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TESTIMONY OF

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OFFICE OF THE COMPTROLLER OF THE CURRENCY**

before the

**CONGRESSIONAL OVERSIGHT PANEL
FEBRUARY 4, 2011**

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 Kaufman and members of the Congressional Oversight Panel, my name is Dave Wilson and I am the Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to present the OCC's observations about the commercial real estate (CRE) market and its impact on national banks. The OCC supervises approximately 1,415 insured national banks, which comprise about 18 percent of the 7,760 FDIC-insured depository institutions (IDIs) in the United States, holding approximately 63 percent of all IDI assets. In terms of size, national banks constitute 13 of the 19 banks with assets over \$100 billion, including the six largest banks in the United States; 42 percent of mid-size banks, with assets ranging from \$5 billion to \$100 billion; and 22 percent of community banks, with assets of less than \$5 billion.¹

Commercial real estate lending is a prominent business line for many national banks, and many have been adversely affected by the sharp and protracted downturn in the commercial real estate markets. The vast majority of national banks have and will continue to be able to manage through their troubled CRE exposures. For these banks, our supervisory message has been consistent and clear: work constructively with borrowers who are facing difficulties, but also recognize and address problem credits by maintaining appropriate loan loss reserves and taking appropriate charge-offs when repayment is unlikely. There will, however, be national banks whose CRE exposures and related losses are such that the bank will no longer be viable. In these cases, our supervisory objective is for early and least cost resolution strategies.

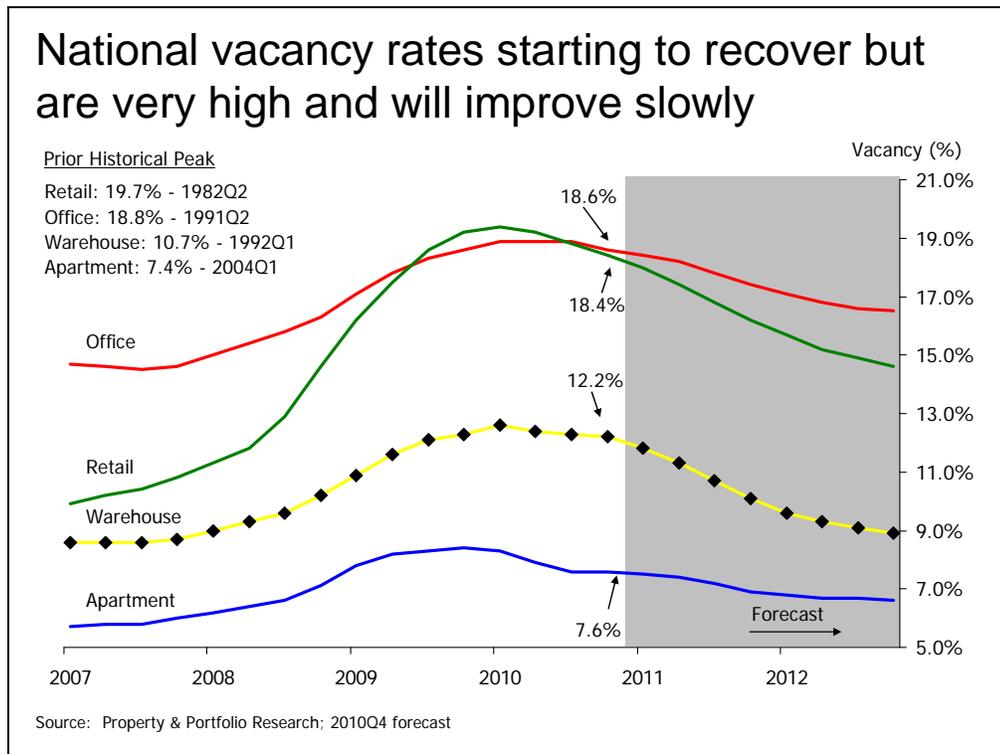
¹ Figures are based on 9/30/2010 data and include all FDIC-insured institutions, but do not include federally insured credit unions.

Pursuant to the Panel’s request letter, the first part of my testimony discusses the OCC’s current assessment of the CRE markets and the status of national banks’ CRE lending portfolios. I then address the OCC’s supervisory approach and actions for dealing with banks with high CRE concentrations.

II. Current CRE Market Conditions and National Banks’ CRE Portfolios

Commercial property markets across the United States have begun to show signs of stabilization, as the economy slowly regains momentum. As shown in Chart 1 below, national vacancy rates across property types have started to recover, but remain high by historical standards. Based on projections by Property & Portfolio Research, elevated vacancy rates are likely to continue well into 2012.

Chart 1

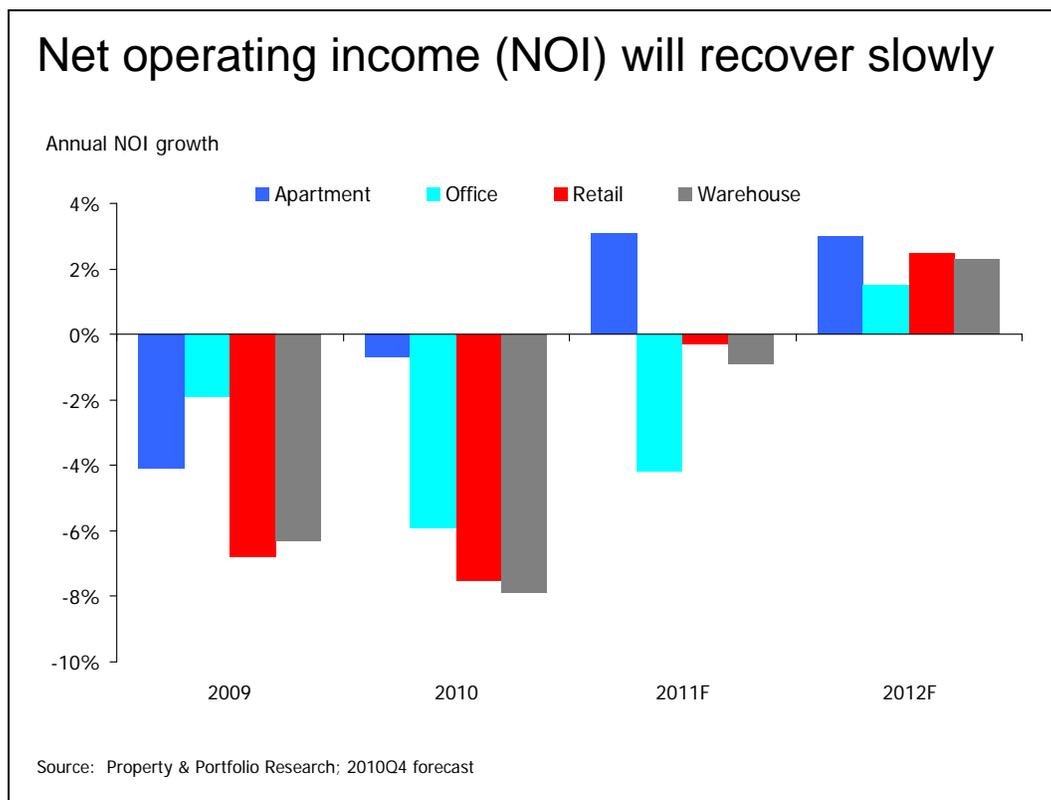


Notwithstanding the modest improvement in vacancy rates, net operating income – a key driver for CRE property values and the primary source for loan repayment –

continues to decline across most CRE sectors. This is because leasing rates remain soft.

Chart 2 below shows the recent and projected annual percentage changes in net operating income (NOI). As can be seen from the chart, while NOI is expected to stabilize for apartments this year, other property types are expected to experience further declines. Additionally, growth in 2012 is projected to be relatively modest.

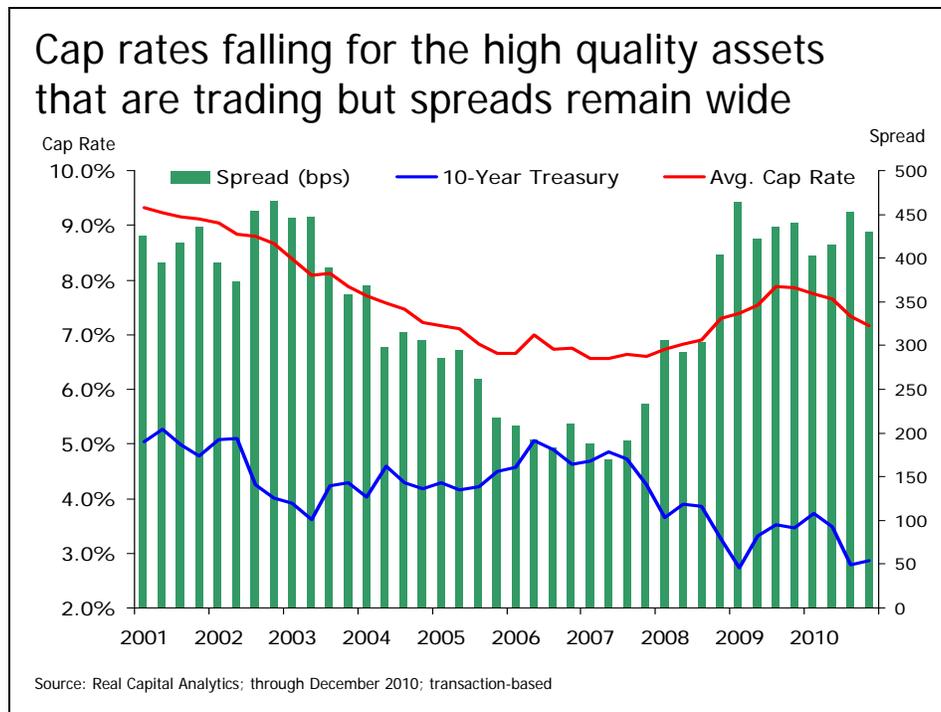
Chart 2



A third factor affecting commercial property values is the capitalization rate, or rate of return, demanded by investors. This rate of return reflects, in part, investors' outlook on risk. The higher the required return, the lower the price investors are willing to pay (all other factors held constant). As occurred in other sectors, capitalization rates and risk premiums in relation to Treasury securities fell substantially for much of the past decade as investors and lenders competed for deals, relaxed their underwriting and

investment standards, and accepted lower rates of return. We believe those capitalization rates were unsustainable as they often did not fully reflect the risks associated with the properties being financed. As investors became more selective, capitalization rates increased rather markedly in 2008 and 2009. As shown in Chart 3, cap rates appear to have stabilized and indeed have fallen somewhat, particularly for high quality assets, but the spreads being demanded by investors, relative to Treasuries, remains wide.

Chart 3



These trends in vacancies, NOI, and cap rates are reflected in overall property prices. In aggregate, commercial property prices fell roughly 40 percent from their peak in 2007, but prices have begun to show signs of stabilization. The Moody's/REAL All Property Type Aggregate Index² recorded an increase of 0.6 percent in November 2010, the third consecutive month of national price gains. While this is an encouraging trend,

² The Moody's/REAL Commercial Property Index measures the change in actual transaction prices for commercial real estate assets based on the repeat sales of the same assets at different points in time. Moody's Investors Service: Moody's/Real Commercial Property Price Indices, August 2010, page 3.

we expect that property values may remain volatile until underlying market fundamentals improve consistently. Within the aggregate Moody's index, only apartments are experiencing a meaningful recovery. As a further sign of the continued softness in the market, the Moody's report indicates that about 24 percent of the November transactions involved sales of properties that had notices of default, were in foreclosure, or had an owner in bankruptcy.³ As measured by this index and illustrated in Chart 4, commercial property prices, while up 2.8 percent from a year ago, are still well below the 2007 peak.

Our expectation is that property values will slowly rise, but remain substantially below their 2006/2007 peaks (see Chart 5). While the pace and range of recovery will vary by geography, in general we expect office markets will face the longest road to recovery. Many retail markets will continue to be adversely affected by weak consumer spending and the overbuilding that occurred in this market segment. Within the CRE market, there is substantial bifurcation, with aggressive pricing reserved for quality assets in major urban markets such as Los Angeles, San Francisco, Chicago, Boston, New York, and the District of Columbia.

³ Bloomberg/Business Week, "U.S. Commercial Property Prices Rise for Third Month," January 24, 2011.

Chart 4

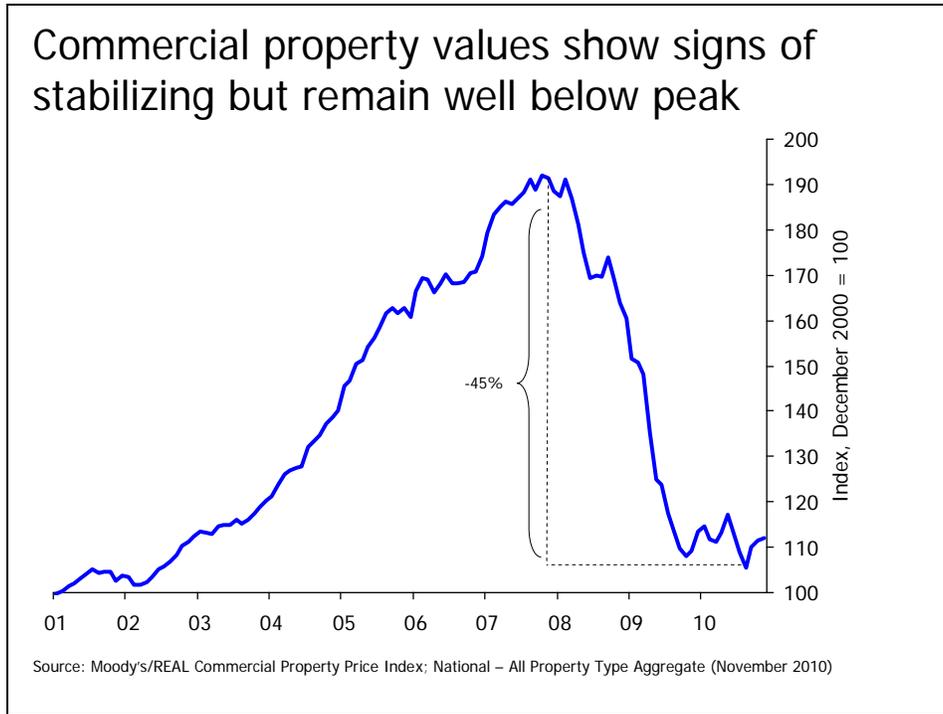
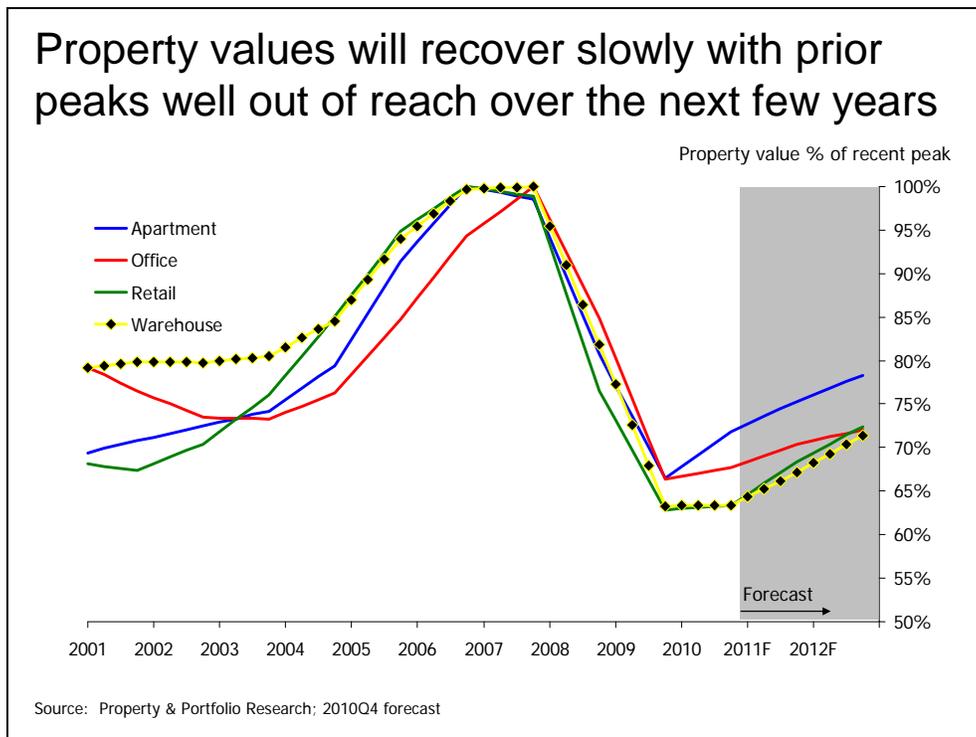


Chart 5



There also are some early signs of improvement in the CRE capital markets, but here again, activity is substantially below past peak levels. Issuance of commercial

mortgage backed-securities in the U.S. totaled approximately \$11.6 billion in 2010, up from \$2.7 billion in 2009, but well-off the record level of \$230.2 billion in 2007.⁴

Similarly, sales transactions of CRE properties nearly doubled from 2009 to 2010, but at \$120 billion, sales activity in 2010 was just a fraction of the \$514 billion of properties traded in 2007.⁵

As shown in Chart 6, the rate of increase in CMBS delinquencies appeared to have moderated in the latter part of 2010, but trends remain uneven. By any measure, delinquency rates are exceedingly high and will continue to be a drag on this market.

Chart 6

**Increases in CMBS delinquency have moderated;
but level remains exceedingly high**

CMBS Delinquency Rate

| | <u>Dec-10</u> | <u>Nov-10</u> | <u>Sep-10</u> | <u>Dec-09</u> |
|-------------|---------------|---------------|---------------|---------------|
| Aggregate | 8.8% | 8.6% | 8.2% | 4.9% |
| Industrial | 6.5% | 6.4% | 6.3% | 3.4% |
| Multifamily | 14.4% | 13.9% | 13.4% | 8.1% |
| Office | 6.7% | 6.7% | 6.4% | 3.2% |
| Retail | 7.4% | 7.1% | 6.6% | 4.5% |
| Hotel | 16.4% | 16.4% | 15.9% | 9.1% |

Source: Moody's CMBS Delinquency Tracker; January 2011

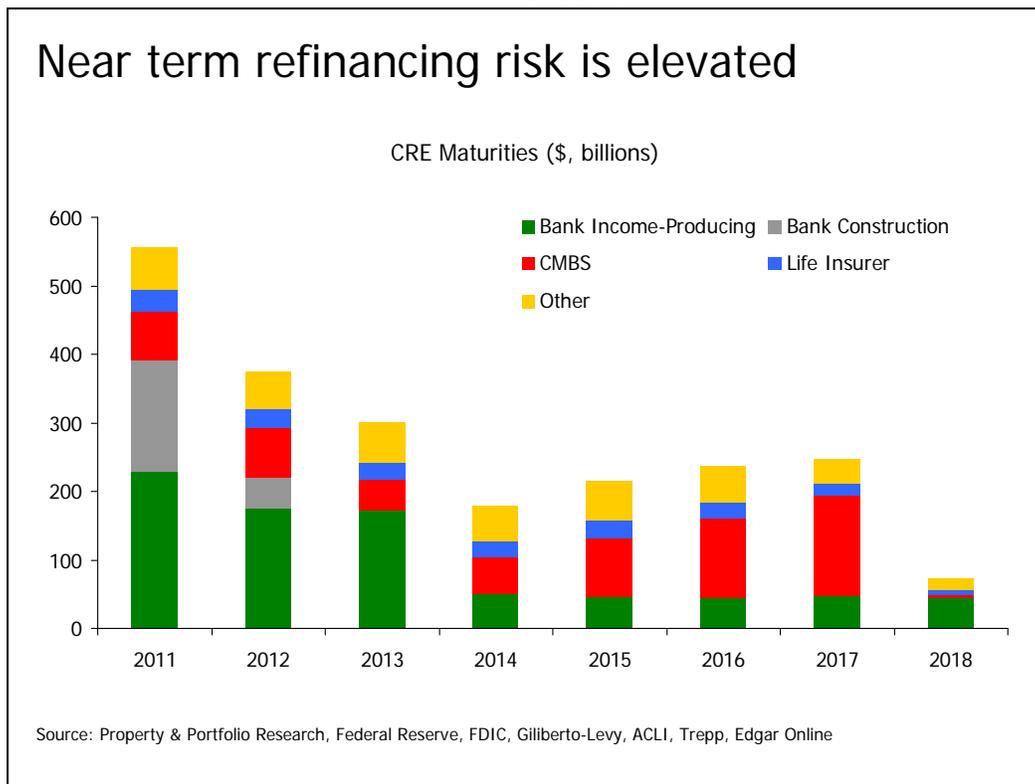
Given the continued weakness of CRE capital markets, the overhang of commercial mortgages that mature in the next few years represents one of the greatest risks to CRE loan performance. As shown in Chart 7, approximately \$2.2 trillion of CRE

⁴ Source: Commercial Mortgage Alert, January 2011.

⁵ Source: Real Capital Markets Analytics, data through December 2010 for sales of \$5 million or more.

loans are scheduled to mature from 2011 to 2018, with CRE loans from banks representing more than 60 percent of all maturities over the next few years. Additionally, a substantial portion of CRE debt that was expected to mature in 2010 may have been extended into 2011 or later. Permanent or rollover refinancing of these loans may be difficult due to lower property values coupled with lenders' and investors' greater reliance on in-place cash flow and more stringent loan-to-value requirements. One mitigating factor is the current low interest rate environment, which allows for some projects to cash flow since debt service requirements are low. If interest rates increase without a corresponding improvement in the economy, CRE refinancing difficulties would be exacerbated. This is a situation that we are continuing to monitor.

Chart 7



Consistent with the trends in the CRE markets, there are signs that CRE lending and loan portfolio performance have begun to stabilize within the banking sector. As

measured by the Federal Reserve Board’s Quarterly Senior Loan Officer Opinion Survey and summarized in Chart 8, fewer bankers are tightening underwriting standards and loan demand is starting to improve. These trends are consistent with what we are hearing from our examiners in the field. Despite these improving trends, new loan originations remain tepid (see Chart 9). As previously noted, we expect significant new activity in the CRE market to remain sluggish until underlying fundamentals, such as vacancies, NOIs, cap rates, and overall economic demand, show consistent and marked improvement.

Chart 8

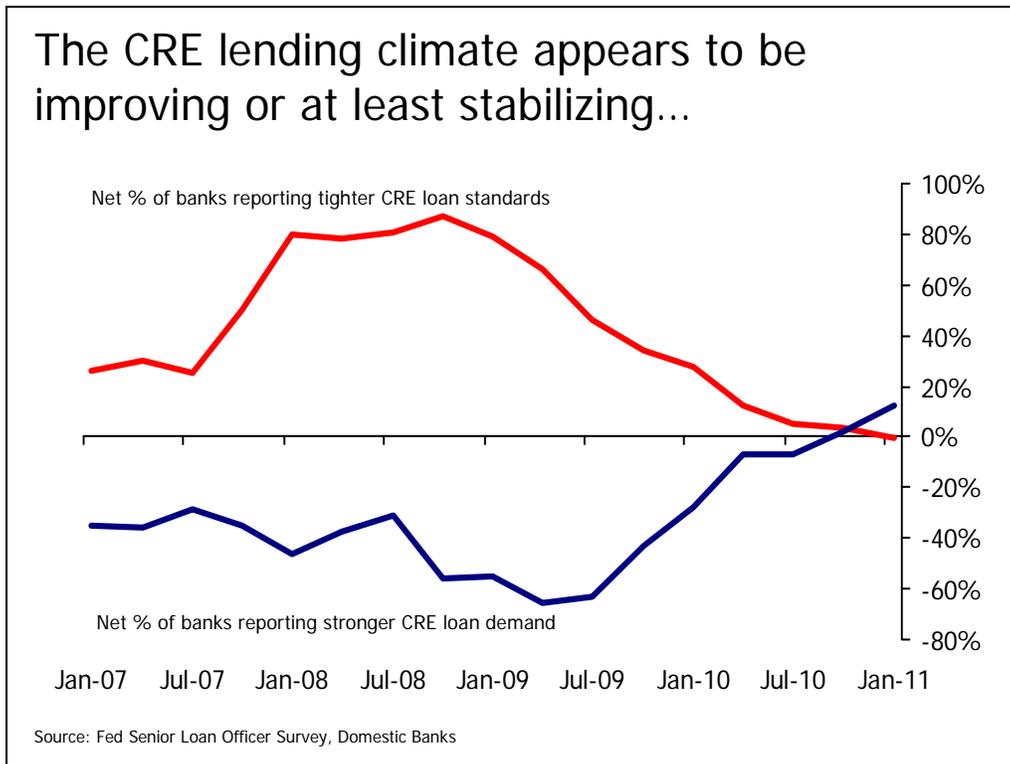
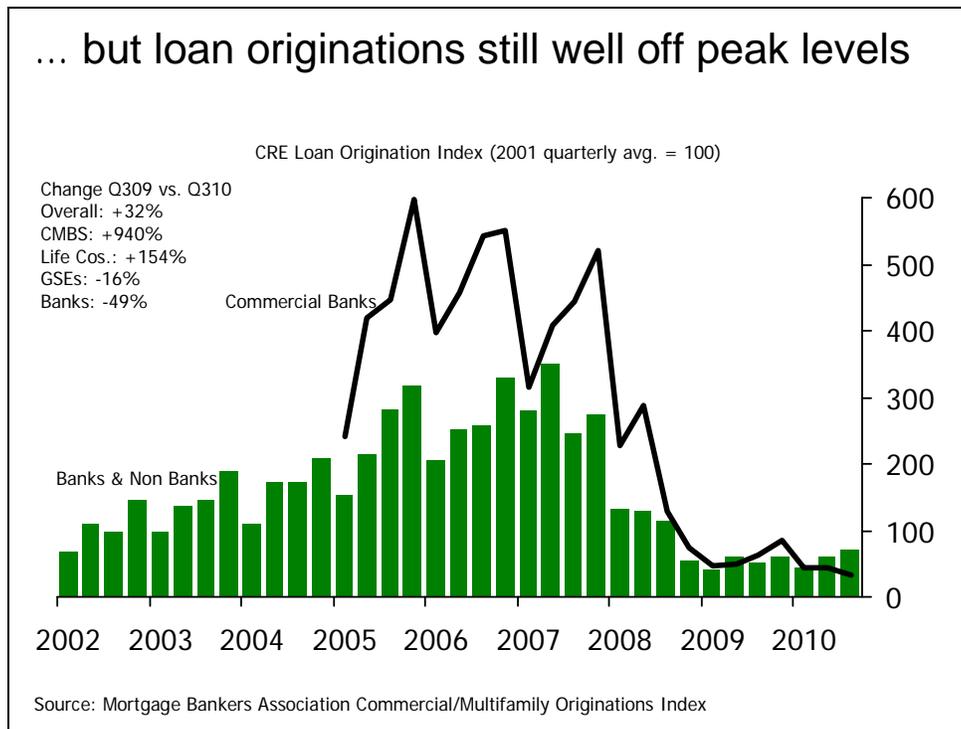


Chart 9



High vacancy rates and declining NOIs continued to adversely affect national banks' CRE portfolio performance throughout 2010 as nonperforming loan levels and loss rates remained well above long-term averages. Within the national bank population, there appears to be some stabilization in the level of non-performing CRE loans.⁶ After increasing for every quarter since the third quarter of 2006, non-performing levels relative to total CRE loans declined slightly in the second and third quarters of 2010 to 8.41 percent (see Chart 10). However, through the third quarter of 2010, income-producing commercial mortgage charge-off rates continued to trend upward while charge-off rates for construction loans remained elevated (see Chart 11).

⁶ Non-performing loans include loans that are on nonaccrual plus any other loans that are 90 days or more past due.

Chart 10

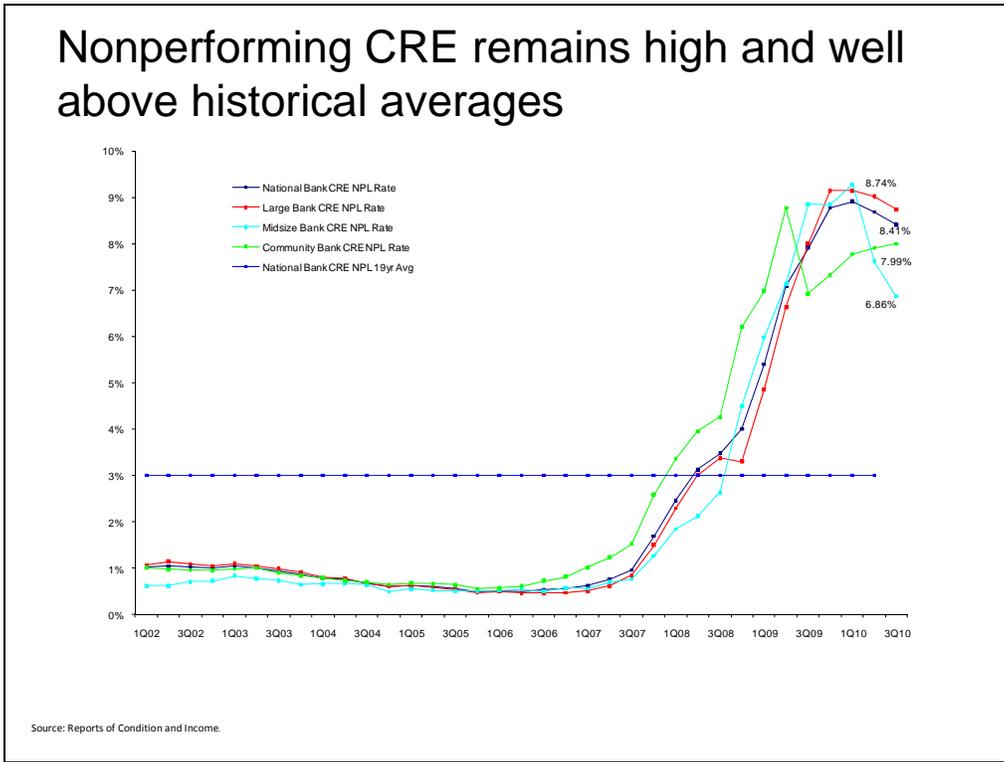
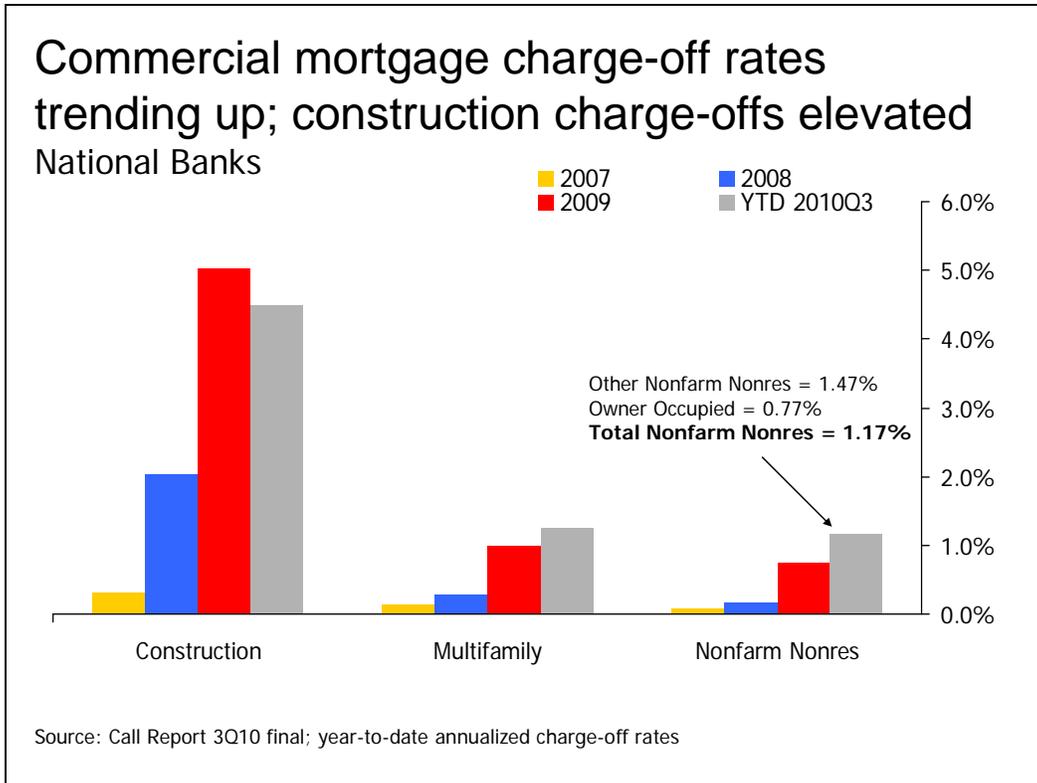


Chart 11

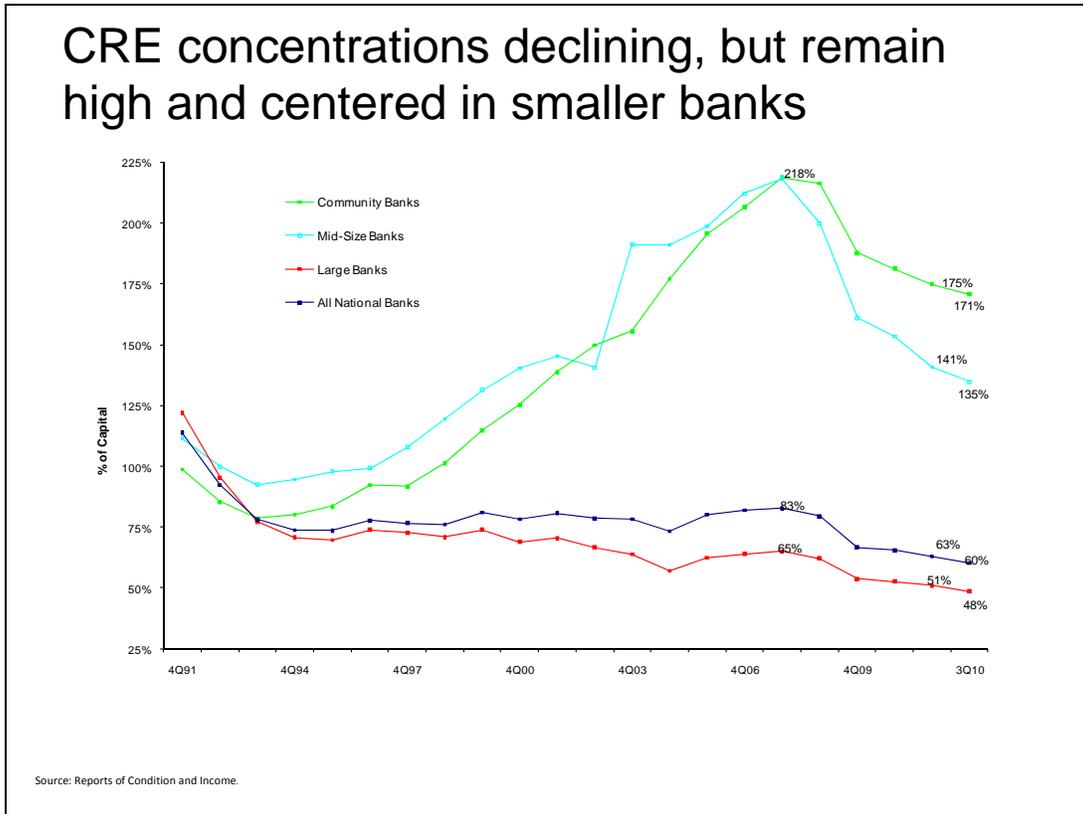


As part of our on-going supervision, the OCC uses a variety of tools to stress test possible CRE losses under a range of possible economic scenarios. Our current baseline analysis suggests that the two-year charge-off rate for CRE in total will remain near recent levels, with a peak in 2011, followed by a slight decline in 2012. In this scenario, commercial mortgage charge-offs increase due to another year of declining NOI in 2011 across most property types. Under a slower growth economic scenario, CRE charge-offs would rise higher, as demand for space falls, property values decline, and CRE credit markets tighten. This scenario would result in faster income-producing commercial mortgage deterioration and a slower improvement in construction loans compared to our baseline scenario.

The timing and effect of the distressed CRE market on national banks' overall financial condition varies by the size, location, and type of CRE exposure of the bank. As noted in Chart 11, charge-off rates for construction loans have led performance problems in the CRE sector and thus banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. Conversely, banks whose lending is more focused on income-producing commercial mortgages, including many smaller community banks, are continuing to experience increased charge-off rates. Compounding this problem for many community and mid-size banks is their significant CRE concentrations. As shown in Chart 12, although CRE concentrations as a percentage of capital have trended downward for all national banks, they are still significant for many mid-size and community banks. High CRE concentrations centered in construction and development loans have been a significant factor in the sharp uptick in bank failures over the past two years. In the vast

majority of cases, failed banks had CRE concentrations of 300 percent or more of their capital two years before their eventual failure.

Chart 12



III. OCC Supervisory Approach to CRE Concentrations

The OCC has been raising and addressing concerns about the CRE market, and in particular, the concentrated exposures that many community banks have to this market, since early 2004 when we initiated the first of a series of targeted examinations at banks that we believed were at significant risk due to the nature and scope of their CRE activities. These supervisory efforts have continued with various targeted examinations and reviews at national banks with significant CRE concentrations. For example, in each of the last three years, we have conducted annual targeted examinations in all of our mid-size national banks that have significant CRE exposures. Similarly, our district offices

have established action plans for ongoing monitoring and assessment of community banks with elevated CRE exposures. As part of these reviews, examiners evaluate the adequacy of the bank's internal loan risk rating and classification systems and determine whether bank management is recognizing problem loans and developing realistic workout plans, and maintaining adequate loan loss reserves.

We have also been directing national banks with significant CRE concentrations to develop more rigorous stress testing capabilities. For example, we have instructed banks that their stress testing of CRE transactions should consider the effect of multiple variables (e.g., changes in interest rates, vacancy rates, and capitalization rates), and that such stress tests should be performed periodically throughout the life of the loan.

To assist bankers in identifying and assessing potential CRE vulnerabilities, we developed, and have made available via our National BankNet Web site, a CRE stress testing tool that bankers can use. Although BankNet is a system designed for national banks, we make available our CRE tools to state banks upon request. Currently, we have two tools available on BankNet. The Acquisition & Development (A&D) Stress-Testing Worksheet is an Excel-based tool that allows bankers to perform comprehensive sensitivity analysis on an A&D project quickly and easily. The tool helps to identify potential changes in project value based on changes in market and project conditions. The CRE Stress Testing Worksheet is an Excel-based tool that only requires an input of some basic loan underwriting criteria, yet it provides a concise output of the potential credit quality deterioration posed by the embedded risks. The worksheet shows the progression of the potential impact to debt service coverage (DSC) and loan-to-value (LTV) from individual changes in the capitalization rate, interest rate, and vacancy rate.

We also provide examiners with access to various market databases that allow them to monitor and analyze CRE trends by major geographies and product type.

We elected to start targeted exams at selected banks early in the credit cycle – before problems were manifested in borrower performance – so that we could give bankers an opportunity to correct and address weaknesses. Findings from these initial examinations, and the weaknesses we discovered in various risk management practices, helped to formulate the guidance that we and the other federal banking agencies issued in 2006 on sound risk management practices for concentrations in CRE lending.⁷

To ensure that we were applying a consistent approach in our examinations, in April 2008, we issued internal supervisory guidance to our examiners to reiterate and clarify our policies on CRE lending. That same month we held a nationwide teleconference with our examiners to discuss the guidance. During that call we stressed the need for examiners to take a balanced approach in their supervision and to maintain open and effective communications with bankers during their examinations. Given the issues that examiners were identifying in CRE loans, in April 2009 we issued follow-up supervisory guidance to examiners on factors that they should consider when evaluating banks' workout programs and risk ratings for problem CRE loans. Much of this guidance was subsequently incorporated into the agencies' October 2009 guidance on CRE loan workouts.⁸

The October 2009 guidance includes specific, real world examples to provide greater clarity and certainty for bankers in how examiners review and assess certain CRE loan structures. Given the concerns and questions we were hearing about how examiners

⁷ OCC Bulletin 2006-46, "[Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management.](#)"

⁸ OCC Bulletin 2009-32, "[Commercial Real Estate \(CRE\) Loans: Guidance on CRE Loan Workouts.](#)"

differentiate between performing and non-performing loans, each example provides various fact patterns and describes the appropriate classification, accrual, and accounting treatment for each different set of circumstances. Drilling down into these specifics is a basic tenet of our loan review processes. The simple fact is that two loans or borrowers that initially appear to be similarly situated often have significant differences that will affect their ability to perform as structured.

To help assess the effectiveness of the October 2009 guidance, the federal banking agencies and Conference of State Bank Supervisors asked institutions to complete a CRE Questionnaire included in their pre-examination packages from May 31, 2010 through July 9, 2010. The agencies collectively received 370 responses, consisting of 325 institutions with total assets of less than \$1 billion and 45 institutions with total assets of \$1 billion or more. Approximately 97 percent of the survey respondents indicated that the guidance has been helpful, and nearly 88 percent indicated there were not any specific regulatory policies that were impeding their ability to work constructively with troubled CRE borrowers.

As previously noted, CRE concentrations, risk exposures, and problem loan workouts continue to be areas of emphasis in our current examination activities. We have conducted quality control testing in our banks to ensure that examiners are consistent in the risk rating of CRE loans and in the examination of banks with CRE concentrations. Key objectives of our CRE examinations are to ensure that bank management recognizes and addresses potential problems at the earliest stage possible—when workout efforts are likely to be most successful—and that previously identified deficiencies and shortcomings in risk management practices have been addressed. For example, last year we conducted a CRE horizontal review across 12 mid-size national

banks with significant CRE exposures. Our review focused on a wide range of CRE portfolio management issues, with a particular emphasis on stress testing, concentration management, and compliance with the October 2009 guidance on prudent CRE workouts.

As noted in the agencies' October 2009 guidance, prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. It has been our longstanding policy that examiners will not criticize prudent loan workout arrangements. Similarly, we have encouraged, and continue to encourage, bankers to extend credit to creditworthy borrowers. This does not mean, however, that examiners will allow bankers to ignore loans with structural weaknesses or insufficient cash flows to support repayment. While we encourage bankers to work with troubled borrowers, we also insist that banks maintain the integrity of their financial books and records by maintaining appropriate loan loss reserves and capital, and when warranted, taking appropriate charge-offs. Forestalling the recognition of problems in the hope that market conditions might improve is not an effective regulatory strategy, nor does it promote a return to more sustainable market conditions.

I want to stress that the OCC does not direct banks to classify borrowers that have the demonstrated ability to service their debts under reasonable payment schedules. There are instances, however, where liberal underwriting structures can mask credit weaknesses that jeopardize repayment of the loan. A common example in today's environment is bank-funded interest reserves on CRE projects where expected leases or sales have not occurred as projected, and property values have declined. In these cases, examiners will not just accept that the loan is of good quality because it is current; instead, they will also evaluate the borrower's ability to make future payments required by the terms of the loan. In making loan classification or write-down decisions,

examiners first focus on the adequacy of cash flow available to service the debt, including cash flow from the operation of the collateral, support from financially responsible guarantors, or other bona fide repayment sources. However, if these sources do not exist, and the only likely repayment source is sale of the collateral, then, consistent with generally accepted accounting principles (GAAP), examiners will direct the bank to write down the loan balances to the value of the collateral, less costs to sell.

In addition to our ongoing supervision of individual banks, in light of the significant number of bank failures that have occurred over the last 18 months – most of which had significant CRE concentrations — we also are assessing whether additional supervisory policies or guidance may be needed for examiners and bankers to more effectively deal with the risks that CRE concentrations can pose to the industry and the viability of individual financial institutions. Some of our efforts – such as working with accounting standard setters to develop a more forward looking loan loss model – would extend beyond CRE loans. But we are also evaluating the need to develop more clear and explicit expectations that as concentrations increase, so must the level and robustness of risk management systems, stress testing, capital planning, and capital levels. While this work is still in the very early stages, we believe it is one of the critical lessons learned from the recent financial crisis.

IV. Conclusion

In summary, while there are modest signs of improvement and stabilization, the CRE markets still face significant headwinds. Ultimately, stabilization of these markets will require restoring equilibrium between the underlying supply and demand factors within this market and will hinge on recovery in the overall economy. As we have seen, this process is not painless, and we expect CRE portfolios will continue to be a drag on

national banks' performance for at least the next 12 to 18 months. During this period of adjustment, the OCC will continue to take a balanced and measured approach in its supervision: encouraging bankers to make prudent loans and to work effectively with troubled borrowers, but to also maintain appropriate loan loss reserves and capital levels, and recognize losses.