

Remarks by
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It is a pleasure to be with you again today, one year after my first formal speech as Comptroller. Back then, in Palm Desert last September, I knew already that this year would be challenging and demanding, and it certainly has been. We have had to address an exceptionally broad range of issues, from Basel to commercial real estate to nontraditional mortgages; from deposit insurance premiums to industrial loan companies; and from regulatory burden relief to BSA compliance – among many others.

As I addressed you in Palm Desert, less than two months after I was sworn in, I remember thinking that it would take me only a few more months to get up the learning curve to really do my job effectively. I was wrong. When the issues are this diverse and this complex, the learning process simply never stops. And a critical part of that process results from my discussions with bankers – I’ve tried to remember the adage about God giving us two ears and only one mouth so that we would spend twice as much time listening as talking.

So I have made it a point to meet with, and listen to, as many bankers as possible while I’m in office. We’re off to a good start. I’ve had the chance to meet personally with more than 350 of you during the outreach meetings the OCC has hosted in cities across the country. And I’ve met with hundreds more of you during your visits to Washington or at large conferences like this one. Since bankers are not shy, you’ve certainly let me know what’s on your minds and where you think we’re doing things both and right and wrong – which is just as it should be for this continual learning process to be effective.

Today I would like to raise with you two related issues that have been very much on our minds at the OCC, and no doubt, on yours: credit trends, and the appropriate level of loan loss reserves. Before I do, however, I wanted to say a word about community banking and the OCC.

Whenever I've attended the ABA convention, I have always been struck by the preponderance of community bankers, just as the vast majority of the institutions the OCC supervises are community banks. People are sometimes surprised to hear me say this, because they tend to think of the OCC as the "big bank regulator." But ever since the OCC was established in 1863, community banks have been a mainstay of our mission.

That is just as true today because of the unique role that community banks continue to play in our national economy. Community banks operate in places that larger banks won't; they provide credit and personalized service to customers in ways that larger banks don't; and they force larger banks to compete in ways that bring real benefits to businesses and consumers.

When I say that supervising community banks is central to our mission, it is important to recognize that bank supervision is the OCC's only occupation. We don't worry about monetary policy or deposit insurance: we supervise banks. And while we supervise everything from trillion-dollar "megabanks" to trust banks to credit card banks, we view community banks as our real "bread and butter." They are fully 92 percent of the banks we supervise, involving 65 percent of our bank examination force.

Our supervision of community banks, like that of any bank, focuses first on credit quality, because that is critical to our safety and soundness mission. This is a particular concern for community banks because a relatively small mistake can result in real loss and

even failure, where the same mistake would not threaten a larger bank with a more diverse portfolio. Of course, when large credit problems do occur in larger banks, the consequences can be much more severe.

Community banks like yours also face an increasingly complex set of compliance requirements covering anti-money laundering, fair lending, and consumer disclosures, to name just three, and you “feel the pain” of these requirements more than larger banks that can spread the costs more easily over larger organizations.

It is fair to say that running – and supervising – banks has gotten more complicated over the years. Given our sole focus on supervision, I like to think the service we provide is the “gold standard” of bank supervision – and that is certainly what we strive for every day. We do hold each community bank we supervise to high standards, which we believe in the long run is best for the bank and its customers. But we also recognize that community banks sometimes need more guidance to comply with the regulatory maze than larger banks do. OCC examiners are trained and encouraged to provide advice that goes beyond the scope of the formal examination for those banks who want it. And in this way we really believe that we can, and do, add real value to what you do.

Developments in Credit Risk

Let me now shift gears. While banking risk has become much more complex and diverse in recent years, there is no more fundamental challenge for the banking industry than credit risk. When I spoke to you last year, I said that part of my job would be to monitor trends constantly and carefully, and to let you know when we begin to see risk building in ways that require your attention. With that in mind, let me discuss our recent supervisory findings on credit conditions.

In a nutshell, our recent exam results show that we are now into that stage of the credit cycle where signs of stress may become evident, if you pay close attention. The performance of credit portfolios remains strong, but as you know, losses and even delinquencies tend to be lagging indicators of risk. Other signals indicate credit risk is on the rise, due both to the macroeconomic environment and to industry practices and conditions.

The results from this year's interagency Shared National Credit review focuses on the credit quality part of the story. A Shared National Credit, commonly referred to as a "SNC," is a loan or loan commitment of \$20 million or more, and that is shared by three or more unaffiliated, supervised institutions under a formal lending agreement – in other words, a big loan to a big corporate borrower that is syndicated to others. Eighty-three percent of all SNC commitments are agented by national banks, and this year's review covered over 7,000 credits totaling \$1.8 trillion in loan commitments to nearly 5,000 borrowers. Because the banking agencies have been conducting SNC reviews for three decades, the annual SNC results can be analyzed in the context of previous years' data to give an important current "snapshot" of national trends in credit quality.

The results from this year's SNC review are generally positive. While the number of criticized and classified commitments rose, the increases were relatively small, and they came against the backdrop of 2005 levels that were the lowest in six years. Even such a small decline in credit quality, however, is still a decline. Given the long preceding period of credit quality improvement, we will be monitoring whether this year's decline portends a change in direction, or simply a stabilizing of credit quality of the syndicated loan market.

Our concerns about increasing credit risk – a more forward looking view than credit quality – arise from the OCC's 2006 Underwriting Survey, which will be released later this

week. This survey, now in its twelfth year, canvasses the examiners-in-charge of our 73 largest national banks, and provides a detailed snapshot of trends in lending standards across 18 different product lines, both commercial and retail. The key difference between this survey and others you hear about is that this one is based on the professional opinions of our on-site examiners, rather than self-assessments by banks themselves or third-party observers.

What the underwriting survey says this year should give us pause. Loan standards have now eased for three consecutive years. The reasons most frequently cited are competition, often from non-bank investors, and optimistic – perhaps too optimistic – expectations for loan volume, yield, and market share.

Whatever the reasons, our examiners see these results: thinner pricing, reduced amortization, weaker covenants and controls, and pervasive structural concessions in such terms as tenor and guarantor requirements. Even where the bank's lending policies have not changed, we are seeing an increased volume of exceptions to those policies. And, according to our examiners, these trends apply across both commercial and retail lending.

With respect to commercial lending, we saw the most pronounced slippage in underwriting standards in leveraged lending and large corporate loans. Commercial real estate also showed continued signs of net easing. That, in combination with the increased concentrations in commercial real estate loans in a number of our banks, has certainly raised our antennae.

With respect to retail lending, the underwriting survey showed significant easing in residential mortgage lending standards, including home equity lending. We saw more of what we observed the previous year: longer interest-only periods, more “piggyback” loans to

avoid mortgage insurance requirements, higher allowable debt-to-income and loan-to-value ratios, and greater volumes of loans with reduced documentation requirements.

This year has brought us at least one thing that's new, however: a cooling of the red-hot housing market. In many local and regional markets, prices are leveling off, while in others, they have declined. We would normally expect that trend to change the calculus of many mortgage lending decisions, with lenders tightening their underwriting standards and requiring borrowers to provide more equity.

Yet that's not what the underwriting survey and other recent evidence demonstrates. In fact, with fewer home buyers in the market, competition among lenders appears to be intensifying, and, with some exceptions, that competition has extended to weaker underwriting standards. Frankly, that concerns me. We don't want to see the lending decisions bankers make today result in excessive foreclosures – and reduced affordable housing credit – tomorrow.

In presenting results such as these, we are always mindful of the need to avoid painting a darker picture than is warranted, or ringing a warning bell that doesn't yet need to be rung. It is not my intent to do either of those things today. On the other hand, none of us can afford to overlook or minimize symptoms that historically have been reliable predictors of future problems if not addressed. The challenge we face is managing this risk in an effective and timely way and doing it now – while credit quality is still good, while loan loss reserves are strong, and while the economy is robust. My hope is that next year at this time I will be able to report to you that the 2007 underwriting survey shows that the trend of the last few years has at least stabilized.

Developments Relating to the Allowance for Loan-Losses

In the time I have remaining, let me focus on an issue that is inextricably intertwined with the credit risk I've just described: the allowance for loan loss reserves. This has been very much on our minds at the OCC.

As I just mentioned, reserves today are strong, but we've got to make sure they stay that way. Why? Because loan losses that exhaust a bank's reserve, and ultimately wipe out equity capital, have been the primary cause of almost all bank failures. Thus, solid loan loss reserves – representing the best estimate management can make of how much money the bank will lose on the loans it has made – are critical to a bank's safety and soundness. That is especially true today, at a time of rising credit risk, easing underwriting standards, concentrations in some loan products, and lack of performance experience with others.

For bankers, calculating the reserve has always involved a combination of art, instinct, and experience. It calls on your skills as a credit risk manager and the value judgments that role entails. It also requires knowledge of the accounting framework through which these judgments must be reported. Any two bankers or bank examiners can look at the same loan portfolio and draw different conclusions about the likely loss in any single credit or portfolio of credits. It has to be that way because no two banks make exactly the same value judgments or use the same risk management techniques. But if done properly and skillfully, these different judgments will fall within a reasonable range.

Generally, the reserve has been calculated by combining the bank's estimate of the amount required for each portion of the portfolio, relying on the GAAP definition of an impaired credit. But even at its best, we are still talking about a best estimate within a

spectrum of estimated losses on loans the bank has made. Obviously, the reserve calculation involves a considerable degree of subjective judgment.

That does not mean that calculating the reserve can ever be an exercise in pure speculation. We have always expected banks to have a clear and consistent methodology that documents and justifies its assumptions and conclusions. In other words, the bank's approach must be rigorous, and consistent with generally accepted accounting principles. It should be based on observable information, such as historical loss percentages, loan growth, macro and microeconomic conditions, changes in bank risk selection, and underwriting standards. And it must rely on timely and accurate judgments about the risks in the portfolio.

As you know, in 1998 the Securities and Exchange Commission launched an initiative to address the problem of earnings manipulation. In one notable case, it required a large banking organization to reduce its loan loss reserves by \$100 million. This led to intensive negotiations between the SEC and the banking agencies, which resulted in joint interagency agreements in 1998 and 1999 that reaffirmed the bedrock principles of the reserve methodology I've just mentioned. It recognized the importance of management judgment in arriving at an appropriate allowance. And it emphasized the importance of comprehensive, consistent analysis.

Then, just a few months later, in the Gramm-Leach-Bliley Act, the SEC was required "to consult and coordinate comments with the appropriate Federal banking agency before taking any action or rendering any opinion" on loan loss reserves, including their amount. We followed this with a 2001 joint policy statement of the banking agencies, issued simultaneously by the SEC, which gave further clarity, force, and conformity to our methodologies and practices.

In the past year, a new issue emerged. The Public Company Accounting Oversight Board, or PCAOB, was created by the Sarbanes-Oxley Act to operate under SEC oversight, with a mandate to oversee the establishment of auditor standards and inspect public accounting firms that audit financial statements. A year ago, the Board began releasing the public portions of its inspections, which were highly critical of the audit work performed of bank loan-loss reserves by several public accounting firms. Not surprisingly, this criticism appears to have led at least some auditors to take a harder line in their reviews of bank loan-loss policies and practices.

That concerns us. The one thing we don't want to see – especially with rising credit risk in the banking system – is banks lowering their reserves inappropriately. Given the uncertainties in the financial environment and in credit conditions, this is not the time for banks to drop their guard – or their reserves. We have intervened in cases where we felt an outside auditor was inappropriately trying to substitute its judgment for the bank's in determining reserve adequacy – and we will continue to do so where necessary.

We're trying to support bankers in several other ways, as well. First, we're holding regular talks – both with the PCAOB and with the large CPA firms – to make sure that we understand each other's concerns and perspectives. I think all parties agree that any policy differences must be ironed out among the policy makers. Resolving these conflicts should not be the banker's job. I am pleased to report that our recent discussions have been quite positive, as I believe we are moving toward agreement about the appropriate standards and issues involved in assessing reserve adequacy.

Second, the banking agencies are now engaged in revising our 1993 comprehensive interagency policy guidance on the allowance. This revision, which could be completed as

early as the end of this year, will elaborate our existing policies, make a number of technical additions and improvements, and include a list of frequently-asked questions.

Finally, we are emphasizing in our communications to bankers and examiners that reserves should be maintained at a level that reflects the imprecision inherent in estimating potential losses. What constitutes “appropriate” is to be determined through the consistent application of clear methodology and supporting documentation. Where banks lack these methodologies, examiners will work with them to correct any shortcomings.

Loan loss reserves are a crucial component of solid bank risk management and a crucial bulwark of a safe and sound banking system. While we do not tolerate the use of reserves to manipulate earnings or mislead investors, neither should we do anything to discourage banks from making appropriate provisions. And, speaking for the OCC, I can assure you that we will not.

In closing, one thing we will do is remain vigilant. As I said last year, our job is watching, and watching closely; calling attention to smaller problems before they grow; and, when warranted, taking measured supervisory steps to achieve appropriate remedial action – and in all of this, to listen carefully before we act.

Thank you very much.