Remarks by
Julie L. Williams
Acting Comptroller of the Currency
Before the
BAI National Loan Review Conference
New Orleans, LA
March 21, 2005

It's a great pleasure again to be with BAI, and to make a small contribution to this fine organization's efforts to promote the continuing education of banking professionals. And I'm particularly delighted to take part in this gathering of loan review experts, who play such an important role in identifying and mitigating risk. What you do is vital to keeping our financial institutions safe, sound, and profitable.

I'd like to focus today on the enormous changes that are taking place in the world of retail lending. No facet of the industry has changed more in recent years. With that change has come vast new opportunities -- and new risks. And this evolution is reshaping the role that members of the loan review community play in the banking business today.

Consider the characteristics of the retail lending business 20 years ago. Twenty years is not so far removed from the present in calendar time; but it could be eons ago in terms of the evolving retail banking industry. If you were shopping for what economists refer to as a "consumer durable" back then, and wanted to finance the purchase, you probably had to make a personal appointment with your banker to arrange it. I should emphasize the possessive in "<u>your</u> banker" because an ongoing relationship was a virtual prerequisite.

But even if the banker was a long-time family friend, a loan was no slam-dunk – especially if you actually *needed* the money. You could count on "your" banker going over your application with a fine-tooth comb, calculating your debt ratios, verifying your employment and income, working out a schedule providing for rapid repayment, and filing a security interest in the collateral, whether it would be worth anything in foreclosure or not. All this to replace your washer and dryer!

Of course, things could scarcely be more different today. Relatively small value consumer installment loans, with their prohibitive administrative costs and their intrusiveness and inconvenience to the borrower, are virtually relics of the past. Today, as a result of technological advances in information transfer and credit risk analytics, credit can be instantly available, at a price, to virtually everyone, and it's hard to imagine someone financing a refrigerator or a home theatre by any other means if they have access to a credit card or a home equity line of credit, as most 21st century Americans do.

But it's not only the mechanics of retail lending that have changed radically; it's the philosophy. Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset. Thus, today the challenge for lenders is not so much to control the amount of debt that a household can take on, but to find ways to accommodate the debt within each borrower's financial framework. In other words, it's not repayment of the amount of the debt that is the focus, but rather the income the credit relationship generates through periodic payments on the loan, associated fees, and cross-selling opportunities.

One of my colleagues at the OCC termed the current retail credit environment as one where consumers are "renting money." I think she's right, and the implications are quite profound because that characterization captures today's focus on a borrower's ability to meet current, periodic payment obligations – not on the borrower's ability to repay his or her debt. We have seen this approach penetrate the spectrum of retail credit products: credit cards with minimal required minimum payments; home equity loans with interest-only payments for years; and most recently, *first mortgages* with interest-only payment requirements for the first 10 years of the loan. "Embedded" consumer debt has become a staple of the American consumer.

Retail lending has undergone nothing short of a dramatic transformation. And, not surprisingly, so has the risk profile of the American retail borrower – a change that has profound implications for loan review professionals.

By many measures, American consumers are carrying heavier debt loads than any time in history – and lenders have not balked at those debt levels. In inflation-adjusted dollars, home mortgage debt has more than doubled over the past decade. Outstanding credit card debt has increased by a third over the last five years. That impressive showing would undoubtedly be even more impressive, but for the fact that this same period saw home equity loans and lines of credit increase twice as fast. This reflects the fact that borrowers have been using credit secured by their homes to retire large quantities of higher-priced, non-tax deductible credit card debt.

Nevertheless, some consumers are stretched to the limit -- and beyond. The dramatic increase in the number of personal bankruptcy filings between 2000 and 2003, when they rose by more than a third, is the most commonly cited evidence of that fact. Filings dropped by a modest 3.8 percent last year, and it will be some time before we can tell whether this represents the start of a reversal in the longer upward trend or simply a lull before that trend resumes. However, pending changes in bankruptcy laws and filing standards remind us that bankruptcy trends represent an imperfect measure of the degree to which debt is straining household finances.

A second – and some would say more revealing -- measure of financial stress is the debt service ratio, which measures the share of income that households devote to retiring principal and interest. That ratio has edged up only slightly over the past decade, which might suggest that Americans are successfully managing the higher levels of debt that they have taken on during that period.

However, this should be ventured with caution. First, it does not reflect the fact that, financially speaking, the last decade has created a bifurcated America, consisting of homeowners, on the one hand, and renters, on the other. Homeowners have not only benefited from the increase in the value of their home equity, value they have tapped to pay down higher-priced debt. Homeowners have also taken advantage of declining interest rates and the opportunity to refinance their existing mortgages, reducing that component of their overall debt load. There could hardly be a better advertisement for the benefits of enhancing home ownership opportunities in this nation.

Renters lack these debt-management options. Thus, when we disaggregate the financial obligation ratios between the two groups, we find that renters are more than fifty percent as heavily burdened as homeowners, and that the debt service burden on renters has been rising steadily since 1992.

Second, it's entirely possible that loans extended on easier terms – with declining payment requirements and lengthening amortizations – are enabling borrowers to dramatically increase their debt loads without changing their total payment amount or their debt service ratio.

The fact is, American households today are more highly leveraged than ever before, and, though holding more debt, lenders are permitting them – or even encouraging them – to allocate no greater a share of disposable income to liquidating that debt than they were doing five years ago. The result is that, each month, significant numbers of Americans continue to make their minimum payments and find themselves no less leveraged than they were before. Indeed, millions who faithfully make their payments wind up making little progress on reducing their indebtedness.

How that occurs is no mystery. I'd like to focus briefly on how the terms of some traditional retail banking products – and the underwriting standards bankers use to sell them – reflect the new retail lending philosophy.

I could devote an entire speech to the subject of how the new retail lending philosophy has taken hold in the credit card industry. Suffice it to say that before the OCC implemented the recent interagency account management guidance, requiring national credit card banks to assure that minimum monthly payments amortize the outstanding balance over a reasonable period of time, it was common practice to set those minimums so low that principal repayment was delayed into the distant future – and negative amortization could result if late fees or overlimit fees were rolled into the total balance owed.

And let me be absolutely clear about our objective here – the minimum payment standard is designed to provide evidence that the customer has the capacity to actually *repay* his or her debt. Absent evidence of *repayment* capacity, as a basic safety and soundness matter, what quality can we ascribe to that consumer debt?

Practices in the auto loan business have also changed dramatically. Ten years ago the typical auto loan ran for 48 or 60 months at the outside; today, 72 months is typical; 84 months is an option, and 96 months is not out of the question on luxury vehicles. Not only that, many lenders offer 100 percent financing and beyond, encouraging buyers to roll the cost of such extras as dealer options, service contracts, and the negative equity in their trade-in vehicles into their new loans. These liberal terms enable buyers to afford more car – or more cars, as is often the case in today's multi-vehicle families. It's usually a safe bet, too, because cars are more reliable than ever, and are likely to have some useful life left in them even at the end of an eight-year loan. But those terms come at a price: slower equity accumulation, which for lenders means the increased likelihood of default, and the prospect of repossession of a badly depreciated asset.

In the first mortgage market, interest-only, no-doc or low-doc, and teaser-rate loans have become hot products. These innovations have made it possible for lenders to sustain loan volume at the time when rising interest rates have put a damper on the refinancing boom. They have also enabled borrowers to increase their purchasing power – a significant benefit at a time of continuing inflation in the housing markets. These mortgage products can be especially beneficial for buyers who can count on significant increases in their income, or who are planning to use the additional cash flow for savings or investment purposes, or whose income relies heavily on bonuses or commissions.

But for the average borrower who is merely trying to push the envelope to qualify with an interest-only payment at today's interest rates – or for the lender who is encouraging that behavior – these products are a risky proposition indeed. They are predicated on continued healthy price appreciation for residential properties. If housing prices should stabilize or even begin to fall – and borrowers see their equity dwindle, or worse yet the value of their home fall below what they owe – there's no telling how these loans would perform.

They are also predicated on a continuation of a relatively benign interest rate environment. In the event of a rate spike, borrowers could see a large increase in monthly payments. Given overall debt burdens, borrowers are less likely to have the capacity to absorb a payment that could be several times greater than what it was prior to readjustment.

The practices associated with the new philosophy of retail lending – higher credit limits and loan-to-values, lower minimum payments, more revolving debt, less documentation and verification, and lengthening amortizations – have certainly introduced risk elements not previously present in the banking system. Combine those elements with current macroeconomic trends, including high levels of consumer leverage, sluggish job and wage growth, and a rising interest rate environment, and all signs point to considerably more credit risk embedded in the retail loan portfolios of banks than the current performance measures would indicate.

And with the changes I've been discussing in the retail lending landscape have also come heightened risks of another kind. Banks must be mindful of the reputation and compliance consequences of their retail lending practices. Even where institutions meet technical regulatory compliance requirements, their policies and practices may still come in for public criticism when, for whatever reason, conspicuous numbers of customers find themselves unable to meet their financial commitments. Obviously, the reputation and compliance repercussions would be even more severe if it turns out that the non-performing loan products bear predatory, discriminatory, or other impermissible characteristics.

Savvy bankers know that there is a subtle interplay between reputation and credit risk that can involve wrenching trade-offs: the choice, for example, of just writing off the loss on a residential mortgage, or foreclosing on the collateral, with all of the reputation and publicity consequences that foreclosure – especially multiple foreclosures – entails. These are contingencies with both safety and soundness and reputation consequences that should be considered when a bank's mortgage lending policies are first developed and implemented.

While one can never be certain about how consumer loans (or loans of any kind) will fare under particular circumstances, there is one thing that can be said with complete certainty: that the time to address the problem of embedded credit (and related reputation) risk is now – when interest rates are still at near-historical lows, when housing prices are still climbing (albeit at a slower rate than before in many markets), and, most of all, when the banking industry's overall health is good, its earnings are strong, and the industry – and especially its credit professionals – are in a position to make necessary adjustments.

Right about now, you may be asking what those adjustments should be? What, if anything, should loan review professionals be doing differently than what they have done in the past?

I have two suggestions. One involves altering the way that you think about credit risk. The other involves altering what you do about it.

By the first, I mean viewing retail credit risk in a different light than in the past. I have tried to describe today why the nature and dynamics of consumer credit risk are quite profoundly different than they were several decades ago. To cite just one prime illustration: it is no longer possible to assess credit risk accurately by using lagging indicators, such as delinquencies and losses, when it has become so much easier for consumers to avoid delinquencies as a result of decreased payment requirements. Remember the "renting money" analogy that I described at the outset of these remarks.

Because reduced payment requirements and extended amortization arrangements can mask credit risk, loan review professionals need to adjust the focus of how they look at retail credit exposures in order to ensure that the risk is identified and managed. That means developing broader, more discriminating, and more forward-looking approaches to measuring and monitoring risk in the retail portfolio.

What that entails is zeroing in on those particular loans that have the highest probability of default. It means identifying particularly risky borrowers: those with unusually high debt levels and utilization of their credit card lines, and declining credit scores. It means singling out high LTV loans, loans with extensions, renewals, and rewrites; and loans in work-out programs. It means testing transactions to ensure compliance with policies and procedures. It means evaluating whether collection practices are effective, loan reserves are appropriate, and losses are recognized in a timely manner. And it means doing this consistently, constantly.

The pockets of higher risk, or portfolio segments, need to be factored into the overall assessments of the risk profile of the portfolios. An important role that loan review can perform is to help identify how much of the portfolio is exposed to a higher probability of default, and how well the credit risk is being managed.

To institutionalize this approach – and to provide guidelines for the industry as well as for our own examiners -- the OCC last December issued comprehensive new examination procedures for retail lending. The new procedures were designed to accomplish a number of purposes: to provide an up-to-date foundation for our supervision of all types of retail credit; to pull together a considerable backlog of previous guidance on specific products; to enhance and reinforce awareness of the ever-changing consumer compliance environment; and to emphasize our portfolio approach to risk management.

But in today's context, I should emphasize that this guidance was designed to do two other things, as well: to ensure our supervisory approaches addressed the changes in retail lending philosophy and practices that I've been discussing with you today; and to raise awareness of those changes throughout the industry, and especially with those like yourselves, whose business it is to help identify and control credit risk.

That also has been the purpose of my remarks today. Credit risk today has dimensions not even dreamt of in the retail lending business 20 years ago. I hope I have provided you with some food for thought – and action – on how to address it.

Thank you.