Remarks by
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I appreciate the opportunity to be here today with such a large and enthusiastic group of community bankers. I want to begin by congratulating Chairman Al Jones on another outstanding year for IBAT, and his successor, Cliff McCauley, as he assumes the chair – both national bankers, I might add.

I also want to thank Chris Williston for his very kind words at lunch yesterday about Jeri Gilland, our Southern District Deputy here in Dallas who is retiring next month. Jeri built strong relationships with national and state bankers alike, as well as with colleagues from the state and federal banking agencies. The OCC will miss her fine work and many contributions to the agency. At the same time, we welcome her successor, Gil Barker, who is here today and trying to meet as many of you as possible. We expect Gil to become a very familiar face to your group in the years to come.

Now, it is certainly no secret that I participate in a broad cross-section of banker meetings every year. It's both my responsibility and my pleasure to interact frequently with bankers to make sure we get out the OCC message the way that I want, and just as important, to keep my finger on the pulse of the industry. You've heard me say it before but it bears repeating: community bank supervision is a critical component of the OCC's core mission, comprising nearly two-thirds of our employees, living in every region of the country. We take a back seat to no one in recognizing the importance of community banking to the health of the U.S. economy.

That's why I was especially pleased to participate in an exam of a community bank in Iowa last spring – one of the very best learning experiences I've had since becoming Comptroller. I watched how our examiners do their jobs, and how bankers interact with them. They even gave me some exam work to do myself – on BSA no less – so I could get a first-hand feeling for what you and our examiners go through in the supervision process. Now I'm sure the skeptics among you will think that everything was staged to be hunky dory for the boss – and to be honest, I expected a lot of that myself when the process began – but I want to tell you how pleasantly surprised I was at the real, substantive discussions that I witnessed with both management and the board about the types of issues that you typically confront in your exams, including write-downs, reserves, and BSA compliance. It was really eye-opening.

In that context, let me focus my remarks today on two areas that are critical to many community banks: concentrations in commercial real estate lending, and BSA compliance.

Commercial Real Estate Concentrations

Let me start with commercial real estate lending, which I do with some trepidation. The interagency guidance we released last December was intended to remind everyone of the increased risk that arises from concentrations in this asset class, and to reiterate our expectations when evaluating this increased risk. Those of you who experienced Texas banking in the 1980s probably don't need to be reminded of real estate concentration risk. But I can tell you from our discussions around the country that, as the result of a prolonged period of benign credit conditions, many community bankers had become a little too numb to the numbers over the last few years – which is why we felt the need to issue the guidance. I guess it wasn't surprising, then, that the notice and comment process for the guidance prompted a full-throated chorus of criticism from community banks – many of you were very concerned that examiners would interpret the numerical thresholds in the guidance as hard limits on the amount of commercial real estate lending that any one bank could do.

I spent a lot of time during this period trying to reassure bankers that this was not our intent, and that we simply would not implement the guidance in that way. I'm not sure I really convinced our skeptics at the time, but I think a year of experience under the guidance has gone a long way towards doing just that. In my many banker meetings around the country and in Washington during the last nine months, I've gotten very few complaints or even questions about our implementation, and that's a good thing. In fact, more than one banker has told me that the guidance reinforced sound risk management practices. Overall, we believe the guidance has been effective in reminding bankers and examiners alike of the risk of high concentrations, in stressing risk management, and in providing a consistent message.

So, you may ask, if the guidance has been implemented more smoothly than many had feared, why am I talking about it again here today? The answer is really pretty simple: these concentrations still present elevated levels of credit risk for community banks, and we're now entering a stage of the credit cycle where losses are likely to increase. The mortgage market disruptions of the last two months, combined with declining house prices across the country, are putting considerably more stress on one category of commercial real estate lending: residential construction. Other categories will feel similar stress if general economic activity slows materially. As losses mount, banks need to be prepared, especially banks with significant concentrations.

Indeed, as the recent market turmoil has reminded us, concentrations in almost any financial product can precipitate real financial problems. Given the traditional cyclicality of the economy and real estate markets, prospects for a commercial real estate project can change considerably between conception and completion. Indeed, even a well structured and soundly underwritten project can become a problem during the periodic overbuilding cycles that characterize these markets.

Many of you may be wondering just how much of an issue this is in Texas. Let me give you some perspective based on our supervision of community national banks doing business here. In particular, I'd like to focus on construction and development loans, a good chunk of which relate to residential real estate. National banks in Texas have always had relatively larger C&D portfolios than the national average, and that gap has started to widen in recent quarters as banks here are continuing to grow this portfolio.

This widening gap caught my eye because of trends we're seeing at the national level. While overall commercial real estate performance has been sound, some weaknesses are beginning to emerge in C&D loans, primarily related to the slow-down in residential home sales. Indeed, during the last year national community banks outside of Texas have experienced a significant increase in C&D loans that are 30 days or more past due – more than doubling from 1.2 percent at June 2006 to 2.6 percent at June 2007. Although starting from an admittedly very low baseline, such an increase – over 100 percent in a single year – is clearly a trend that bears watching.

How does Texas compare? Pretty well, fortunately. In fact, at the end of this past June, the corresponding percentage of 30-day or more delinquent C&D loans for national community banks in Texas was just 0.95 percent – well below the 2.6 percent national average. I wouldn't take too much comfort from that, however. As a regulator, I can't help but look at the rapid increase in the national average, which to me illustrates just how quickly things can change. Given the heightened level of C&D lending in Texas, this is plainly a part of your banks' portfolios that requires strong controls and consistent monitoring.

Those of you who are national bankers know very well that commercial real estate concentrations have been a topic of discussion at your examinations for some time. Over the past four years our examiners have assessed your risk management practices in an effort to ensure they are appropriate for the level of risk you have assumed. These efforts have continued all over the country this past year and will continue into 2008.

For consistency in these assessments of existing practices, we have brought together teams of highly experienced examiners to look horizontally across banks with higher CRE concentrations. This allows us to identify and convey best practices more effectively, and provide consistent advice on any additional measures that we believe should be taken.

When we started these "horizontal" reviews four years ago, we found that many banks lacked robust risk management practices and sufficient management information systems to adequately identify risk exposures. Over time, we began to see improvements, especially in risk management policies and in boards of directors articulating the level of risk they believe is appropriate to take, by product, loan structure, and overall borrower creditworthiness.

We are also seeing more use of stress testing, at least through the analysis of the effect of different interest rate scenarios. But given high levels of concentration, banks should also be stress testing other business variables that affect risk, such as vacancy rates, lease rates, and expense scenarios – not only at the time the loan is made, but also periodically throughout the life of the credit relationship. The potential for rapid deterioration in this business is simply too great <u>not</u> to conduct ongoing stress testing.

Another issue that surfaced in the horizontals involved real estate appraisals, which continue to challenge your lenders and loan review. We have seen greater independence in the process of ordering appraisals and appraisal review, which is positive. But we share your concerns with the overall quality of many appraisals, and are mindful of the pressure that places on those making credit decisions. The federal banking agencies are working on guidance that updates and clarifies many previous supervisory interpretations on real estate appraisals, including independence of the appraisal program, minimum appraisal standards, and internal review processes. The agencies plan to propose the guidance for comment, and I encourage you to carefully review it and provide us feedback.

As we continue with our CRE horizontals forward into 2008, we won't be trying to supplant your assumptions of market trends and conditions with our own, as long as yours appear reasonable and well supported. But we will be talking with you about how those assumptions were developed and how they are actually materializing. While we normally will not impose regulatory parameters on your assumptions, we <u>will</u> expect banks with concentrations to have a better risk management system for that portfolio than lenders who don't have such concentrations.

Stepping back, we think it's reasonable to expect that more of your borrowers will experience credit problems in the coming months. The information we collect and the indicators we track indicate that credit quality will be moving away from the halcyon days of the last several years towards more traditional, higher levels of loss, past dues, and classifications. Recent market disruptions and declines in house prices have only reinforced that view.

In that context, we want you to be prepared. You need to make sure your officers and loan review staff realistically assess the strength of your borrowers, and identify problem credits early. You should also ensure that you have adequate loan loss reserves to cover the increase in losses that may occur. I know that in recent years, some bankers have been fearful of criticism from their external auditors if the bank's loan loss reserves were deemed too high. As we and other banking agencies have stressed, your methodologies for arriving at your loan loss reserves, and the reserves themselves, need to be sound and well documented. But I firmly believe that in this environment, increases in loan loss reserves for many banks are both warranted and prudent. I would be extremely surprised if your auditors disagreed with this position – but if they do with respect to a national bank, I urge you to contact your examiner-in-charge or Assistant Deputy Comptroller. If we have to intervene in this situation, we will do so.

Money Laundering

Now I want to turn to an entirely different topic: managing the risk of money laundering. I recognize that several years ago the bar was raised sharply with respect to BSA compliance, and you've had to spend a lot more time and money on it than was ever true in the past. I also recognize that there was a good deal of uneven implementation of the new regime by regulators, and that all too often, the costs of compliance were far more visible than the benefits.

I genuinely believe we have made progress in addressing a number of these concerns. In terms of regulatory expectations and a more level playing field of compliance, we worked with the other agencies to publish a comprehensive BSA manual to help both our examiners and the industry. The manual compiles in one place the various BSA-AML requirements, and provides guidance on potential risks that can arise in various banking products, services, customers, and geographies. We have revised and reissued the manual twice since it was first published in 2005. We have also conducted teleconference calls for the industry on technical subjects and spoken at countless industry educational forums.

Through all these efforts I believe bankers now have a much better understanding of the new rules of the road. We at the OCC have learned, and we hope you have, too, that managing money laundering risk in a community bank doesn't have to be as difficult as it first may have seemed. Accordingly, the OCC has tried over the last few years to distinguish between those banks that have higher levels of BSA risk, and those that don't.

There is a certain tension here, however. On the one hand, given the changes in BSA compliance requirements over the last several years and the outcry it provoked, there was plainly a felt need for clear and understandable rules that could be applied to all – and the BSA manual and its implementation have been good efforts to address that need. On the other hand, that kind of approach inevitably creates a kind of "one size fits all" feel to it, with less risky BSA banks sometimes subjected to many of the very same supervisory expectations as more risky BSA banks. That cuts across our grain at the OCC to some extent, because we have long applied a risk-based approach to supervision.

As a result, we continue to try to develop ways of better segmenting banks according to risk. Over time, we hope increasingly to use that information to devote more of our supervisory efforts to the riskier banks, and fewer to those who need it least. We're not there yet, and there will always be tension, as I said, between the need for minimum procedures and the efficiencies of risk-based supervision. But I think the effort is a sound one, and promises relief over time for those community banks – which are most of you – that present lower levels of BSA risk.

So let me talk now about one particular OCC effort in this area. Two years ago, we launched a project called the Money Laundering Risk System, or "MLR," in which we asked all community national banks to send us data about their products and services that relate to money laundering risk. The MLR is designed to identify money-laundering risk factors by quantifying higher risk bank products, services, customers, and geographies. We collect this information annually, analyze it, and provide reports to our examiners and bankers. The data are used as a tool in developing individual bank strategies, determining necessary examiner resources and skills, and selecting areas for transactional testing during BSA examinations. Examiners may also use MLR data in conducting a BSA risk assessment for any bank that has not performed its own risk assessment as prescribed by the interagency exam manual.

Examiners use the MLR data, in conjunction with their knowledge of the bank, to identify those community banks that may have higher risk for BSA issues. For example, a bank may submit information that shows it has a very active wire room, a private banking department, and several correspondent banking accounts. This will put the bank higher up on our priority list than a bank that engages in no such activities. Of course, in every case we temper the raw data we receive with an examiner's knowledge and judgment about the individual bank.

Now, we wouldn't ask you to gather and report information unless it's really significant for complying with BSA, because we know it's a burden. We also know the first year of submitting this information was more time consuming for some of you than we anticipated – in fact, I know this myself because it was one of the questions I asked in the exam I went on last spring. We are hearing that it was much easier in the second year, and we've been working hard on improving the process – so I would be very interested in your feedback on how we're doing.

Overall, I can tell you that collecting the MLR data has helped in our BSA supervision. As I said, OCC examiners use the data to understand BSA risks and to develop their examination strategies. We believe this allows us to use our resources more effectively, and lets us get in and out of your bank as quickly as is prudent. We know our approach is working, because for banks we identify as lower risk, we are using far fewer examination workdays.

We also use the data for systemic analyses. Now that we have two years of data, we can measure trends in the industry, such as identifying how many banks are involved in higher risk activities. And we can analyze where we are spending examiner time in relation to risk.

In addition, some of you have told us you needed more guidance on developing the required BSA risk assessment, and that the information you submitted for the MLR has helped you do just that. This year, based on your feedback, we provided peer data back to you so you can compare your bank's level of risk to other banks. In fact, this is the first time that peer information for BSA risk has been available and provided to the banking industry, which we think really does help let you know where you stand. It also has helped bankers identify internal control gaps and set the scope of audits. Finally, when bankers and examiners share MLR data, it allows them to discuss risk from an informed, common perspective.

Let me now share with you some important specific observations from the data. First, according to our MLR metrics, the vast majority of OCC's community national banks are considered low risk; specifically, 89 percent are low risk; seven percent are moderate risk; and only four percent are high risk.

The data also show that as banks get larger, the types of products and services they offer often put them at higher risk for money laundering. In dollar terms, banks with total assets under $100 million generally demonstrate lower risk attributes. It is no surprise, but nevertheless good to confirm, that the size, complexity, and products and services offered have a direct impact on a bank's overall AML risk profile.

The MLR data also give us a window into the types of products banks offer, in terms of BSA risk. For example, we know that for our community banks in Texas, only two percent reported having a foreign correspondent bank account; but 64 percent sent or received international wire transfers; and 54 percent provided banking services to check cashers. Such statistics not only help our examiners, but also help us make informed policy decisions about BSA issues, based on facts – which can really augment our supervisory approach.

Finally, as I said earlier, the data we receive helps us allocate our own supervisory resources according to risk. Our average BSA exam workdays for lower risk banks is about four days; for moderate risk banks, 10 days; and for higher risk banks, 22 days. These are substantially fewer workdays than we experienced in each risk category just two years earlier. Thus, the data you send us is clearly helping us to prioritize and supervise based on identified areas of risk.

So if I could leave you with one overall thought about the MLR data, it would be this: this is a tool that really helps measure BSA risk in community banks, which over time we believe will help lead to fewer supervisory resources and less regulatory burden directed towards the vast majority of community banks, which are lower risk, with more resources focused on those higher risk banks that really need it.

In closing, let me again thank the IBAT leadership for inviting me here today. The OCC recognizes the vital role that community banks play in our nation's economy, and I believe we share a common goal – to make sure that banks remain safe and sound so you can continue to meet the needs of your customers.

Thank you very much.