&I loans from large and middle market companies was moderately or substantially weaker and 65 percent reported weaker demand from small businesses. Almost 53 percent reported decreases in the number of inquiries from potential borrowers regarding the availability and terms of new credit lines. Reduced customer inventory and receivables financing needs and reduced investment in plant and equipment were factors cited as contributing to the decrease in loan demand. Nearly all respondents reported that the less favorable or more uncertain economic outlook and the worsening industry-specific problems contributed to tightening credit standards and loan terms.[5]

Similarly, the results of a recent National Small Business Poll on Access to Credit conducted by the National Federation of Independent Business indicate that only 8.9

[5] See: "January 2009 Senior Officer Opinion Survey on Bank Lending Practices," Federal Reserve Board, at: http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200902/table1.htm.

percent of respondents cited an inability to obtain credit as their most immediate problem, compared to slowing or lost sales (45 percent) and the unpredictability of business conditions (23 percent).[6] The same study reports that "…sharply falling real estate values accompanied by the onset of what appears to be an abnormally severe recession have become the real small business problems and are the principal causes for the most obvious small business credit consequence, depressed demand."[7]

Because of various anecdotal reports about the shutdown of credit in the commercial real estate market, we recently asked our examiners at a cross section of national banks to describe their observations regarding banks' appetite for, and willingness to extend, this type of credit. Our findings indicate that while national banks are still making income-producing commercial real estate loans to well qualified borrowers, bankers are reducing their appetite for risk. Examiners report that most banks, both large and small, are being more circumspect in their underwriting.

For example, as real estate values continue to decline in many parts of the country, many banks are underwriting to lower loan-to-value ratios, typically in the 70 to 80 percent range, than was previously the case. Others are increasing cash equity requirements or are requiring higher pre-leasing requirements. We believe these more selective underwriting criteria have been prompted by the sharp deterioration of, and continued uncertainty about, the underlying real estate markets, rather than a fear of examiner criticism. Weaknesses in underlying commercial real estate projects, coupled with expectations that there will be further increases in retail and office vacancies, have led to concerns about the adequacy of debt service capacity and the ability of collateral to maintain its value. In addition, because most banks tend to be short-term lenders, some

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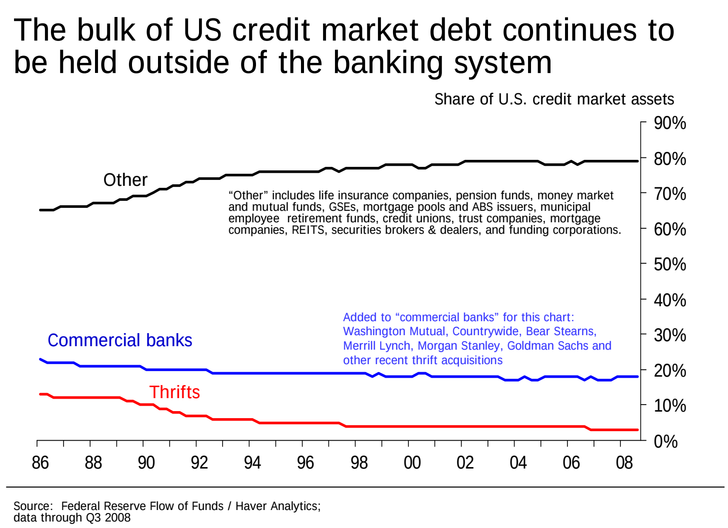
[6] NFIB National Small Business Poll – *Access to Credit*, page 15.
[7] Ibid, page 2.

banks have scaled back their commercial real estate lending due to the lack of more permanent financing for completed properties through the commercial mortgage-backed securities markets.

Another factor that has played a critical role in the reduction of credit availability is the absence of fully functioning and liquid securitization markets. While commercial banks are a key component of credit intermediation, as Chart 4 illustrates the bulk of U.S. credit market debt is held *outside* of the commercial banking system. In 2006, the non-agency securitization markets financed $1.46 trillion in new credit originations. By 2007, these levels had fallen to just under $1.1 trillion before contracting dramatically to $176 billion in 2008.[8] Restoring these markets must continue to be an overarching objective of our collective efforts to stabilize and revitalize our financial system. Banks do not and will not have the capacity to fill this gap.

Chart 4



[8] Non-agency securitizations include credit card, auto, student loan, collateralized debt obligations, subprime residential mortgage-backed securities, equipment, commercial mortgage-backed securities, other. Source: Deutsche Bank.

Regulators and Examiners are Taking a Balanced Approach Consistent with Safe and Sound Banking Practices

The mission of the OCC and our examination force is to ensure that the national banking system remains safe and sound and fully able to support the needs of its consumer and business customers. One of the most difficult jobs we have in carrying out this mission is knowing when and how to modulate our actions – when and how hard to tap on the brakes to rein in excessive risk taking without causing bankers to become so conservative or uncertain about regulatory actions that they unduly restrict credit. We are acutely aware that our actions – both on the policy side at the 50,000 foot level, and on the ground, through our on-site examinations – can and do influence banks' behavior and their appetite for taking risk. We also recognize that in past downturns, many believed that overzealous regulators and examiners exacerbated the contraction in credit.

One of the lessons we learned from the early 1990s was the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. We also learned that it is critical that our expectations for bankers be clear and consistent; that the "rules of the game" under which banks operate not be changed abruptly, and that changes in regulatory policies are made in an open and transparent manner that provides bankers with reasonable timeframes to make necessary adjustments.

Throughout this credit cycle, we have strived to take a balanced and measured approach in our supervision, alerting banks as early as September 2003 when we started to see signs of increasing risk embedded in their loan portfolios. These alerts were followed by more specific and targeted supervisory guidance and on-site examinations. To ensure that our expectations and guidelines were clear and transparent, we sought public and industry comment on the guidelines before they were issued and became effective. We also conducted numerous outreach sessions with bankers and bank directors to discuss our concerns and outline our expectations.

More specifically with respect to residential mortgage, home equity, and commercial real estate loans, we started alerting bankers to our concerns as early as 2003 and 2004 in response to the results of various targeted horizontal examinations conducted at a cross-section of banks. While these portfolios were generally still showing favorable performance metrics, we were concerned with declining underwriting practices that were becoming widespread in the industry. These practices included interest only and payment option ARMs, which were often underwritten with limited documentation and no income verification, within residential loan portfolios; extended maturities for revolving home equity lines of credit with little or no amortization of loan balances and acceptance of higher loan-to-value ratios; and increasing concentrations within the commercial real estate portfolios at many community banks. As a result of these findings, we worked closely with the other federal banking agencies to develop and issue additional risk management guidelines for these products.[9]

Similar supervisory concerns led to the 2003 interagency guidance on Credit Card Account Management and Loss Allowance Practices, which addressed a number of inappropriate account management, risk management, and loss allowance practices identified through our examinations. These practices, which often increased credit risk and masked portfolio quality, included the general easing of minimum payment requirements, increased negative amortization, liberal credit line management, and

[9] See: OCC Bulletin 2005-22, "Credit Risk Management for Home Equity Lending;" OCC Bulletin 2006-41, "Interagency Guidance on Nontraditional Mortgage Product Risks;" OCC Bulletin 2006-46, "Interagency Guidance on CRE Concentration Risk Management;" and OCC Bulletin 2007-26, "Statement on Subprime Lending."

excessive over-limit activity. Although we faced considerable criticism by some that our guidance and actions could have negative repercussions on bank profitability, consumer spending, and the broader economy, we thought it was critical that the continuing decline in required minimum payments be curtailed. We also issued additional guidance to national banks on credit card marketing and account management practices that could involve unfair or deceptive acts or practices, or other violations of laws or regulations.

Our goal in issuing these guidelines has been to ensure that bankers recognize potential problems at an early stage so that they can take steps to mitigate risk, including strengthening systems to identify loans or borrowers whose conditions have or are likely to deteriorate; building and maintaining adequate loan loss reserves; obtaining current appraisals when needed to reflect current market conditions; and working with borrowers to restructure credit terms, if appropriate.

We reinforce our expectations through numerous outreach venues with bankers and discussions with bank management teams through our ongoing supervisory efforts. The Comptroller and I, along with other members of the OCC's senior management team, make frequent speeches and visits to a variety of industry groups to convey our message and to listen to their concerns and issues. These sessions are supplemented by our managers in the field who hold frequent meetings with bankers and bank directors, and by web conferences for bankers led by OCC examiners and risk experts. We also conduct a series of workshops tailored for community bank directors that discuss key risk concepts and regulatory requirements, including a credit risk workshop designed to improve directors' ability to affect and influence credit risk in their banks. For banks where we do not have a continuous on-site presence, examiners conduct quarterly calls and onsite visits with bank management to discuss emerging trends and issues.

Equally important to the outreach we conduct with bankers are the steps we take with examiners, through training, guidance, and periodic nationwide conference calls, to ensure that they understand and apply our policies in a consistent manner. We also have various mechanisms in place to help ensure consistency in our examination findings and any attendant supervisory actions. For example, each report of examination is reviewed and signed off by the applicable deputy comptroller or assistant deputy comptroller before it is finalized. Supervisory enforcement actions are reviewed by district and, for certain cases, headquarter supervisory review committees. Our Large Bank and Midsize/Community Bank lines of business have instituted quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies and procedures. These reviews are augmented by targeted reviews conducted by the OCC's Enterprise Governance unit.

Notwithstanding these efforts, there are going to be occasions where we may not have made the right call, or where there are additional facts and circumstances that a banker believes were not given full consideration. To address these situations, the OCC was the first federal banking agency to establish an Office of the Ombudsman. The independent Ombudsman's office administers the OCC's national bank appeals process that bankers may use to appeal a pending supervisory action or decision. Perhaps more important, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff. The office also administers the OCC's consumer complaint resolution process.

As we work through this stage of the credit cycle, our message to examiners continues to be this: take a balanced approach; communicate concerns and expectations clearly and consistently; and provide bankers reasonable time to document and correct credit risk management weaknesses. This does not mean that examiners are giving bankers a "free pass" to ignore or obfuscate their credit problems. If a banker does not or cannot identify and take appropriate action to manage the risks in the bank's credit portfolio, examiners will direct bank management to take corrective action. Our expectations and standards for banks remain the same throughout the cycle. Specifically, bankers should:

- Make loans to borrowers on prudent terms, based on sound analysis of financial and collateral information, with a full assessment of the borrower's ability to repay;

- Have sufficient risk management systems and practices to be able to identify, manage, and control risks;

- Continue to work with borrowers to restructure or modify loans so that foreclosure or repossession of collateral is avoided wherever possible;

- Set aside sufficient reserves and capital to buffer and absorb actual and potential losses; and

- Accurately reflect the condition of their loan portfolios in their financial statements.

At some institutions where bank management has not sufficiently identified or addressed their loan problems, our reviews may result in a bank needing to make additional loan loss provisions; to charge off loans that are deemed loss; or to place loans on nonaccrual where full collection of principal and interest is in doubt. Similarly, some banks may be directed to strengthen their credit underwriting or risk identification and management practices. These efforts may prompt bank management to obtain new appraisals, rework loan terms or covenants, or reduce concentrations to certain borrower or industry segments. While these actions may be prompted by an examiner's directive to improve risk management, let me underscore what examiners will <u>not</u> do. Examiners will not tell bankers to call or renegotiate a loan; dictate loan structures or pricing; or prescribe limits (beyond regulatory limits) on types or amounts of loans that a bank may make if the bank has adequate capital and systems to support and manage its risks. These are and must be decisions by bank management. It is also important to note that an examiner's directive to classify a loan does not preclude bankers from working with those borrowers to restructure or modify the loan. As stated above, the OCC expects and encourages bankers to continue to work constructively with customers who may be facing difficulties in meeting their loan obligations.

Similarly, I would like to clarify four other misperceptions that we hear from bankers and others about examiners' actions.

- *Examiners are directing banks to classify loans to borrowers who are current and can meet their debt obligation – what has sometimes been referred to as "performing non-performing" loans.* The OCC will not direct banks to classify borrowers who have the demonstrated ability to service their debts under reasonable payment schedules. There are instances, however, where liberal underwriting structures can mask credit weaknesses and obscure the fact that perceived performance by the borrower is really illusory. This can be the case where the initial term of the loan allows a borrower to delay any meaningful principal amortization or uses an introductory low interest rate that will increase over the life of the loan. Or, a more common example in today's environment, bank-funded interest reserves on commercial real estate projects. For these types of loans, the initial contractual payment performance does not reflect the ultimate payment terms that a borrower must meet, and may mask deterioration in the borrower's underlying condition and hence, their ability to continue to perform over the life of the loan. In these cases, examiners will not just accept that the loan is good quality because it is current. Examiners will also evaluate the borrower's ability to make future payments required by the terms of the loan, or, in the case of certain types of commercial real estate projects, the viability of the underlying project. This forward-looking analysis may sometimes result in classifying a loan that is still current. This is appropriate because, while the borrower may be "current" under their existing liberal contractual obligation, there are demonstrable weaknesses that raise obvious doubts about the borrower's ultimate ability to repay the loan.

- *Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined.* The OCC does not classify borrowers solely as a result of a decline in collateral value. An evaluation of a credit is based principally on cash flows, whether derived from operations or conversion of assets, not collateral. The collateral value, while often directly tied to the ability to generate cash, is not a sufficient reason by itself for an examiner to classify a loan. For many commercial real estate projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage in these types of loans, current collateral values can be an important indicator of the project's viability and can signal adverse changes, such as the loss of major tenants that will adversely affect the cash flow that will ultimately be available to service or repay the loan.
- *Examiners are telling bankers to stop making commercial real estate loans.* The OCC does not direct what types of loans a bank can make. We do, however, expect banks to appropriately recognize and manage their risks, including the

risks that can be posed from significant loan concentrations with a borrower, market or industry segment. There are some banks that may need to strategically redirect resources from a particular type of lending. This can be due to a number of factors, including past decisions by management to become too concentrated in a particular product or poor underwriting and risk selection decisions that have led to an excess level of problem loans within a particular product line. In these instances, we expect bank management to take prudent steps to manage their risk appropriately, and in fact, they may need to reduce their concentration levels for various products.

- *If bankers raise issues with an examiner or examination finding, examiners will retaliate.* While this is not a common allegation, it is one so serious that I want to take this opportunity to address it with the Committee. Simply put, this type of behavior is not tolerated at the OCC. Any banker who believes this is an issue should contact me or the OCC's Ombudsman directly to discuss the specific circumstances underlying their concerns.

Conclusion

We are clearly dealing with an unprecedented financial and credit environment that will require the resources and cooperative efforts of both the public and private sectors to resolve. While I believe we are taking positive steps to address these problems, I also fully expect that we will see further deterioration in some banks' loan portfolios in the months ahead as the effects of the economic downturn work through these portfolios. Nonetheless, it is critically important that we not lose sight of several important facts:

- The vast majority of national banks are strong and have the capacity to weather this financial storm;

- The vast majority of borrowers – both consumers and businesses – are performing and meeting their loan obligations; and

- National banks are continuing to meet the legitimate credit needs of their communities.

The OCC is committed to work constructively with bankers as they work through these problems. We will continue to encourage bankers to extend loans to creditworthy borrowers and stress that we expect them to work with borrowers who are facing financial difficulties. And we will continue to ensure that our supervision remains fair and balanced.