Remarks by

Thomas J. Curry
Comptroller of the Currency

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Good morning, and thank you, Bill [Githens, RMA CEO and President]. It's a great pleasure to kick off your conference and support the important work RMA does in helping bankers recognize, understand, and manage risk. I'm sure it comes as no surprise to you that we at the Office of the Comptroller of the Currency regard risk management as among the most important activities a bank can undertake. In fact, risk-based supervision has long been an organizing principle in our approach to examining banks. More recently, however, we've taken a page from your book in our own approach to risk management throughout the organization. In fact, we've established an Office of Enterprise Risk Management and named a Chief Risk Officer to provide a check on how we're approaching our own work. I suspect that's not a common practice in government, but I'm a firm believer in practicing what we preach.

One reason conferences like this are so important for bankers is that risk is never static. It rises and falls with the cycles of the economy and changes in technology and the evolving operational environment. The risks that were front and center nearly four years ago when I became Comptroller are not necessarily the risks that preoccupy us today – nor should they be. Risk is a forward-looking concept that requires a certain amount of predictive skill about conditions and behaviors. If each of us had a crystal ball, that would be easy. But since we don't, it's essential that banks recruit the very best men and women in the industry to take on these responsibilities and that you take advantage of every opportunity to share the insights and techniques that can make you better practitioners.

Today, I'd like to focus on a category of risk that was muted in 2012, but rising in importance since then: credit risk. It was something we didn't need to discuss very much then, when banks were still in the post-financial crisis recovery mode and were exercising considerable caution in their lending. In fact, some wondered if banks were exercising too much caution and holding back economic recovery as a result.

I don't think that was ever the case. At that time, loan demand was relatively soft, reflecting weak business and consumer confidence and the businesses most anxious to borrow were probably the least creditworthy. Today, of course, our economy is stronger and unemployment is down. Interest rates are essentially where they were four years ago, which continues to spur spending, borrowing, and investment. Banks are generally profitable. They have seen steady growth in loan demand over the past 18 months, and many have worked with their regulators to resolve most of their compliance miseries, although often at substantial cost. Although compliance risk remains high, banks are adapting to the new regulatory requirements.

One of the best measures of the industry's condition is asset quality, and on that score, there's good news. Even bank supervisors like me, who are professional skeptics, have trouble finding fault in the numbers we've been seeing. In the fourth quarter of 2014, asset quality in OCC-supervised banks nearly matched the levels achieved when the economy peaked in the fourth quarter of 2006, right before the start of the financial crisis.

But the satisfactory condition of the banking system today raises an important question: where do we go from here? What will it take to ensure that banks remain solvent, stable, and secure in their role in the payments and credit system?

The new rules and regulatory structures that went into effect after the financial crisis were designed to prevent future meltdowns. But things needn't get to that point if we make the right decisions today, particularly in addressing the rise in credit risk we are seeing throughout the banking system.

Some might wonder how it's possible that a bank with very few credit quality problems could trigger credit risk concerns at the same time. The answer, of course, is that many asset quality metrics are lagging indicators of performance and reflective of the soundness of decisions made when loans were originated. It can be readily appreciated that the credit quality of loans issued when banks were more cautious about who they were lending to would be of higher quality than loans issued in times of greater optimism. Some of the loans we see banks making today are going to customers who almost certainly would not have qualified for the same loan four or five years ago.

But it's not only that their customers' financials have improved. Many banks have made a conscious decision to increase their risk appetite and take on additional credit risk. They are doing this in part because in times of economic growth banks feel confident that they can. But they are also targeting less creditworthy customers and offering easier terms and conditions because they feel that they must, in order to hold their own against the competition for loan growth, market share, and revenue.

In any case, credit risk is showing up in two of its classic forms: relaxed credit underwriting and increased loan concentrations.

Of course, it's possible for lenders with growing concentrations and easing underwriting standards to do quite well for quite a while time during an extended period of economic growth. But there comes a point when these trends cannot be sustained, and eventually a day of reckoning arrives.

Since 2012, OCC examiners have been reporting on the relaxation of underwriting standards in the banks they supervise. This is taking many forms. Margins are thinner, protective covenants are weaker or non-existent and loan maturities are longer. In addition, banks are increasing their participation in riskier products, such as leveraged lending. The pattern I'm describing is common during the later stages of the economic cycle, which happens to be where we are today. But it also signals a rise in credit risk that bank risk officers must be aware of.

Banks always face a risk that rising interest rates or deterioration in one or more sectors of the economy could impair loan performance even in well-managed portfolios. The energy industry, for example, has been buffeted by the steep decline in oil and gas prices, leading producers to curtail exploration and production and reduce general operating expenses and personnel costs. Producers are also working with lenders to restructure their debt. Losses in energy-related loans have been moderate so far, although we are likely to see some increases in the months ahead. This is especially true if oil and gas prices remain at their current depressed levels.

Challenges in the energy sector speak more generally to the risk associated with loan concentrations. While some banks have concentrations of energy-related loans, others have increasing concentrations in commercial real estate, construction, multifamily housing, and loans to non-depository financial institutions. At present, these concentrations flash yellow lights rather than red ones, and, as I've noted, credit quality has not suffered significantly as a result. Our job as supervisors is to ensure that things stay that way.

What I would hope to see happens is for banks to take the initiative to address concentration risk on their own, without supervisory action. That's why we have provided tools, such as the interagency guidance that we issued in December 2006. It describes key elements for managing the concentration risk posed by concentrations in CRE and other assets. Relevant guidance on related issues like stress testing to identify and quantify risk in loan portfolios and creating effective capital planning processes is also available.

Finally, I would suggest that risk managers at every bank should be taking a hard look at the loan loss allowance, and asking if it's appropriate for the level of risk their institution is taking on. We've been through a long period in which banks have been steadily reducing reserves. Just over the last two years, the key ratio of the loan loss allowance to total loans dipped by more than 40 percent. Although banks have argued, with some justice – and please note the qualification – that improvements in loan quality justified those reserve releases, drawdowns of that magnitude are clearly disproportionate.

That's because the environment is changing significantly. We're seeing loan growth in all asset categories, greater risk acceptance, weaker underwriting, and growing asset concentrations. Growth rates in commercial real estate, for example, are above 14 percent year-over-year for OCC-supervised community and midsize banks, which are the banks that have the highest commercial real estate concentrations. Loans for multifamily housing also represent a growing concentration for many banks, a segment that could see deterioration as interest rates rise and refinance risks increase. It's crucial that these and other concentration are soundly managed, supported by adequate capital, and properly reserved for.

It's clear to me that these reserves need to rise to account for the increasing credit risk we are seeing in the system. But how much of an increase is necessary? I'm not going to get into the weeds today on the methodology for loan-loss provisioning or the accounting changes that are in store. It's important to point out, however, that even the incurred loss model that we currently use doesn't limit banks to the previous three years of historical experience in calculating the allowance. We do expect banks to bring qualitative judgment to bear upon that analysis, using the so-called "Q" factors to adjust historical experience. In our 2006 policy statement on the loan loss allowance, the banking agencies identified nine separate qualitative factors that can be used to adjust historical experience to current reality. Several are particularly relevant in the current environment, including changes in underwriting, changes in loan growth and credit concentration.

I know that the Q factors are challenging to apply, and they require supporting analysis. If the analysis isn't supported by appropriate documentation you are likely to get some pushback from your external auditors. But if you simply apply historical analysis without taking account of the very real changes we are seeing today, you will almost certainly get some pushback from your examiners.

We do recognize that you face some cross currents in setting the allowance, and we at the OCC are doing everything we can to help you navigate these currents. In addition to the accounting updates we provide, we are putting a lot of time and energy into outreach. Our chief accountant and his team are talking to bankers, auditors, accountants, and staff at the Public Company Accounting Oversight Board, and we are stressing the importance of the qualitative factors. At the end of the day, what we would expect, at minimum, is directional consistency: when credit risk rises, so should the allowance.

So let me conclude by answering the question I raised at the outset. We can ensure a safe and sound banking system and avoid crises if we take sensible and tough-minded steps now to address the emerging risks I've discussed today.

The future, as they say, is in our hands.

Thank you.