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TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND REGULATORY RELIEF

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

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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

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify on the condition of consumer credit in the United States. Over the past few years we have seen a rise in consumer loan delinquencies and loss rates. As bank supervisors, we are concerned about these trends and are taking steps to ensure the continued safety and soundness of the national banking system. Nonetheless, it is important to place these developments in perspective in order to react appropriately.

In that context, we must recognize that the economy is strong. The nation's banks have recorded four consecutive years of record profits, and figures for the first quarter of 1996 -- while not a quarterly record -- are quite strong. Preliminary indications are that second quarter earnings will also be strong. Bank capital levels are at their highest levels in years. Problem commercial banks totaled 127 as of March 1996 compared with over 1,000 at the end of 1991. For the first six months of 1996, 3 commercial banks have failed, compared with 55 in the first six months of 1991.

Today I will discuss what is happening in consumer lending in the commercial banking system, where we see areas of concern, and what the Office of the Comptroller of the Currency (OCC) is doing to address current and potential problems in consumer credit and bank safety and soundness. I will begin my testimony with a discussion of developments in the roles that banks are playing in financing larger amounts of consumer debt. Next, I will discuss the rise in credit problems. I will then outline the major recent initiatives that the OCC has undertaken in supervision of consumer lending.

Banking Industry Consumer Loan Trends

Over the past ten years, commercial banks have shifted into consumer lending residential real estate lending such as home mortgages and home equity loans, installment lending such as automobile and boat loans, and credit cards. As shown in Figures 1 and 2, the largest and fastest growing area of consumer lending is in loans secured by residential real estate. This includes 1-4 family residential real estate loans, with a small volume of home equity loans. Figure 1 shows the dollar amount of loans outstanding, while Figure 2 expresses this dollar amount as a percentage of total assets. Residential real estate loans now account for nearly 15 percent of bank assets, compared with 7 percent at year-end 1984. Installment loans have grown at a slower rate. In 1984, installment loans were the largest component of consumer lending, at approximately 10 percent of commercial bank assets. Installment loans' share of assets declined between 1985 and 1992 and now account for 7 percent of assets. Although credit card loans account for less than 5 percent of total commercial bank assets, this category has grown faster than other types of consumer loans over the last three years.

(See Attachment Figure 1)
(See Attachment Figure 2)

Some banks concentrate their lending efforts in one type of consumer loan. A small number of commercial banks, 134, have a portfolio of credit card loans that exceeds 10 percent of assets. At 62 banks (42 of which are national banks), credit card loans exceed 50 percent of assets. By comparison, a larger number of commercial banks, 1,096, have residential real estate loans that represent more than 30 percent of assets. We find that the overall increase in consumer lending has caused total consumer loans-to-assets ratios to increase at certain banks. As shown in Figure 3, a larger percentage of banks today are more likely to have consumer loans-to-assets ratios over 30, 40, or 50 percent than in 1984. In fact, 35 percent of all commercial banks have a consumer loans-to-assets ratio over 30 percent, compared with 26 percent of all commercial banks at year-end 1984.

(See Attachment Figure 3)

This shift into consumer lending occurred as traditional business customers increasingly went directly to credit markets or nonbanks for funding, therefore slowing the growth rates for commercial lending at commercial banks. Commercial banks also reduced their loans to less developed countries and commercial real estate loans. Figure 4 illustrates that commercial banks currently hold more consumer loans than commercial loans. Consumer loans rose to almost 27 percent of assets from 18 percent in 1984. On the other hand, commercial loans as a percent of assets declined over the last five years to 25 percent, after remaining fairly constant at 30 percent from 1984 to 1990.
(See Attachment Figure 4)

Not all banks that extend credit card and other consumer loans keep the loans in portfolio. A number of institutions securitize and sell their credit card receivables. In September 1991, when we first started collecting data on assets of credit card loans securitized without recourse through the call report, credit card loans securitized represented nearly 37 percent of credit cards held in portfolio by banks. By March 1996, that percentage had risen to 66 percent. The OCC is monitoring carefully the implications of this rising trend in securitizations.

Consumer Credit Trends

As discussed in the section above, growth is one factor we evaluate when monitoring lending developments. We also evaluate credit quality, which includes an analysis of trends in loan charge-offs and delinquencies. Several factors work together to mitigate the credit risk posed by commercial banks' shift into consumer lending. Those factors include historically low loss rates on residential real estate loans, the relatively small average loan size for credit card loans, the relatively wide margin obtained on credit card loans, the ability to limit or withdraw credit, a diverse base of borrowers, and an active

secondary market for many types of consumer loans. For example, because virtually all banks sell 1-4 family mortgage loans into the secondary market, underwriting criteria on those loans are essentially standardized, and delinquencies on home mortgages continue at low rates. In addition, the increase in consumer lending has meant that banks decreased their earlier reliance on certain riskier assets, such as commercial real estate.

One way to review banking industry credit quality is to analyze the net loan loss rates on various loan types. As seen in Figure 5, residential real estate loans, the largest share of consumer sector lending, have the lowest loss rate among consumer loans. Although residential real estate loans have low credit risk, they may present other forms of risk to banks, such as interest rate risk. Furthermore, as we will discuss later, we remain concerned about the consumers' ability to take on additional debt, such as home equity debt, given their high level of debt to disposable income. On the other hand, credit card loans, the smallest share of consumer lending, have the highest credit loss rates. Moreover, loan loss rates for residential real estate and installment loans generally are less volatile than those of credit cards.

(See Attachment Figure 5)

Another way to look at credit quality is to examine delinquent loans whose payments are past due 30 or more days plus nonaccrual loans. These delinquent loans may or may not need to be charged off eventually, and so they only provide a rough indication of future losses. Figure 6 shows that the percentage of delinquent consumer loans has risen for several quarters.

(See Attachment Figure 6)

Deterioration in credit quality, caused by both cyclical and secular trends, is never good news. Some deterioration in credit at this stage of the business cycle is not unexpected, particularly given the low level from which this indicator is rising. Also, employment growth has slowed and interest rates have risen, putting further pressure on credit quality. As seen in Figure 5, loan loss rates have risen since 1994.

A second factor influencing the recent deterioration in credit quality may be the rise in total debt as a percentage of disposable income. Figure 7 shows that total debt as a percentage of disposable income is at a relatively high level. People with a higher ratio of debt to income are more likely to fall behind on their debt payments when confronted by a setback, such as the loss of a job. The overall rise in debt since the early 1970s corresponds to the aging of the "baby boom" population cohort. In the early stages of establishing a household, "baby boomers" consumed more and were more willing to increase their level of debt in the process. As the "baby boom" population cohort begins to work its way through the period when saving for retirement becomes predominant, the ratio of debt to disposable income may decrease.

(See Attachment Figure 7)

Trends in bankruptcies are also a concern, and may be contributing to the rise in loan defaults. Total bankruptcy filings are estimated to have risen 27 percent, to 318,893, over the four-month period between January 1 and April 26, 1996. This was the largest four-month rate of increase since 1986 and the biggest four month total ever. Some have attributed this rise to the liberalization of the U.S. Bankruptcy Code, which took effect late last year, making Chapter 13 debt reorganization available to more debtors. Previously, consumers with more than $100,000 in unsecured debt and $350,000 in secured debt could seek bankruptcy protection only by liquidating their assets under Chapter 7. Now, consumers with as much as $250,000 in unsecured debt and $750,000 in secured debt may seek reorganization under Chapter 13 rather than liquidation. In addition, even if a debtor elects liquidation under Chapter 7, the Reform Act permits the debtor to retain more of his assets than was previously allowed under the Bankruptcy Code.

Others have suggested that the rise in consumer bankruptcies reflects a secular change in consumer attitudes toward debt and responsibility. Such attitudes have changed greatly. In the 19th century, failure to pay debts resulted in debtors' prison. Since 1960, annual bankruptcy filings have increased tenfold, from about 110,000 in 1960 to the million bankruptcies we would observe for 1996 if the pace exhibited in the first four months of 1996 continues. Bankruptcies as well as consumers' willingness to assume debt are much more commonplace today.

Despite these trends, the losses and delinquencies on credit card loans should be considered in the appropriate context. Credit card loans have high net interest margins that reflect, in part, the higher credit risk and proportionately high losses expected of an unsecured credit line. The relatively small number of banks that specialize in credit card lending have successfully managed loan losses in the past, as evidenced by their consistently high profitability. Despite cyclical fluctuations, these banks have been able to price their products to incorporate expected losses, manage credit quality problems through aggressive collection, charge-off and recovery programs, as well as limit or withdraw credit as warranted.

The trends in losses and delinquencies in consumer lending are developments that we as regulators must continue to monitor. We remain concerned, although we do not believe there is a widespread or systemic problem. There are two primary reasons for our concern. First, the high levels of debt today leave consumers and therefore bankers vulnerable to adverse shocks impacting consumers' ability to repay their debts. Second, the high returns associated with credit card loans have lured some bankers into the business without having adequate risk management systems and human capital in place.

OCC Initiatives

As supervisors, our job is to make sure that banks have sound

risk management systems in place, have fundamental structures in place including capital and strong loan loss reserve levels, and that banks are managing risk appropriately. Recent trends suggest that there are some problems with consumer lending that neither regulators nor the banking industry can ignore. Over the past three years, the OCC has taken a number of steps to learn more about developments in consumer credit lending and take appropriate actions to ensure that banks continue to manage risk and operate their businesses profitably.

During my term as Comptroller, our supervisory process has evolved to take into account changes in the banking environment and the banking industry. We monitor developments in the industry to assess risk by gathering information from our database of examination findings, surveys, industry comparisons for nonbank competitors, and reports on the entire banking industry. To respond to that assessment of risk, we educate our examiners through training and revised examination procedures, educate the industry by issuing guidance, and develop regulations as appropriate. We constantly review our examination procedures to ensure that our examiners have up-to-date procedures for assessing bank products and are able to identify and respond to risk. The process is continual, not only because we need to ensure that banks have the necessary risk management processes, but also because the market is constantly developing new products.

Before I provide you with more detail on our actions with respect to consumer credit, I want to stress that as regulators we must continue to insist on safe and sound practices. At the same time we also have a responsibility not to unduly restrict the workings of the market, including the development of innovative lending programs that may ultimately allow more businesses and individuals to participate in the credit process without affecting the safety and soundness of the banking system. We believe our actions reflect these standards.

Credit Card Horizontal Review. In 1994, observing the rapid growth in bank credit card operations, the increase in the number of banks specializing in credit card operations, and increased competition among the major issuers, we became concerned that changes in industry underwriting standards could expose banks to increased risk. As a result, we formed a working group to take a closer look at the credit card industry.

During the second half of 1994, OCC examiners reviewed credit card operations at the fifteen largest national bank credit card issuers. We learned more about many aspects of credit card operations and in some banks identified several areas where operations could improve. For example, at some banks we recommended a change in the methodology used to determine the allowance for loan and lease losses. We required that some banks analyze and maintain documentation to support the feasibility and effectiveness of policies designed to bring current the accounts of troubled borrowers. For a few banks, we recommended improvements to monitor the impact of procedures of approving lines of credit for borrowers who do not meet their normal

lending criteria. In 1995, OCC examiners worked with these banks to ensure they made changes noted to improve their operations.

The results were presented to the examiners and discussed with the banks involved in the survey. We also presented the results of our review to the other bank regulatory agencies and to the Federal Financial Institutions Examination Council (FFIEC) Supervision Task Force in August 1995. Information obtained from this analysis was incorporated into examiner training and the Comptroller's Handbook for examiners, as will be discussed below.

Survey of Automobile Lending. To learn more about automobile lending underwriting standards, OCC examiners reviewed the underwriting standards of regional and multinational banks in July 1994. Nearly two-thirds of the examiners surveyed reported no changes in underwriting criteria in the banks over the prior twelve months. However, the survey did point out one trend we want to monitor. Historically, banks based decisions for the amount of automobile loans on the collateral underlying the loan. With the cost of repossession and sale extremely high, the actual benefit to the bank of collateral has decreased. The results of our survey confirmed that auto lending is shifting toward an approach more reliant on a borrower's ability to repay rather than on collateral values. We will continue to monitor trends in automobile lending to assess the impact of this change on portfolio quality. We want to ensure that banks accrue any benefits associated with this change, and we will take action as appropriate if problems develop.

National Credit Committee. In February 1995, the OCC created a National Credit Committee. As I stated publicly shortly thereafter, we were concerned about potential erosion in credit underwriting standards, and wanted a group to focus on further analysis of the trend and recommendations for OCC actions. Composed of some of the OCC's most senior and experienced credit analysts, the Committee helps the OCC identify and respond to changes in credit risk that could affect the safety and soundness of the national banking system. The objectives of the Committee are:

- To identify significant concentrations of credit risk affecting the national banking system,
- To identify deteriorating financial trends and other conditions affecting industries that are a significant source of credit risk to the national banking system,
- To identify adverse changes in underwriting standards for loan products or industries that are a significant source of credit risk to the national banking system,
- To advise OCC management on appropriate supervisory responses to significant credit risks, and
- To identify the credit-related training needs of examiners.

The Committee acts as a steering committee for credit-related initiatives. To date, the Committee has undertaken two surveys of underwriting standards.

1995 Underwriting Standards Survey. Between May 1994 and May

1995, the National Credit Committee surveyed loan underwriting standards, including retail credit, at the 40 largest national banks. The survey results found relaxed standards for making loans on some products, primarily in retail lending. Where standards had relaxed, banks made the changes to meet competitive pressures and to reflect changes in market strategy. The changes in standards we noted included higher loan-to-value ratios, longer maturities, lower loan fees and interest rates, and increased usage of "teaser" rates for marketing purposes. While the surveyed banks had adequate systems to approve and report individual loan policy exceptions, OCC examiners expressed concern about the banks' ability to track the aggregate level of loan policy exceptions. Examiners also reported a wide variation in the systems used to identify and manage risk associated with concentrations of credit, but noted that the systems appeared to be effective. I stated at the time we released our results that I continued to be concerned that banks not lose sight of the effect of new lending on the risk levels in their portfolios. These results and issues identified were communicated to bank management.

1996 Underwriting Standards Survey. The National Credit Committee recently concluded its second survey of national banks' underwriting practices. Examiners conducted the survey at 82 of the largest national banks in May 1996. Our preliminary results show that our examiners believe the consumer loan portfolios are experiencing increased inherent risk. The increased risk is attributed to competition, growth, rising bankruptcy rates, and high levels of consumer debt.

The survey's results for lending underwriting standards in the consumer area overall show some bias toward tightening of underwriting standards as compared with last year's survey. But there were some differences. Banks are tightening credit card lending underwriting standards in response to changes in the bankruptcy law, weak portfolio performance with rising delinquencies and charge-offs, and poor product selection. On the other hand, home equity loans are the one retail product where standards continued to ease in response to competitive pressures. The most commonly mentioned change for home equity lending was increased loan-to-value ratios, including greater availability of 100 percent loan-to-value financing. Residential real estate showed no significant change or trend in underwriting standards, while the results for installment lending were mixed, with an equal number of banks surveyed reporting easing as tightening of standards.

These survey results are just in, and I can assure you that as we analyze them further, we will factor the findings into our supervision. For now, let me describe some of the things we are doing based on earlier analyses and findings regarding consumer credit.

Revised Examination Procedures. I am committed to making sure that our examination procedures change where necessary to ensure that they are appropriate and effective to meet industry changes. Our surveys and analyses have helped us identify areas for

improvement in examination procedures, and we have substantially revised the retail credit sections of the Comptroller's Handbook -- the examination guide used by national bank examiners. Handbook sections are being brought current in line with the significant market developments and will have a greater focus on risk management. In recognition of the growing importance of mortgage banking to national banks, in April 1996 we issued a new section to the handbook on mortgage banking operations. It discusses the business of mortgage banking, the risks associated with this activity, and the procedures that OCC examiners will use when they review mortgage banking activities at national banks.

We are also working with the other bank regulatory agencies in reviewing and updating policies for consumer credit. In May 1996, we convened an interagency working group to examine the existing interagency policy on the uniform classification of consumer retail credit delinquencies. As part of this effort, the working group is also addressing minimum payment policies.

The OCC will release new Handbook sections on installment lending, credit cards, residential and home equity lending, and merchant processing by the end of 1996. Also, as securitizations of financial products continue to expand, the OCC is developing examiner guidance which will focus on risk management of retail credit securitizations. While most of these Handbook sections are being revised, the section on credit cards in particular is being revised substantially to incorporate more detailed guidance to assist examiners in evaluating the effectiveness of a national bank's entire credit card lending process rather than by focussing on loan outcomes -- in line with our Supervision by Risk approach. Figure 8 illustrates the difference between the two approaches. In the traditional approach, examiners analyzed nonperforming loans. Now, they examine the complete lending process.

(See Attachment Figure 8)

The examiners pay close attention to changes in trends in delinquencies and net credit losses in determining where to focus supervisory resources in their review of the bank's consumer credit operations. Examiners review a bank's strategic and business plan and the policies and procedures governing retail credit operations, its compliance with OCC guidelines, its response to any criticism by internal or external auditors, its response to any internal loan review or comments made by the OCC in its previous examinations, and its compliance with other laws, rulings, and regulations. They look for changes in credit administration policies and underwriting standards, and sample credit card loans to compare against stated underwriting standards. OCC examiners focus on the banks' risk management systems to ensure that the necessary controls exist to identify, monitor, and control risks. Examiners evaluate the credit cycle process, including organization and management of marketing, underwriting, collections, securitizations, and management information systems.

In addition, the increasing use of credit scoring systems by banks to assist in their decision making on marketing, granting, and pricing retail credit requires us to incorporate an analysis of these systems into our examination process and training programs. In recognition of the growing technical sophistication of these systems, OCC examiners work with economists with expertise in evaluating the validity of these models.

The OCC is concerned about increased competition in the credit card business, rapid portfolio growth rates, the availability of diverse credit card products, and the impact of changes in the economic and business cycle on national banks' credit card performance. As a result, we are issuing additional guidance to bankers later this summer. Specifically, this guidance will focus on the problems which have led credit card portfolios to exhibit higher risk profiles than originally projected, including insufficient market testing, adverse selection, liberalized underwriting criteria, and inadequate monitoring of loan performance, and offer potential solutions to these problems.

Examiner Training. The OCC has devoted extensive resources over the past three years to broadening examiner skills and knowledge by means of training. Just as we have enhanced our training programs, or developed new ones, in other specialized areas such as capital markets and bank information systems, we are currently drafting a new curriculum for retail credit training in response to the changing nature of this market. We will incorporate these revised procedures into the examiners' Retail Credit School curriculum by year-end 1996. This curriculum pays particular attention to credit cards. In addition to this formal curriculum, we offer periodic credit seminars to our credit specialists. These seminars address current and emerging trends. The last seminar, in June 1996, addressed topics including various risk management functions, electronic banking, credit bureau scoring and accuracy of credit bureau reports, collection strategies, and securitizations.

National Risk Expert. The OCC recently created a new position for a national risk expert. I named National Bank Examiner G. Scott Calhoun to serve in this role. As the Deputy Comptroller for Risk Evaluation, Mr. Calhoun will be my principal advisor on risks facing the national banking system. Drawing on nearly twenty years of experience with the OCC, including serving as the examiner-in-charge of several of the nation's largest banks, Mr. Calhoun will help the OCC identify risks in national banks, assist in developing timely supervisory responses, and monitor them to ensure that supervisory responses are effective. He will also chair the OCC's National Risk Committee, which is charged with identifying potentially serious risks to the banking system.

Planned Initiatives. As part of our efforts to remain at the forefront of bank supervision, we must continue to monitor and be at the forefront of understanding developments in consumer lending. This includes learning more about issues associated with special purpose credit card-only banks, outsourcing, risk-based pricing and subprime lending. Based on what we learn, we will issue appropriate examiner and industry guidance. In

addition, we plan to focus particular attention on evolving developments in underwriting standards for small business lending and the use of credit cards in extending small business loans, and determine the extent of activity in automobile dealer floor plan financing and indirect automobile lending to consumers.

Conclusion

Commercial banks have moved increasingly into consumer sector lending over the last 10 years. The largest and fastest growing sector is residential real estate lending, which historically has had lower loan loss rates than other types of lending. Commercial banks have experienced some deterioration in consumer sector credit quality in recent quarters, particularly in installment and credit card loans. While there is no evidence of systemic consumer credit quality problems in the banking system at this time, we remain concerned about trends in credit quality, particularly given the rise in consumer debt and bankruptcies. We will continue to be vigilant and proactive, and make this area a priority for analysis, training, and other appropriate actions.

A regulator's job is to ask questions -- even when it appears that everything is going well. How will today's asset and liability management strategies weather economic changes? And how will banks' new sources of revenue be affected if interest rates change or the economy weakens? While a great deal has changed in banking, some things have not -- particularly the need to focus on the fundamentals of sound risk management. I have mentioned today some of the steps the OCC has taken as the banking industry has shifted larger portions of its portfolio to consumer lending. We will continue to develop and refine supervisory initiatives in order to maintain the safety and soundness of the national banking system.