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**TESTIMONY OF**  
**JOHN C. DUGAN**  
**COMPTROLLER OF THE CURRENCY**

**before the**

**SUBCOMMITTEE ON FINANCIAL INSTITUTIONS**  
**SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**OCTOBER 14, 2009**

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.

## **I. Introduction**

Chairman Johnson, Senator Crapo, and members of the Subcommittee, I am pleased to testify on the current condition of the national banking system, including trends in bank lending, asset quality, and problem banks. The OCC supervises over 1,600 national banks and federal branches, which constitute approximately 18 percent of all federally insured banks and thrifts, holding just over 61 percent of all bank and thrift assets. These nationally chartered institutions include 15 of the very largest U.S. banks, with assets generally exceeding \$100 billion; 23 mid-sized banks, with assets generally ranging between \$10 billion and \$100 billion; and over 1,500 community banks and trust banks, with assets between \$1.5 million and \$10 billion. The OCC has dedicated supervisory programs for these three groups of institutions that are tailored to the unique challenges faced by each.

My testimony today makes three key points. First, credit quality is continuing to deteriorate across almost all classes of banking assets in nearly all sizes of banks. As the economy has weakened, the strains on borrowers that first appeared in the housing sector have spread to other retail and commercial borrowers. For some credit portfolio segments, the rate of nonperforming loans is at or near historical highs. In many cases, this declining asset quality reflects risks that built up over time, and while we may be seeing some initial signs of improvement in some asset classes as the economy begins to recover, it will generally take time for problem credits to work their way through the banking system.

Second, the vast majority of national banks are strong and have the financial capacity to withstand the declining asset quality. As I noted in my testimony last year before the full Committee, we anticipated that credit quality would worsen and that banks would need to further strengthen their capital and loan loss reserves.<sup>1</sup> Net capital levels in

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<sup>1</sup> Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 5, 2008, page 2.

national banks have increased by over \$186 billion over the last two years, and net increases to loan loss reserves have exceeded \$92 billion. While these increases have considerably strengthened national banks, we anticipate additional capital and reserves will be needed to absorb the additional potential losses in banks' portfolios. In some cases that may not be feasible, however, and as a result, there will continue to be a number of smaller institutions that are not likely to survive their mounting credit problems. In these cases we are working closely with the FDIC to ensure timely resolutions in a manner that is least disruptive to local communities.

Third, during this stressful period we are extremely mindful of the need to take a balanced approach in our supervision of national banks, and we strive continually to ensure that our examiners are doing just that. We are encouraging banks to work constructively with borrowers who may be facing difficulties and to make new loans to creditworthy borrowers. And we have repeatedly and strongly emphasized that examiners should not dictate loan terms or require banks to charge off loans simply due to declines in collateral values.

Balanced supervision, however, does not mean turning a blind eye to credit and market conditions, or simply allowing banks to forestall recognizing problems on the hope that markets or borrowers may turn around. As we have learned in our dealings with problem banks, a key factor in restoring a bank to health is ensuring that bank management realistically recognizes and addresses problems as they emerge, even as they work with struggling borrowers.

## **II. Condition of the National Banking System: Credit Quality Has Replaced Liquidity as Major Concern**

Beginning in the fall of 2007 and extending through the first quarter of this year, bank regulators and the industry were confronted with unprecedented disruptions in the global financial markets. In the wake of severe problems with subprime mortgages, the value of various securitized assets and structured investment products declined precipitously. Key funding and short term credit markets froze, sparking a severe contraction in the liquidity that sustains much of our economy and banking system, including uninsured deposit funding. The combination of these events led to failures, government assistance, and government takeover of several major financial institutions. Through the collective efforts and programs resulting from actions taken by Congress, the Treasury Department, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and governments around the world, there has been significant stabilization in credit and funding markets for all financial institutions, including banks of all sizes.

As reflected in both the TED and Libor-OIS spreads,<sup>2</sup> each of which has fallen to less than 20 basis points after peaking at well over 300 basis points during the crisis, the interbank funding market has vastly improved, with banks once again willing to extend credit to counterparties. There has also been a slight rebound in certain securitization markets. For example, non-mortgage asset-backed securities issuance for 2Q:2009 totaled \$49 billion, up 121 percent from 1Q:2009. Similarly, syndicated market loan issuances increased to \$156 billion in 2Q:2009, up 37 percent from 1Q:2009.

The drag on national banks' balance sheets and earnings from the overhang of various structured securities products has been very significantly reduced due to the

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<sup>2</sup> The TED spread reflects the difference between the interest rates on interbank loans in the Eurodollar market and short-term U.S. Government Treasury bills. The OIS is the overnight indexed swap rate. Both spreads are a measure of how markets are viewing the risks of financial counterparties.

substantial write-downs that banks took on these assets in 4Q:2008 and 1Q:2009 and the overall recovery in credit markets. Losses sustained at our 10 largest banking companies for these securities reached \$44 billion in 2008, but dropped to \$8 billion in 1Q:2009 and \$1 billion in 2Q:2009. There are some banks that still face strains in their investment portfolios, largely due to their holding of certain private label mortgage-backed and trust preferred securities. While most banks will be able to absorb the losses that may arise from these holdings, there is a small population of banks that have significant concentrations in these products that we are closely monitoring. We expect these banks will continue to take incremental credit impairments through earnings until mortgage metrics improve.

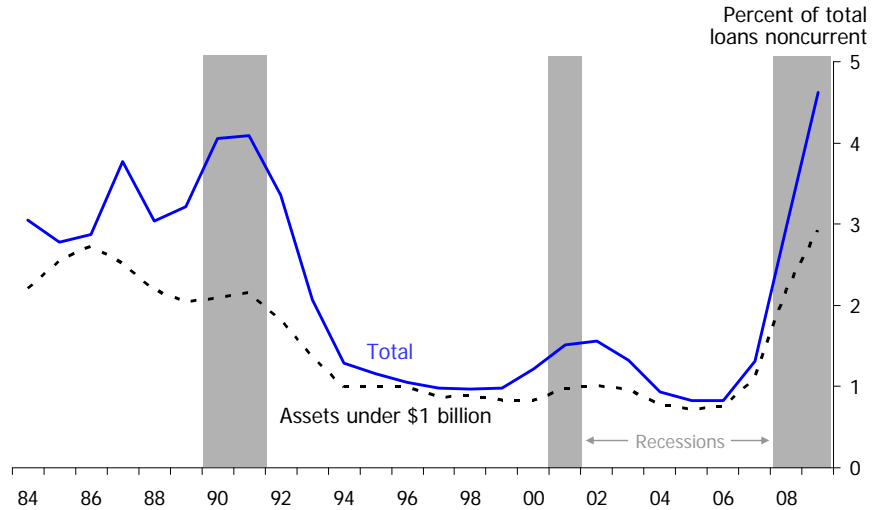
In my financial condition testimony before the full Committee last year, I observed that, as market conditions began to stabilize, the focus of supervisors and bankers would increasingly turn to the more traditional challenges of identifying and managing problem credits.<sup>3</sup> That has indeed proven to be the case, as declining asset quality has become the central challenge facing banks and supervisors today. While there recently have been some signs of economic recovery, data through the second quarter of this year demonstrate that asset quality across the national bank population significantly deteriorated over the preceding twelve months, as both retail and commercial borrowers remained under stress from job losses and the overall contraction in the economy. The percentage of noncurrent loans (loans that are 90 days or more past due or on nonaccrual) increased dramatically and reached the highest level in at least twenty five years (see Chart 1).

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<sup>3</sup> Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 5, 2008, page 9.

Chart 1

## Noncurrent loan rate highest in at least 25 years National banks



Source: Integrated Banking Information System (OCC)

\* 2009 data as of June 30, 2009. All other data as of year-end. Data series begins in 1984.

In addition, the rate at which banks are charging off loans has also accelerated and, for some portfolio segments, now exceeds previous peaks experienced during the last credit cycle. Continued concerns about the economy are also affecting loan growth and demand as businesses, consumers, and bankers themselves retrench on the amount of leverage and borrowing they want to assume. As a result, loan growth through 2Q:2009 has slowed across the national bank population and in various portfolio segments. (See charts 2 and 3)

Chart 2

## Charge-off rates continue to set records National banks

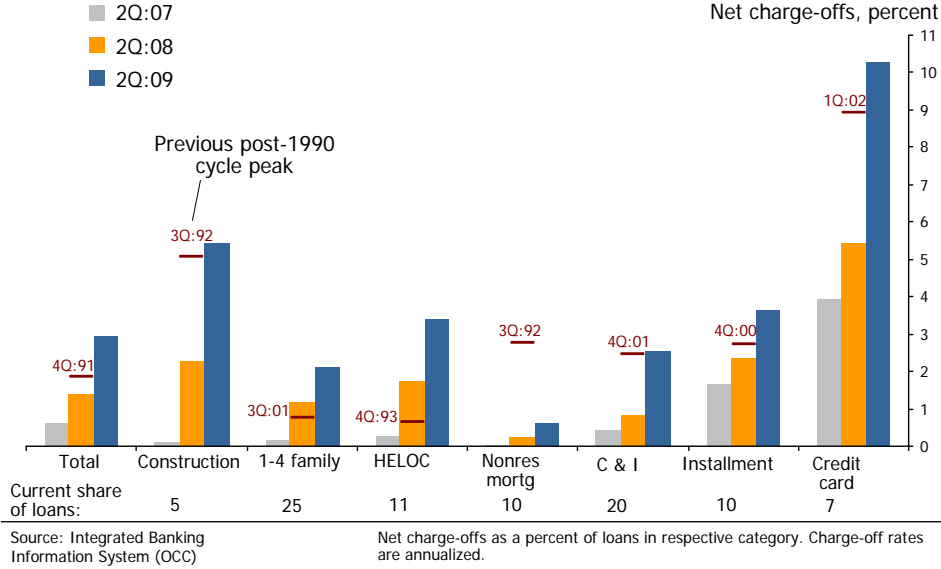
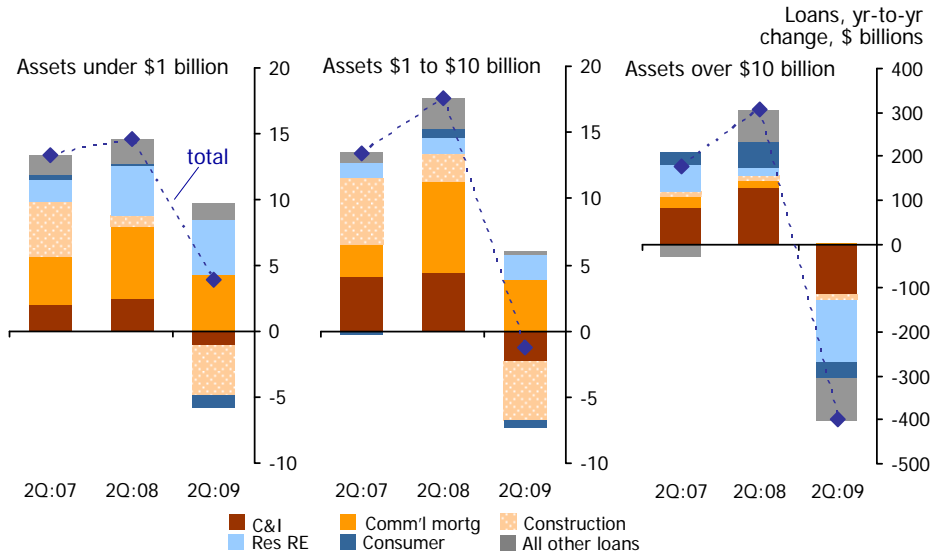


Chart 3

## Loan growth slowing sharply National non-specialty banks



Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for banks in operation from 1Q:06 to 2Q:09. Excludes credit card and trust banks. \$1-10B size group excludes downsized BNY Mellon.

A number of factors are evident for this decline in credit, including the following:

- Reduction in loan demand, as reductions in consumer spending have caused businesses to cut back on inventory and other investments;
- Reduction in the demand for credit from borrowers who may have been able to afford or repay a loan when the economy was expanding, but now face constrained income or cash flow and debt service capacity;
- Reductions in loan demand as households work to rebuild their net worth, as reflected in the increased U.S. savings rate;
- Actions taken by bankers to scale back their risk exposures due to weaknesses in various market and economic sectors, and to strengthen underwriting standards and loan terms that had become, in retrospect, too relaxed. In addition, many banks have increasingly shifted their focus and resources to loan collections, workouts, and resolutions, and some troubled banks have curtailed lending due to funding and capital constraints; and
- Continued uncertainty on the part of borrowers and lenders about the strength and speed of the economic recovery in many regions of the country.

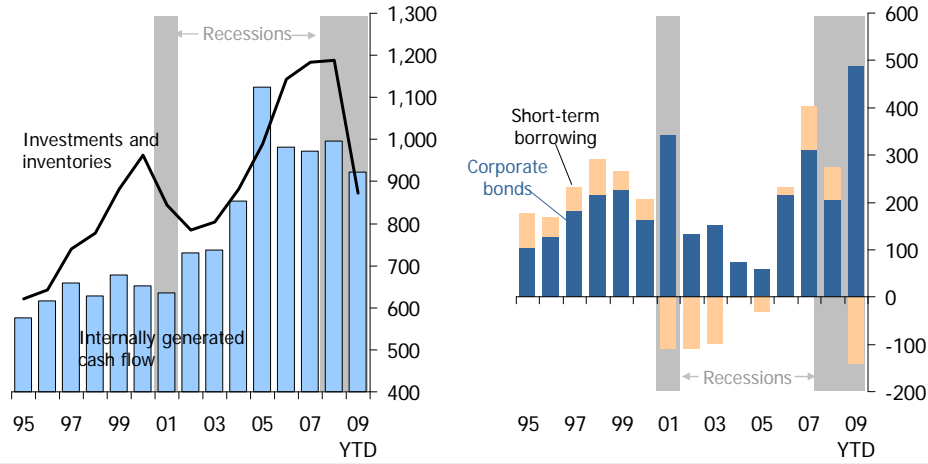
As demonstrated in chart 4 below, businesses have significantly reduced their investments and inventories and, in an effort to strengthen their own balance sheets, many larger businesses have replaced short-term borrowing with longer-term corporate bond issues. Similarly, chart 5 shows that consumers are repairing their personal balance sheets with significant increases in their personal savings rates.



Chart 4

## Businesses need fewer C&I loans

Non-financial corporate business outlays and borrowing, \$ billions

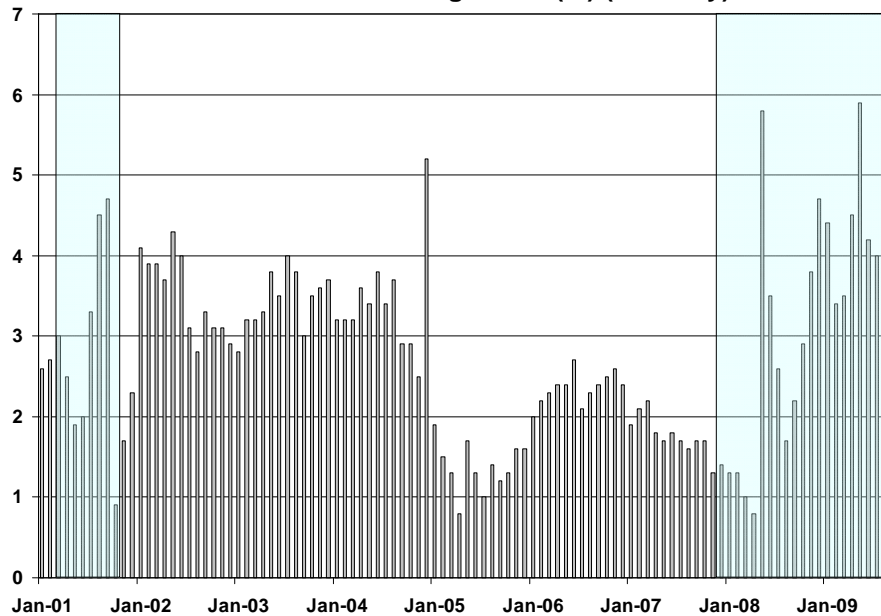


Source: Federal Reserve/Haver Analytics  
 Quarterly data, Flow of funds "flow" data tables

09 YTD is average of 1Q:09 and 2Q:09  
 annualized quarterly rates.

Chart 5

## US Personal Savings Rate (%) (monthly)



Source: BEA (via St. Louis Fed). Recessions are indicated with shaded columns.

This interplay of factors and their effects on lending are consistent with our recent annual underwriting survey and the Federal Reserve Board's most recent Senior Loan Officer Survey. OCC examiners report that the financial market disruption continues to affect bankers' appetite for risk and has resulted in a renewed focus on fundamental credit principles by bank lenders. Our survey indicates that primary factors contributing to stronger underwriting standards are bankers' concerns about unfavorable external conditions and product performance.<sup>4</sup> In its July Senior Loan Officer Survey, the Federal Reserve reported that "demand for loans continued to weaken across all major categories except for prime residential mortgages."<sup>5</sup>

Some have also suggested that unnecessary supervisory actions may have significantly contributed to the decline in credit availability. While I do not believe the evidence supports this suggestion, I do believe, as addressed in more detail at the end of this testimony, that it is critical for supervisors to stay focused on the type of balanced supervision that is required in the stressful credit conditions prevalent today.

Finally, the combination of deteriorating credit quality, lower yields on earning assets, and slower loan growth is the primary factor currently affecting national banks' earnings. As shown in Chart 6, there has been a marked deterioration in the return on equity across the national banking population as modest increases in banks' net interest margins due to more favorable costs of funds have failed to offset credit quality problems and the continued need for banks to build loan loss reserves.

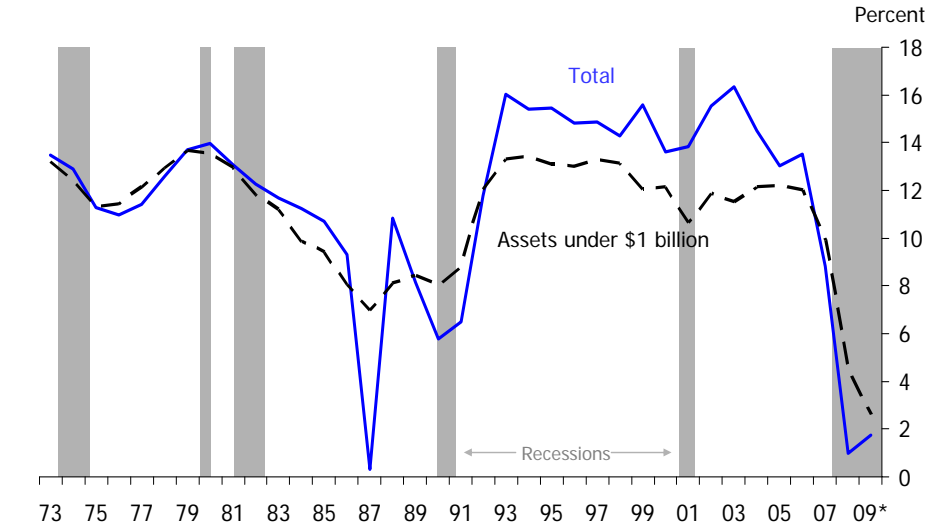
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<sup>4</sup> OCC Survey of Underwriting Practices 2009, page 3.

<sup>5</sup> Board of Governors of the Federal Reserve System, "The July 2009 Senior Loan Officer Survey on Bank Lending Practices," page 1.

Chart 6

**National banking system profitability remains low**  
National banking company ROE



Source: Integrated Banking Information System (OCC)

Data for all bank and thrift charters in companies where national bank assets represent at least 50% of total assets. Data are merger-adjusted and held constant on a 1-year rolling basis. \*2009 data are June year-to-date, annualized. Effects of purchase accounting overstate reported 2008 ROE; removing these effects, 2008 ROE was -1.1%.

**III. Trends in Key Credit Portfolios and Capital and Reserve Positions**

Against this backdrop, let me now describe trends in major credit segments and in capital and loan loss reserve levels.

*A. Retail Credit*

Although retail loans – mortgages, home equity, credit cards, and other consumer loans – account for just over half of total loans in the national banking system, they currently account for two-thirds of total losses, delinquencies, and nonperforming credits. To a large extent, however, these problems are confined to the largest 15 national banks, which hold almost 91 percent of retail loans in the national banking system.

*1. First and Second Mortgages*

The residential mortgage sector was the epicenter of the financial turmoil and continues to figure prominently in the current condition of the banking industry. As the economy has worsened, problems that started in the subprime market have spread to the so-

called “Alt A” market, and increasingly, to the prime market. While over-leverage and falling housing prices were the initial drivers of delinquencies and loan losses, borrower strains resulting from rising unemployment and underemployment are an increasingly important factor. In the first mortgage market, the June 30, 2009 Mortgage Bankers Association’s National Delinquency Survey shows continued growth in foreclosure inventory, but a relatively flat rate of new foreclosure starts overall between the first and second quarter of this year. The rate of prime foreclosures, however, continues to increase, with starts at about one percent of the surveyed population as of the end of the second quarter. Although this percentage is still relatively small, the impact is significant given the much larger size of the prime market segment compared to the markets for subprime and Alt-A loans. While it is true that many first mortgages were sold to third party investors via the securitization market, and the loan quality of such mortgages retained by banks is generally higher than those sold to third parties, it nevertheless remains the case that a number of larger banks have significant on-balance sheet exposure to first mortgage losses from portfolios that continue to deteriorate.

The same is true of second mortgages – home equity loans and lines of credit – except that the overwhelming majority of these loans reside on bank balance sheets. There were some positive signs in the second quarter showing home equity loan delinquency rates falling, and the pace of increase in second lien charge-off rates slowing. But the hard fact is that losses on these loans through the first half of this year nearly equaled total losses for all of 2008, and loss rates are expected to continue to climb – though at a slower rate – through at least the middle of 2010.

In short, deterioration in the first and second residential mortgage markets continue to dominate the credit quality performance in national banks’ retail portfolios, as it has

since the second half of 2008. Total delinquent and nonperforming residential real estate loans (mortgage and home equity) in national banks now hover around 9.4 percent, with a loss rate of just over 2.5 percent – the highest level since we have been collecting this data.

There have been some positive indicators in the housing market in recent months that could slow the pace of losses in residential mortgages, including increased home sales in June and July, and slight increases in the Case-Shiller composite index for certain metropolitan areas. While these signs are encouraging, it is too early to determine whether they signal a true turning point in this sector. For example, the increase in home sales this summer is consistent with seasonal trends and may not be sustainable. In addition, sales may be enjoying a temporary boost from the First-Time Homebuyer Tax Credit program which, unless extended, will end in November. Much will depend, of course, on the extent to which economic recovery takes hold and truly stabilizes the housing market.

In terms of mortgage modifications, all of the major national bank mortgage servicers are actively participating in the Administration's Making Home Affordable Program. Servicers have been significantly expanding their staff levels in the loss mitigation/collection areas – doubling and tripling customer contact personnel, and requiring night and weekend overtime work. Servicers have also been ramping up their training efforts, customer service scripts, and automated qualification and underwriting systems to improve the processing of loan modification requests. The OCC is closely monitoring these and other home modification efforts through on-site examinations and other ongoing supervisory initiatives, as well as through our Mortgage Metrics quarterly reporting program. And examiners continue to monitor modification programs for compliance with all applicable fair lending and consumer compliance laws.

Our latest Mortgage Metrics report shows that actions to keep Americans in their homes grew by almost 22 percent during 2Q:2009.<sup>6</sup> Notably, the percentage of modifications that reduced borrowers' monthly principal and interest payments continued to increase to more than 78 percent of all new modifications, up from about 54 percent in the previous quarter. We view this as a positive development, as modifications that reduce borrowers' monthly payments generally produce lower levels of re-defaults and longer term sustainability than modifications that either increase payments or leave them unchanged.

## *2. Credit Cards*

Credit card performance began to deteriorate sharply in the latter part of 2008 and has continued to weaken further this year, with record levels of losses and delinquencies. As with second lien mortgages, there have been some encouraging signs recently in the form of declining early stage delinquency rates, but loss rates continue to climb. As of June 30, the overall loss rate was 10.3 percent for national banks, and more recent data shows continued deterioration-with industry analysts predicting even higher loss rates into 2010.

In response to these trends and the overall deterioration in the economy, many credit card issuers are adjusting their account management policies to reflect and respond to the increased risk in these accounts. In some cases these actions have resulted in credit lines being reduced or curtailed. In other cases, they have led to increased interest rates, effectively increasing the minimum payment to cover the higher finance charges. In still other cases they have resulted in an increase in minimum payments to extinguish the outstanding debt more quickly. Many credit card issuers are also re-evaluating certain

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<sup>6</sup> See OCC News Release 2009-118, September 30, 2009.

credit card product features, such as “no annual fees” or various reward programs, and are offering cards with simpler terms and conditions, in part due to the recently enacted Credit CARD Act.

We are monitoring these changes in credit card account terms to ensure that they comply with all applicable limit and notice requirements, including those mandated by the Credit CARD Act. For example, in July we notified national banks that, effective August 22, 2010, they must conduct periodic reviews of accounts whose interest rates have been increased since January 1, 2009, based on factors including market conditions and borrower credit risk. More recently, we issued a bulletin advising national banks about the interim final rules issued by the Federal Reserve under the Credit CARD Act that became effective on August 20, 2009. The Federal Reserve’s rules require lenders to notify customers 45 days in advance of any rate increase or significant changes in credit card account terms and to disclose that consumers can have the right to reject these changes. Under the rules, the new rates or terms can be applied to any transaction that occurs more than 14 days after the notice is provided – even if the customer ultimately rejects those terms. To address the risk of consumer confusion, the OCC directed national banks to include an additional disclosure not required by the rules to alert consumers, if applicable, to the imposition of the new terms on transactions that occur more than 14 days after the notice is provided, regardless of whether the consumer rejects the change and cancels the account.

As with residential mortgages, we are encouraging national banks to work with consumers who may be facing temporary difficulties and hardships, and more banks are reaching out to assist customers before they become delinquent. Banks have a number of

viable default management options to assist in this endeavor, although it is important that, as they do so, they continue to appropriately account for losses as they occur.

Card issuers are also reevaluating the size of unused credit lines in response to current credit conditions, recent regulatory changes, and recent adoption by the Financial Accounting Standards Board (FASB) of two new accounting standards, Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140* (FAS 166) and Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). These standards become effective for an entity's first fiscal year beginning after November 15, 2009, and will have a significant impact on many banking institutions. In particular, many securitization transactions, including credit card securitizations, will likely lose sales accounting treatment, prompting the return of the securitized assets to banks' balance sheets. Although we are still evaluating the impact of these changes, we anticipate that they will have a material effect on how banks structure transactions, manage risk, and determine the levels of loan loss reserves and regulatory capital they hold for certain assets, including credit cards. The net effect of these changes is that banks will most likely face increased funding and capital costs for these products.

The combination of all these factors has resulted in a decline in overall credit card debt outstanding and – especially – overall unfunded credit card commitments, reflecting pullbacks by both consumers and lenders. For national banks, managed card outstandings (*i.e.*, funded loans both on and off banks' balance sheets) declined by four percent thus far this year, or roughly \$27 billion. Unfunded credit card commitments (lines available to customers) have declined more precipitously, by 14.8 percent or \$448 billion. These trends are consistent with overall industry data.



In summary, retail credit quality issues continue to be an area of concern, especially for the larger national banks. Although there are some early signs of delinquency rates declining, with some bankers telling us they are beginning to see adverse trends leveling off, sustained improvements in this sector will largely depend on the length and depth of the recession and levels of unemployment.

*B. Commercial and Industrial Loans*

The fallout from the housing and consumer sectors to other segments of the economy is evident in the performance of national banks' commercial and industrial (C&I) loan portfolios. Adverse trends in key performance measures, including 30-day or more past due delinquencies, non-performing rates, and net loss rates, sharply accelerated in the latter part of last year and have continued to trend upward in 2009. For example, the percentage of C&I loans that are delinquent or nonperforming has risen from a recent historical low of 1.02 percent in 2Q:2007 to 3.90 percent in 2Q:2009. Although this is the highest rate since the ratio peaked at 4.15 percent in 2Q:2002 during the last recession, it is still well below the 1991 recession peak of 6.5 percent.

In contrast to retail loans, which primarily affect the larger national banks, the effect of adverse trends in C&I loans is fairly uniform across the national bank population. This segment of loans represents approximately 20 percent of total loans in the national banking system, with levels somewhat more concentrated at larger institutions than at community banks, where C&I loans account for approximately 16 percent of total loans. While credit quality indicators are marginally worse at the larger national banks, the trend rate and direction are fairly consistent across all sizes of national banks.

One measure of C&I loan quality comes from the federal banking agencies' Shared National Credit (SNC) program, which provides an annual review of large credit

commitments that cut across the financial system. These large loans to large borrowers are originated by large banks, then syndicated to other banks and many types of nonbank financial institutions such as securitization pools, hedge funds, insurance companies, and pension funds.<sup>7</sup> This year's review, which was just recently completed, also found sharp declines in credit quality. The review, which covered 8,955 credits totaling \$2.9 trillion extended to approximately 5,900 borrowers, found a record level of \$642 billion in criticized assets – meaning loans or commitments that had credit weaknesses – representing approximately 22 percent of the total SNC portfolio. Total loss of \$53 billion identified in the 2009 review exceeded the combined loss of the previous eight SNC reviews and nearly tripled the previous high in 2002. Examiners attributed the declining credit quality to weak economic conditions and the weak underwriting standards leading up to 2008.<sup>8</sup>

### *C. Commercial Real Estate Loans*

The greatest challenge facing many banks and their supervisors is the continued deterioration in commercial real estate loans (CRE). There are really two stories here, with one related to the other.

The first involves residential construction and development (C&D) lending, especially with respect to single family homes. Not surprisingly, given the terrible strains in the housing sector over the last two years, delinquency rates have already climbed to high levels, with significant losses already realized and more losses continuing to work their way through the banking system. For national banks as of June 30, total delinquent and nonperforming rates were at just over 34 percent in the largest national banks; 23.4 percent in mid-size banks; and 17.5 percent in community banks. The relative size of these

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<sup>7</sup> In fact, nonbanks hold a disproportionate share of classified assets compared with their total share of the SNC portfolio, owning 47 percent of classified assets and 52 percent of nonaccrual loans, whereas FDIC-insured institutions hold only 24.2 percent of classified assets and 22.7 percent of nonaccrual loans.

<sup>8</sup> See OCC News Release 2009-11, September 24, 2009.

loss rates is somewhat misleading, however, because many community banks and some mid-size banks have much greater concentrations in residential C&D loans than the largest banks. As a result, the concentrated losses in these smaller institutions has had a much more pronounced effect on viability, with concentrated residential C&D lending constituting by far the single largest factor in commercial bank failures in the last two years. At this point in the credit cycle, we believe the bulk of residential C&D problems have been identified and are being addressed, although a number will continue to produce losses that result in more bank failures.

The second story involves all other types of commercial real estate loans, including loans secured by income producing properties. Credit deterioration has spread to these assets as well, and trend lines are definitely worsening, but thus far the banking system has not experienced anywhere near the level of delinquency and loss as it has in C&D lending.

Still, the signs are troubling. Declining real estate values caused by rising vacancy rates, increasing investor return requirements, falling rental rates, and weak sales are affecting all CRE segments. For example, Property and Portfolio Research reports that apartment vacancy rates have hit a 25-plus year high at 8.4 percent nationally, and there are similar patterns for retail, office, and warehouse space as demand falls across all segments. But unlike the CRE markets in 1991, much of the current fallout is driven more by a decrease in demand than from an oversupply of properties.

The outlook for these markets over the near term, especially for the income producing property sector, is not favorable. In general, deterioration in performance for these CRE loans lags the economy as borrowers' cash flows may be sufficient during the early stages of a downturn, but become increasingly strained over time. There are also growing concerns about the refinancing risk within the commercial mortgage-backed

securities market (CMBS) where there is a currently moderate-but-growing pipeline of loans scheduled to mature. Permanent or rollover refinancing of these loans may be difficult due to the declines in commercial property values coupled with the return to more prudent underwriting standards by both lenders and investors. While this is an area that we are monitoring, the largest proportion and more problematic of these mortgages will not mature until 2011 and 2012.

As with C&I loans, trends in total delinquent and nonperforming CRE rates (including C&D loans) have been fairly consistent across all segments of the national bank population, climbing to roughly 8.3 percent in 2Q:2009. While C&D losses will continue to be most problematic for the banks that have the largest concentrations in these assets, the extent to which other types of CRE loan losses will continue to climb will depend very much on the overall performance of the economy.

*D. Capital and Reserve Levels*

Perhaps the most critical tools for dealing with and absorbing credit losses are substantial levels of capital and reserves. As a result, in anticipation of rising credit losses over the last two years, the OCC has directed banks to build loan loss reserves and strengthen capital. In aggregate, the net amount of capital in national banks (*i.e.*, the net increase after items such as losses and dividends and including capital as a result of acquisitions and net TARP inflows) has risen by over \$186 billion over the last two years, and the net build to loan loss reserves (*i.e.*, loan loss provisions less net credit losses) has been over \$92 billion. These increases in loss-absorbing resources are critical contributors to the overall health of the national banking system.

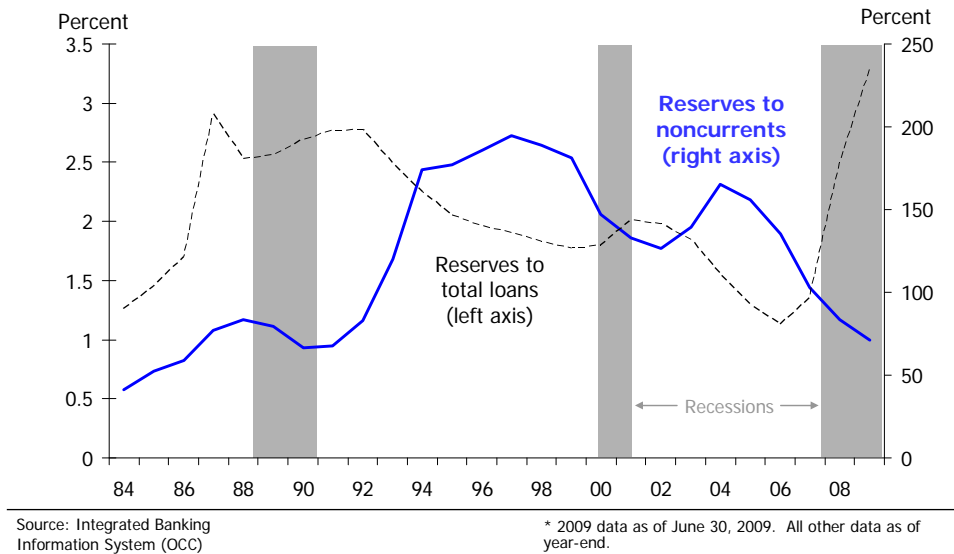
As illustrated by the dotted line in the chart below, the level of reserves to total loans in the national banking system has increased dramatically to a ratio of 3.3 percent, the

highest in over 25 years. While such high reserves are imperative for dealing with the high level of noncurrent loans, the solid line in the chart below shows that more provisions may be needed, because the ratio of reserves to noncurrent loans has continued to decline, to under 100 percent – reflecting the fact that the substantial growth in reserves is not keeping pace with the even greater growth in noncurrents.

Chart 7

### Ratio of reserves to noncurrents at lowest in 20 years despite elevated provisioning

National banks



Substantially building reserves at the same time as credit conditions weaken is often described as unduly “pro-cyclical,” because bank earnings decline sharply from provisioning well before charge-offs actually occur. That is certainly an accurate characterization under the current accounting system for loan loss reserving, although there will always be a need to build reserves to some extent as credit losses rise. The issue is really about how much; that is, if reserve levels are high going into a credit downturn, then the need to build reserves is far lower than it is when the going-in levels are low. Unfortunately, our current accounting standards tend to produce very low levels of reserves

just before the credit cycle turns downward, especially after prolonged periods of benign credit conditions as we had in the first part of this decade. In such periods, the backward-looking focus of the current accounting model creates undue pressure to decrease reserve levels even where lenders believe the cycle is turning and credit losses will clearly increase. I strongly believe that a more forward looking accounting model based on expected losses would both more accurately account for credit costs and be less pro-cyclical. This is an issue that I have been working on as co-chair of the Financial Stability Board's (FSB) Working Group on Provisioning, and I continue to be hopeful that accounting standard setters will embrace this type of change as they consider adjustments to loan loss provisioning standards.

#### **IV. Most National Banks Have Capacity to Weather This Storm**

The credit conditions I have just described are stark and will require considerable skills by bankers and regulators to work through. Despite these challenges, I believe the vast majority of national banks are and will continue to be sound, and that they have the wherewithal to manage through this credit cycle. Notwithstanding the negative trends and earnings pressures that banks are facing, we should not lose sight that, as of June 30, 2009, 97 percent of all national banks satisfied the required minimum capital standards to be considered well capitalized, and 76 percent reported positive earnings.

As previously described, the OCC has separate supervisory programs for Large Banks (assets generally exceeding \$100 billion); Mid-Sized Banks (assets from \$10 billion to \$100 billion); and Community Banks (assets below \$10 billion). Let me summarize our general assessment of the condition of each group.

A. *Large Banks*

In some respects, large banks faced the earliest challenges, with the disruptions in wholesale funding markets, the significant losses they sustained on various structured securities, and the pronounced losses that emerged earlier in their retail credit portfolios. As I mentioned, there are some preliminary indicators that the rate of increased problems in the retail sector may have begun to slow, but as with credit conditions in general, much of this will depend on the timing and strength of the economy, and in particular, on unemployment rates. C&I and CRE loan exposures remain a concern for these banks, but they have more diversified portfolios and exposures than many smaller banks and thus may be in a better position to absorb these problems. Collectively, the fifteen banks in our Large Bank program raised \$132 billion in capital (excluding TARP funding) in 2008 and, over the past twenty four months, their net build to loan loss reserves totaled approximately \$85 billion.

Earlier this year we and the other federal regulators conducted a detailed stress test of the largest U.S. banks as part of the Supervisory Capital Assessment Program (SCAP) to examine their ability to withstand even further deterioration in market and credit conditions. I believe that was an extremely valuable exercise for four reasons. First, the one-time public assessment of individual institution supervisory results – which was only made possible by the U.S. government backstop made available by TARP funding – alleviated a great deal of uncertainty about the depth of credit problems on bank balance sheets, which a number of analysts had assumed to be in far worse condition. Second, the reduction of uncertainty allowed institutions to access private capital markets to increase their capital buffer for possibly severe future losses, instead of requiring more government capital. Third, the additional capital required to be raised or otherwise generated now –

over \$45 billion in common stock alone has already been issued by the nine SCAP institutions with national bank subsidiaries – provides these banks with a strong buffer to absorb the severe losses and sharply reduced revenue associated with the adverse stress scenario imposed under SCAP for the two-year period of 2009 and 2010, should that scenario come to pass. Fourth, as we track banks’ actual credit performance against the SCAP adverse stress scenario to ensure that capital levels remain adequate, we have found that, through the first half of 2009 – which constitutes 25 percent of the overall two-year SCAP stress period – actual aggregate loan losses were well below 25 percent of the aggregate losses projected for the full SCAP period, and actual aggregate revenues were well above 25 percent of the aggregate projected SCAP revenues. While those trends could change as the stress period continues, the early results are promising.

*B. Mid-Size Banks*

Although mid-size national banks engage in retail lending, the scope and size of their exposures are not as significant as those of the largest national banks. Mid-size banks also did not have the significant losses that larger banks did from various structured investment products. Nevertheless, loan growth at these banks turned negative in 2Q:2009, and although they experienced modest improvements in net interest margins in the second quarter, they still face downward earnings pressures, primarily due to increasing loan loss provisions. Given their exposures to the C&I and CRE markets, we expect these pressures will persist, notwithstanding the \$3.5 billion in net reserve builds over the last twenty four months. These banks have also had success in attracting new capital, raising close to \$5 billion thus far this year.



C. *Community Banks*

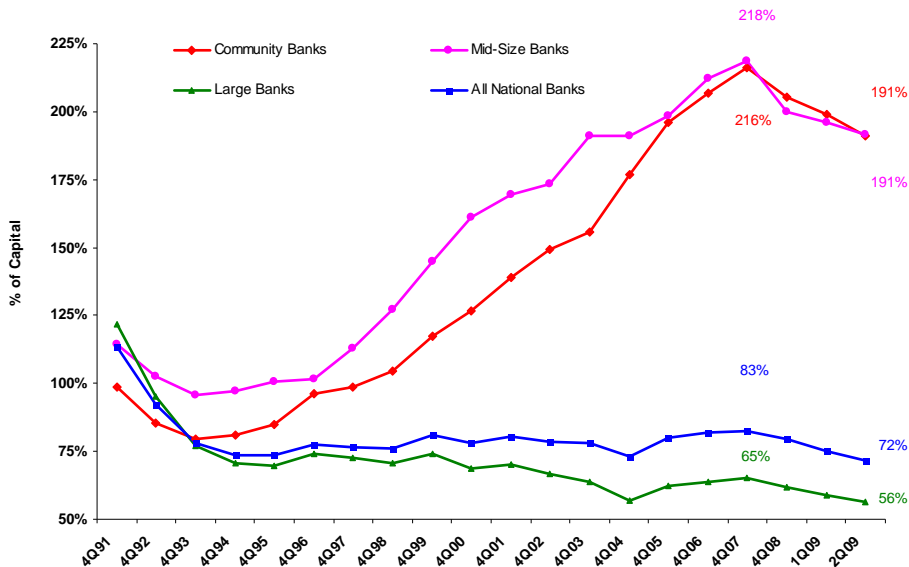
Nearly all national community banks entered this environment with strong capital bases that exceeded regulatory minimums. As a group, they have been less exposed to problems in the retail credit sector that have confronted large and mid-size banks, and the vast majority of these banks remain in sound financial condition. As noted earlier, there is a small number of community banks that have concentrations in trust preferred and private label mortgage-backed securities that we are closely monitoring.

Of more significance are the exposures that many community banks have to commercial real estate loans. As I noted in my June 2008 testimony, we have been concerned for some time about the sizeable concentrations of CRE loans found at many smaller national banks. While national banks of all sizes have significant CRE exposures, as shown in Chart 8, CRE concentrations are most pronounced at community and mid-size banks.

Chart 8

**National Banks' CRE Concentration History**

Dec-1991 to Jun-2009



Source: Call Reports.

Because of this, the OCC began conducting horizontal reviews of banks with significant concentrations about five years ago. As credit conditions worsened, our efforts intensified in banks that we believed were at high risk from downturns in real estate markets. Our goal has been to work with bankers to get potential CRE problems identified at an early stage so that bank management can take effective remedial action. In most but not all cases, bank management teams are successfully working through their problems and have adequate capital and stable funding bases to weather additional loan losses and earnings pressures.

## **V. Resolution of Problem Banks**

Given the strains in the economy and banking system, it is not surprising that the number of problem banks has increased from the recent historical lows. In the early 1990s, the number of problem national banks – those with a CAMELS composite rating of 3, 4 or 5 – reached a high of 28 percent of all national banks. Thereafter, the number of problem national banks relative to all national banks dropped dramatically and then fluctuated in a range of three to six percent until 2007. Since then, however, the number of problem banks has risen steadily, and it is now approximately 17 percent of national banks.

As would be expected, this upward trend in problem banks also has resulted in an increased number of bank failures. In January, 2008, we had the first national bank failure in almost four years, the longest period without a failure in the 146-year history of the OCC. That began the current period of significantly increased failures. In total, since January 1 of 2008, there have been 123 failures of insured banks and thrifts. Of these, 19 have been national banks, accounting for 11 percent of the total projected loss to the deposit insurance fund from all banks that failed during this period. All of the 19 failed national banks have been community banks, although the total obviously does not include the two large bank holding companies with lead national banks that were the subject of systemic risk determinations and received extraordinary TARP assistance on an open-institution basis.

While the vast majority of national banks have the financial capacity and management skills to weather the current environment, some will not. Given the real estate concentrations in community banks, the number of problem banks, the severe problems in housing markets, and increasing concern with CRE, we expect more bank failures in the months ahead. Some troubled banks will be able to find strong buyers – in some instances

with our assistance – that will enable them to avoid failure and resolution by the FDIC. But that will not always be possible. When it is not, our goal, consistent with the provisions of the Federal Deposit Insurance Corporation Improvement Act, is to effect early and least cost resolution of the bank with a minimum of disruption to the community.

## **VI. OCC Will Continue to Take a Balanced Approach in Our Supervision of National Banks**

Finally, I want to underscore the OCC's commitment to provide a balanced and fair approach in our supervision of national banks as bankers work through the challenges that are facing them and their borrowers. We recognize the important roles that credit availability and prudent lending play in our nation's economy, and we are particularly aware of the vital role that many smaller banks play in meeting the credit needs of small businesses in their local communities. Our goal is to ensure that national banks can continue to meet these needs in a safe and sound manner.

I have heard some reports that bankers are receiving mixed messages from regulators: on one hand being urged to make loans to creditworthy customers, while at the same time being subjected to what some have characterized as "overzealous" regulatory examinations. In this context, let me emphasize that our messages to bankers have and continue to be straightforward:

- Bankers should continue to make loans to creditworthy borrowers;
- But they should not make loans that they believe are unlikely to be repaid in full;  
and
- They should continue to work constructively with troubled borrowers – but recognize repayment problems in loans when they see them, because delay and denial only makes things worse.

Let me also underscore what OCC examiners will and will not do. Examiners will not tell bankers to call or renegotiate a loan; dictate loan structures or pricing; or prescribe limits (beyond regulatory limits) on types or amounts of loans that a bank may make if the bank has adequate capital and systems to support and manage its risks. Examiners will look to see that bankers have made loans on prudent terms, based on sound analysis of financial and collateral information; that banks have sufficient risk management systems in place to identify and control risks; that they set aside sufficient reserves and capital to buffer and absorb actual and potential losses; and that they accurately reflect the condition of their loan portfolios in their financial statements.

Nevertheless, balanced supervision does not mean that examiners will allow bankers to ignore or mask credit problems. Early recognition and action by management are critical factors in successfully rehabilitating a problem bank. Conversely, the mere passage of time and hope for improved market conditions are not successful resolution strategies.

We have taken a number of steps to ensure that our examiners are applying these principles in a balanced and consistent manner. For example, we hold both regular meetings and periodic national teleconferences with our field examiners to convey key supervisory messages and objectives. In our April 2008 nationwide call, we reviewed and discussed key supervisory principles for evaluating commercial real estate lending. In April of this year we issued guidance to our examiners on elements of an effective workout/restructure program for problem real estate loans. We noted that effective workouts can take a number of forms, including simple renewal or extension of the loan terms, extension of additional credit; formal restructuring of the loan terms; and, in some

cases, foreclosure on underlying collateral. We further reiterated these key principles in a nationwide call with our mid-size and community bank examiners earlier this month.

Through the FFIEC, we are also working with the other federal and state banking agencies to update and reinforce our existing guidance on working with CRE borrowers and to help ensure consistent application of these principles across all banks. This guidance will reaffirm that prudent workouts are often in the best interests of both the bank and borrower and that examiners should take a balanced approach in evaluating workouts. In particular, examiners should not criticize banks that implement effective workouts after performing a comprehensive review of the borrower's condition, even if the restructured loans have weaknesses that result in adverse credit classification. Nor should they criticize renewed or restructured loans to borrowers with a demonstrated ability to repay, merely because of a decline in collateral values. Consistent with current policies, loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally will not be classified. However, deferring issues for another day does not help the CRE sector or banking industry recover. It is important that bankers acknowledge changing risk and repayment sources that may no longer be adequate.

## **VII. Conclusion**

I firmly believe that the collective measures that government officials, bank regulators, and many bankers have taken in recent months have put our financial system on a much more sound footing. These steps are also crucial to ensuring that banks will be able to continue their role as lenders and financial intermediaries. Nonetheless, it is equally clear that there are still many challenges ahead, especially with regard to the significant deterioration in credit that both supervisors and bankers must work through. There are no

quick fixes to this problem, and there is the real potential that, for a large number of banks, credit quality will get worse in the months ahead. Notwithstanding the significant loan loss provisions that banks have taken over the past two years, more may be needed as provisions and resulting loan loss reserves have not kept pace with the rapid increase in nonperforming assets.

The OCC is firmly committed to taking a balanced approach as bankers work through these issues. We will continue to encourage bankers to lend and to work with borrowers. However, we will also ensure that they do so in a safe and sound manner and that they recognize and address their problems on a timely basis.