

“Act Now to Address Emerging Risks”

Remarks

By

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Good morning, I'm Darrin Benhart, Deputy Comptroller for Credit and Market Risk for the Office of the Comptroller of the Currency. Thank you for inviting me here to speak to you today about a subject that is, in many ways, at the heart of the banking industry, risk management. More specifically, I want to discuss the OCC's views on some of the emerging risks facing national banks and savings institutions. At OCC, we not only monitor risk carefully, we also work to increase focus on potential risks before concerns become real problems.

For nearly 150 years, the OCC has overseen the safety and soundness of the national banking system. Last year, federal savings associations came under OCC's regulation, the result of the merger with the Office of Thrift Supervision[as authorized under the Dodd Frank Act]. Over the last year, we have integrated our staffs, completed initial work to rescind over 900 documents (contrary to popular belief we don't ALWAYS add to burden) and are diligently working to update and combine over 150 handbooks.

At OCC, I am one of the principal advisors on emerging systemic risks facing the banking system. I manage and set policies for the Commercial and Retail Credit Policy units in our Credit and Market Risk division. I also co-chair the OCC's National Risk Committee, which in July began publishing a Semi Annual Risk Perspective report that focuses on emerging risk in the industry. I will talk more about that report in a couple of minutes.

First, I'd like to touch briefly on the use of stress testing to help banks understand their key vulnerabilities and to identify emerging risk areas. Why is there such an emphasis on stress testing you may ask? Bankers and regulators have used the term for several years, but until recently it has been a somewhat ambiguous process with few if any action items as outcomes. The thought is that hypothetical scenarios will assist management, the board and regulators to better understand changes in the risk profile of an institution over time. I think those last words "over time" are often an aspect of stress testing that is overlooked. The real value in stress testing is looking at the trends in outcomes to understand how risk is changing; and then taking action based on that quantification of risk. At the OCC we are looking at lessons learned from the recent crisis and trying to determine ways that we could have better quantified the build-up of risks in the market place. For example, we saw that, in too many cases, concentrations in commercial real estate led to significant losses and failures of community banks. The vast majority of community bank failures over the past three years involved commercial real estate, and in most of these cases, that exposure was the primary reason for failure.

Construction and development loans were by far the worst performers in the crisis, and concentrations in C&D proved to be a reliable indicator of the likelihood of

failure for both national and state community banks. In March of 2007, nearly 2,000 of these banks held C&D loans that exceeded their capital. By September of last year, 13 percent of them had failed. Looking at excessive real estate lending through the lens of the agencies' 2006 real estate guidance reveals some stark differences. That guidance set thresholds of 100 percent of capital for construction lending and 300 percent of capital for total CRE. Where banks were in excess of those concentration thresholds, 23 percent failed. Where banks were within those thresholds, only about one-half of one percent failed.

Numbers like that are hard to ignore, so you are seeing increased emphasis on stress testing across the entire industry. The OCC and other regulatory agencies have issued guidance and rules about expectations for stress testing processes for institutions over \$10 billion as required by Dodd Frank. While many of the largest banks have conducted fairly comprehensive stress testing in the past, many mid-size and smaller institutions are working to establish or enhance stress testing processes. In response to questions from bankers and the lack of clarity in this area, the OCC just issued guidance tailored specifically for community banks and a stress testing tool for many community banks' largest asset class, income producing commercial real estate. This is all part of the OCC's ongoing commitment to provide technical assistance and practical solutions to the community bank sector of the industry.

Our guidance provides an example of a simple stress test framework to consider. This stress testing process should allow bank management to better support their risk appetite and tolerances, set concentration limits, adjust strategies, and appropriately plan for and maintain adequate capital levels. The guidance makes the point that stress tests

do not require sophisticated analysis or third-party consultative support. Effective methods can range from a single spreadsheet analysis to a more sophisticated model, depending on portfolio risk and the complexity of the bank.

Let me move on to how the OCC identifies emerging risks. We really emphasize a “bottoms up” approach. That means we initially rely heavily on our field examiners’ analysis and interaction with bankers through examinations and the many outreach meetings we conduct. We supplement that information with analysis on macro policy and economic issues conducted in our district offices and headquarters. At the OCC, we call this internal team the National Risk Committee. The group’s primary charter is to monitor the condition of the banking system and to advance our ability to see threats to the system’s safety and soundness. This group includes key members of our legal, policy, economics and supervisory areas.

Because many risks build up over time, bankers and supervisors need to remain vigilant to spot those potential emerging risks. Our Semiannual Risk Perspective report is our effort to be more transparent with the institutions we supervise and the industry as a whole on the risks we are seeing. That way bankers, analysts, and examiners all hear a consistent message. We issued our first perspective earlier this year, and soon we’ll issue a second one.

As an aside, the first time OCC released our Semiannual Risk Perspective, analysts, bankers and others asked if we’re also identifying opportunities. The report does acknowledge overall improvement in asset quality, earnings, liquidity and capital but the intent is to focus on emerging or potential threats to safety and soundness. I just want to provide you fair warning that the rest of my discussion does focus primarily on risk but

that doesn't mean we don't also understand the opportunities and the fact that many banks are positioned well to participate in an economic recovery.

What are the top emerging risks that the OCC sees? There are three broad areas of emerging risk that I will talk about today.

The first area of concern is broadly captured as strategic risk. More specifically our concern centers around how the potential search for higher profitability may lead to taking inappropriate levels of risk. We know that many banks face challenges in:

- Identifying prudent sources of alternative revenue to offset lost income,
- Prudently diversifying balance sheets and revenues, and
- Effectively managing the costs of compliance in light of increasing regulatory expectations.

This strategic risk is manifesting itself in a number of areas. The first area is underwriting. Underwriting standards remain under pressure as banks compete for limited, high-quality opportunities to expand lending, thus pushing more attention to traditionally higher-risk lending areas. Standards for leveraged loans, in particular, have continued to weaken over the past 18-to-24 months and yields on high risk assets are at record lows with risk continuing to rise toward an inflection point.

Underwriting for middle market commercial and industrial lending is showing signs of slippage as banks compete for lending opportunities in these markets. We also see banks entering new or less familiar product lines in an effort to increase revenue and diversify their balance sheets. Some of the most common products include indirect auto, mortgage operations and various commercial lending opportunities such as oil and gas

lending, asset based lending and even leverage lending at community banks. All of these new areas bring with them unique risks that institutions need to fully understand.

Against this backdrop, we are concerned that reserve releases have fueled much of the growth in bank earnings, a trend that is not sustainable over the long term. While we acknowledge that the ALLL will decrease as asset quality improves, there are still risks in the loan portfolio, especially in the residential mortgage and commercial real estate areas that warrant strong reserves.

A second area of concern revolves around the aftereffects of the housing-driven credit boom-bust cycle.

There are some positive signs in the housing market. At mid-year, data show stabilization in the housing sector with modest price increases in selected markets. The rates of new foreclosures and mortgage defaults have slowed. Construction permits are picking up and providing modest stimulus from a sector that has been hardest hit by the collapse of the housing bubble. While there has been progress in remediation of standards and practices in mortgage servicing, foreclosures and reputational cost will remain high for an extended period of time. Our last risk perspective highlighted a risk that many people hadn't focused on yet. That is the risk presented by home equity lines of credit, or HELOCs. The risk here is that as the end-of-draw periods are reached and payments step-up to meet amortization requirements, borrowers may not be able to make adequate payments at the new payment level. We are asking banks to assess this risk and address it in their allowance for loan and lease loss methodology. They should also establish renewal policies especially for loans where repayment capacity or collateral value area questionable.

A third area for banks and savings institutions to remain focused on is the revenue growth and earning challenges from a slowly growing economy and continued heightened financial market volatility.

Our country's economy continues to grow but at a slower rate than anticipated. In addition, the Eurozone crisis, slowing growth in emerging markets, and uncertainty regarding U.S.-fiscal policy including the resolution of the "Fiscal Cliff," all color the financial outlook. While domestic demand for loans has improved, particularly in the manufacturing led Midwest, further meaningful gains will depend on sustained economic growth.

Over the past four years, corporations and individuals have de-levered while most sovereigns have increased leverage. How these trends develop over the medium term will affect the pace of sustainable lending and revenue growth in the banking system, both here and abroad.

Low interest rates seem likely to stay with us for some time and will keep pressure on net interest margins, as older assets continue to mature or default and are replaced with lower yielding instruments.

The recent reduction in revenue from margin compression is exacerbated longer term by an increased vulnerability to interest rate shocks. Once stronger loan growth resumes, any increase in net interest margin may be limited by a rise in funding costs. The protracted and unprecedented period of near-zero short term interest rates may have altered historical rate and volume sensitivities on many deposit products . The impact of these changes will be difficult to gauge until these unusual influences abate.

A final area of focus for the OCC is ensuring that as banks respond to their revenue and cost challenges, they not shortchange the operational and compliance resources, systems, and controls needed to manage risks effectively. In fiscal year 2011 and 2012 the OCC issued enforcement actions at a much slower pace than the levels seen in 2009 and 2010. Nevertheless, compliance risk remains high, especially as banks strive to keep pace with new and emerging regulations. In addition, Bank Secrecy Act and Anti-Money Laundering risk remain a concern as the BSA programs at some banks are not evolving quickly enough in response to the increasing sophistication of criminals and their steadily changing methods to launder cash thru the financial system.

While these are some of the key risks facing the banking system, the nature and scope of risks will typically vary among banks. For example, many community and mid-sized banks are still dealing with some lingering asset quality issues while attempting to define and implementing a strategy that allows them to thrive amongst historically low margins, competitive pressures from larger banks, and evolving regulatory changes. Down the road, interest rate risk could be a concern for smaller banks that have increased their investment portfolios as loan demand slacked off. The bulk of that growth has come in the form of agency mortgage-backed securities, which again, could make them vulnerable to interest rate risk.

Meanwhile, larger banks face on-going concerns and challenges to profitability from legal, operations, and reputational costs stemming from prior residential mortgage underwriting and servicing deficiencies and other forms of high transaction volume or fee based products. Threats to information security at large institutions also present an

ongoing concern as criminals and other illicit actors challenge bank preventive controls and monitoring abilities.

One of our goals in issuing our Risk Perspectives report is to generate a discussion across the banking industry to include senior management and your bank's board of directors. You and your board must understand how the other views risk in your institutions. Your senior management and directors should be asking how emerging risk applies to your institution and identifying what areas may require further risk management emphasis or adjustments. The key is to address risks early, while they can be managed and mitigated and not wait until it's too far down the road.

I'm biased but I think one of the things we attempt to do best at the OCC is maintaining a strong working relationship with the banks we supervise. I would encourage national banks and savings associations to talk to our subject matter experts about emerging risks and how to prepare for them. OCC has about 2,600 examiners in the field as well as subject matter experts located on resident exam teams in large bank office and headquarters, who can advise on a range of issues including product offerings, legal issues, economic analysis and other services.

In conclusion, as the U.S. banking industry continues to emerge from recession, and make adjustments to the operating and regulatory environments, the OCC's National Risk Committee will continue its work to monitor, detect and inform the banking industry on our perspective of emerging risk as part of the OCC's mission to charter, regulate, and supervise national banks and federal savings institutions and ensure the safety and soundness of the national banking system. Thank you.

