Remarks

by

John C. Dugan
Comptroller of the Currency

before the

ICBA National Convention

March 19, 2010

It is a pleasure to be here today, although this will be my last time with you as Comptroller. I want you to know that I have really enjoyed these meetings and have found them to be useful and constructive – not just for the opportunities to speak on the key issues that face community banks, but even more important, because they've allowed me to talk to many of you individually about your particular concerns and the challenges you face.

These concerns are very important to me and to the OCC. Despite my best efforts, I sometimes still confront the stereotype that the OCC is only concerned about big banks. Let me say again, emphatically, that that's just not true.

We supervise just under 20 percent of all insured banks and thrifts with assets under $1 billion, and fully two-thirds of our examiners are dedicated to community bank supervision. These examiners live in your local communities, and in fact, in a number of states, we have many more OCC boots on the ground than the state banking commissioner.

I also want you to understand how much time that I and our senior managers in headquarters spend with community bankers. Not only do we host frequent visits in Washington – from both national and state bankers – but we regularly conduct outreach sessions around the country. I myself am particularly keen on in-depth sessions with small but diverse groups of community national bankers, as we recently held in Denver and are about to hold in Philadelphia. These sessions go four and five hours at a time, and we cover a lot of ground. I find that I often learn more in one of these meetings than I do in many larger meetings or briefings on community bank issues. A number of you here today have been to one of these sessions, and I think you would agree that these have been very constructive.

My overriding point here is that we at the OCC consider community bank supervision as core to our mission, and never more so than right now, in our current very difficult climate.

In that context, today I would like to discuss the serious shorter term challenges confronting community banks and their regulators. But I would also like to provide some observations about longer term steps that need to be considered to avoid a repeat of the serious problems we face today.

Shorter Term Challenges

While we are starting to see some welcome signs of life in the economy, times remain extremely difficult for many community banks. Loan demand is down, and criticized and classified assets are increasing, especially as commercial real estate markets continue to worsen. While the vast majority of community banks are sound – nearly 80 percent of community national banks have CAMELS ratings of 1 or 2 – a growing minority have ratings that are lower. For example, the FDIC's problem bank list of institutions rated 4 and 5 swelled to 702 at the end of last year, constituting almost nine percent of all insured depository institutions.

Worse, 195 banks – nearly all of them community banks – have failed since the start of the crisis in 2008. That's nearly 2.5 percent of all insured depository institutions, with an estimated cost to the deposit insurance fund exceeding $58 billion. And projected failures this year are expected to exceed last year's total of 145, maybe by a significant amount.

These hard times have produced a very difficult regulatory climate, for both community banks and their supervisors. A number of bankers and their trade associations – including ICBA – have complained that regulatory measures have been too stringent. We have heard that message loud and clear.

At the same time, others have criticized regulators for being too lenient with troubled banks, arguing that we should have closed failed banks sooner or taken harsher measures earlier to head off failure or lessen the costs to the deposit insurance fund.

Let me give you my perspective, and the OCC's, on these contradictory criticisms. In fact, I'd like to share with you the exact message I gave just last week to the OCC managers that supervise our examiners all over the country.

First, it is critical that examiners strive continually for professional judgment that is balanced. We have to be forthright in addressing problems as we see them, and ensuring that bank management does exactly the same. But we have to be equally careful not to overreact and make problems worse by acting too precipitously or being more stringent than we need to be. Striking that professional balance will not always be an easy task, but that comes with the job of being a good regulator.

Second, as significant issues arise, we can and should do more over time to provide appropriate guidance. The set of examples we used in the recent interagency commercial real estate guidance is the type of thing I have in mind – a communication that I think was quite well received and one where the process of developing it helped the regulators agree on consistent positions regarding issues that had been raised.

Third, in the expectations we communicate to banks and the actions we take, we need to be consistent. At the OCC we spend a great deal of time and effort on ensuring the consistency of messages to our examiners throughout the country via guidance, nationwide teleconferences, quality assurance programs, and training. We believe it is one of our strengths as an organization. In fact, we have tried very hard to stay ahead of the commercial real estate part of this crisis through a series of communications to examiners and bankers beginning in 2005 and extending into this year. While we were criticized early on as being unduly stringent relative to other regulators, we frankly have heard far less of that type of complaint recently – which we see as evidence of the consistency of our expectations.

Fourth, our examiners and their supervisors need to engage bankers forthrightly and address the specific concerns that you raise. I am talking here about both informal discussions with individual bankers in the examination process, as well as more formal outreach sessions with groups of bankers. These efforts can be very helpful – in getting out specific messages, in addressing misconceptions, in giving bankers a chance to really air your concerns, and in learning about some issues where we may in fact need to make adjustments. Part of this process means being open to criticism and complaint, whether informally through our field offices, more formally through our Ombudsman, or up the chain of command to Washington and me personally. That obviously doesn't mean we will always agree with particular complaints, but we will sometimes, and in all cases we need to strive to be open and fair.

Having said all of this, I need to be clear that the OCC simply cannot turn a blind eye to increasing losses and mounting credit problems. Thirty-three of the 195 banks that have failed since the start of the crisis have been national banks, causing just under 13 percent of estimated losses thus far to the deposit insurance fund. In this environment, we need to avoid the kind of forbearance that resulted in huge additional losses in the savings and loan crisis – an experience that led Congress to enact the Prompt Corrective Action regulatory regime in 1991. That regime reinforced to supervisors how important it is for distressed institutions to realistically recognize losses and deal with them – hopefully in a manner that will allow them to make it through the crisis while minimizing further problems.

Longer Term Challenges

Let me turn now to some longer term challenges. As I look back on my four and a half years as Comptroller, I believe there are some hard issues that policymakers, regulators, and the industry need to consider in order to avoid in the future the kinds of severe problems that community banks face today. In terms of the recent surge in community bank failures, the questions I keep asking myself are ones I think we should all be asking ourselves: what could we have done differently to avoid the scale and magnitude of these losses? And what changes should we make in the future to avoid finding ourselves in this terrible predicament again?

These are hard questions, made even more so by the difficult circumstances at the root of the financial crisis. We are in the worst recession since the Great Depression, triggered in the first instance by severe problems at our biggest financial institutions, including our largest banks. The too-big-to-fail problem, lax residential mortgage underwriting, complex financial instruments, unregulated nonbanking companies like mortgage brokers, inadequate regulation of investment bank leverage and trading activities – these were all enormous problems that combined to cause severe systemic damage, and the Administration, Congress, and regulators have rightly focused financial reform efforts on addressing these issues.

At the same time, however, the lax underwriting and excessive leverage produced housing and commercial real estate bubbles. Their collapse resulted in severe loan losses at all lending institutions, which in turn has led to the spike in failures of community banks.

Even in a perfect system in which we had the best managed, best regulated community banks, we would expect a recession of this magnitude to cause a significant number of bank failures and a significant amount of loss to the deposit insurance fund. But is the financial crisis and recession the <u>sole</u> explanation for 195 failures and $58 billion in deposit insurance losses thus far, which may not equal even half of the eventual totals?

These are huge numbers by any standard, and the banking industry, most definitely including all community banks, will be saddled with the costs of paying for these losses in higher deposit insurance premiums for many years to come. Given the magnitude of the losses and potential losses, I think it is imperative for all of us to ask if there were problems in the business and regulation of community banks that substantially contributed to these losses. And if there were, it is equally imperative to consider the steps that should be taken to address these problems.

I think the place to start in thinking about this is a careful examination of the causes of failures in the banks that have been resolved thus far. In this context, one of the jobs I least look forward to as Comptroller is attending the monthly closed FDIC board meetings where we are asked to approve resolutions for new failing banks. After 195 failures and counting, the reasons cited for these failures have become depressingly similar in an exceptionally large proportion of cases:

- Excessive concentrations in commercial real estate lending, especially construction and development lending, which produced very large losses;

- Excessive reliance on non-core funding, especially brokered deposits, to fund rapid growth, especially in CRE lending;
- And, in many cases, recently granted charters as *de novo* banks.

While these are by no means the only causes of recent bank failures – losses on residential mortgages, GSE investments, and trust preferred securities have also played their parts – CRE concentrations and non-core funding have been especially prevalent.

There also seem to be regional factors at play that are not easily explained simply by differences in regional economies. The state of Georgia alone has had 32 bank failures since the start of the crisis, which is only one less than the 33 national banks that have failed in all 50 states. At the same time, there have been <u>no</u> failures of banks in New England states, even though their economies are in many ways faring little better than Georgia.

While there could be a number of reasons for this disparity, from looking at the failures in Georgia thus far – including four national banks – I would suggest that a key factor has been the toxic combination of very high concentrations in construction and development lending funded by high levels of non-core deposits. At the same time, 16 of the 32 failures in the state, or half, were institutions that had been newly chartered in the previous ten years.

My purpose in this example is not to pick on Georgia or any other state or region in the country. It is instead to make a larger point: we need to examine closely the reasons for the spike in community bank failures across the country and determine if there are common threads or particular problems that can and should be addressed to reduce the number and severity of such failures in the future.

This is something the agencies could begin doing now, or it could be something that Congress directs us to do as part of financial services reform. In fact, it is a little surprising, given the magnitude of bank failures and loss, that more attention hasn't been paid to this aspect of the financial crisis.

I think a principal focus should be the issue of commercial real estate concentrations. After all, this is not the first time we have suffered from excesses in that market, and with the benefit of hindsight, we know quite a bit about this problem.

- We know from experience from the late 1980s and the early 1990s, and from the current period, that a significant concentration in CRE lending leaves banks vulnerable to an economic downturn – and the higher the concentration, the more vulnerable the bank.
- We know that a robust economy will mask unsound underwriting for a period of time.
- We know that rapid loan growth, and particularly a rapid build up of CRE loans, is likely to overwhelm risk management controls.
- We know that there is a level of CRE concentration that even the most sophisticated control systems cannot protect from a serious economic downturn.
- We know that banks that build concentrations in CRE are more likely to rely on noncore and/or high interest funding.
- We know that banks, in response to market pressures, have increased their CRE concentrations significantly in recent years; CRE loans now account for well over one third of the loan book on average at commercial banks, and for about half of loans at banks in the $500 million to $2 billion asset range.
- And we know that significant CRE concentrations in economic downturns can lead to an increase in problem banks, an increase in bank failures, loss of jobs, loss of incomes, loss to communities, loss to the deposit insurance fund, and higher costs for all banks, even those that do not have CRE concentrations.

Given what we know, I think we need to revisit the issue of the appropriate regulatory response to CRE lending concentrations, especially for construction and development lending, and especially for concentrations supported by non-core funding. While the concentration guidance we issued in 2006 was necessary – even though it was opposed by many parts of the industry – in retrospect, it has obviously not worked as well as we would have liked.

In revisiting this issue, I don't think we should be pre-disposed towards a particular approach. Instead we should consider a range of options such as harder limits, increased capital requirements, a more granular approach to defining concentrations (since not all CRE is the same), minimum underwriting standards, more stringent requirements for concentrations supported by substantial amounts of non-core funding, or some combination of the above.

I also think we should consider the issue of minimum federal standards for all newly chartered depository institutions, with a particular focus on business plans that call for significant CRE concentrations or reliance on non-core deposits for extended periods.

However, we should not do any of this in haste, or in ways that would exacerbate the current problems of distressed banks. Any course of action would have to be carefully phased in taking into account the current activities of all banks.

Conclusion

I recognize that the issues I have raised in my remarks are difficult ones, and don't have easy answers. I am mindful, too, that as we explore these questions, it opens the door for the larger strategic question of what the business mix of a community bank will look like in five years, 10 years, or in the future when the next generation of community bankers takes over the business. But given the surge in losses, problem banks, failures, and costs to the deposit insurance fund – costs that will have to be borne by healthy banks for a very long time – I don't think the status quo is acceptable. We need to take action, after thoughtful and careful study, to reduce the exposure of the industry and the insurance fund, to such large losses – <u>before</u> the next downturn comes, as it surely will.

Thank you very much.