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TESTIMONY OF

JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON FINANCIAL SERVICES

and the

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

February 26, 2010

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 Frank, Ranking Member Bachus, Chairwoman Velázquez, Ranking Member Graves, and members of the Financial Services and Small Business Committees, I appreciate this opportunity to discuss national banks' lending activities and the OCC's actions to provide a supervisory climate that facilitates sound loans to businesses and consumers. The OCC supervises 1,462 insured national banks, which comprise about 18 percent of the 8,012 insured depository institutions (IDIs) in the United States, holding approximately 63 percent of all IDI assets. In terms of size, national banks constitute 12 of the 19 banks with assets over $100 billion, including the six largest banks in the United States; 35 percent of mid-size banks, with assets ranging from $5 billion to $100 billion; and 18 percent of community banks, with assets less than $5 billion.[1]

Access to credit is critical to the health of our nation's economy, and national banks play a vital role in meeting this need. While there are signs of a recovering economy, there continue to be significant strains that are affecting both the demand for credit and its supply. Many businesses and consumers have become more cautious, reducing their demand for and use of credit. Likewise, many bankers have become more conservative in how they evaluate potential borrowers and structure loan products. Despite these factors, lending remains a core business of national banks, and from my discussions with bankers, I believe they remain committed to meeting the credit needs of their customers.

The first part of my testimony addresses patterns and trends in bank lending, where there has been a general reduction in the total amount of loans by banks of all sizes. The second part discusses the demand and supply factors contributing to this result, that is, the reduced demand for credit by creditworthy borrowers resulting from the recession, and the

[1] Figures are based on 12/31/2009 data and include all FDIC-insured institutions, but do not include federally insured credit unions.

reduced supply of credit resulting from tightened underwriting standards. The final part addresses the role that regulators are playing and should play in facilitating credit availability, specifically including credit to small businesses.

Ensuring that national banks meet the credit needs of their communities and customers in a safe and sound manner is central to the mission of the OCC. It requires us to take a balanced and consistent supervisory approach, especially in this environment, to ensure that our actions do not discourage national banks from making loans to creditworthy borrowers. Many have questioned whether the regulatory pendulum has swung too far, to the point where regulators and examiners are impeding banks' ability to make even prudent loans. We take this matter very seriously, and as a result, have taken and continue to take a number of steps to ensure that OCC examiners are applying supervisory policies in a balanced and consistent manner across the country. We also have worked with the other banking regulators to reinforce our policies and expectations to both the industry and examiners regarding sound lending.

Our messages to bankers have been, and continue to be, the following:

- Make new loans to creditworthy borrowers, using prudent underwriting standards;
- Work constructively with borrowers who are facing difficulties; and
- Realistically recognize and address problem credits by maintaining appropriate reserves and taking appropriate charge-offs when repayment is unlikely. Recognizing and classifying a problem credit does not mean that a banker can no longer work with, or extend credit to, the borrower. We expect bankers to work with troubled borrowers.

Our direction to examiners and the policies they apply has remained consistent. We instruct our examiners not to dictate loan terms, and not to instruct bankers to call or renegotiate loans. Rather, the examiner's role is to determine that banks:

- Make loans on prudent terms, based on sound analysis of a borrower's financial and collateral information and ability to repay;

- Recognize weaknesses in existing credits and work with those borrowers to develop reasonable workout plans wherever possible;
- Have adequate risk management systems to identify and control risk taking;
- Maintain sufficient reserves and capital to buffer and absorb actual and potential losses; and
- Accurately reflect the condition of their loan portfolios in their financial statements.

We focus greatest attention on sectors that have been particularly hard hit by the economic crisis. Given the concerns expressed about how examiners were assessing troubled commercial real estate loans, we and the other banking regulators issued guidance last October to provide greater clarity and certainty to the industry and examiners on our policies and expectations for commercial real estate (CRE) loan workouts.[2] We believe this guidance, with the real world examples it contains, has been useful in providing greater consistency in how examiners apply key supervisory principles.

More recently, on February 5, we and the other agencies issued a statement on lending to creditworthy small businesses. This statement addresses the important role of small businesses in the economy, their dependence on banks for credit, and the recent difficulty experienced by some small businesses in obtaining new credit or renewing existing credit.[3] As with our recent CRE guidance, this statement is intended to facilitate small business lending and provide bankers with more regulatory certainty by outlining our expectations for prudent underwriting practices. In both statements we reiterate our policies that examiners should take a balanced approach in assessing banks' underwriting and risk-management practices and should not criticize banks that follow sound lending practices.

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[2] *See*: "Policy Statement on Commercial Real Estate Loan Workouts," at: http://www.occ.treas.gov/ftp/release/2009-128a.pdf.
[3] *See*: "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers" at http://www.occ.treas.gov/ftp/release/2010-14a.pdf.

Finally, we continue to work with the Administration, Congress, and the industry on programs that can provide additional assistance to the hardest hit sectors. We support the Administration's various small business lending initiatives. We have a number of resources for bankers to help them understand and more fully use the various programs offered by the Small Business Administration (SBA). We continue to be actively involved with the Administration's mortgage modification programs to assist troubled homeowners, and the information we collect through our Mortgage Metrics program helps assess the success of these efforts and determine where further adjustments may be needed.

As we discuss credit availability and the critical need for a balanced supervisory approach, I think it is very important to keep in mind the limits on what banking regulators can and should do. While we should be very careful not to encourage the banks we supervise to become excessively conservative, we simply cannot turn a blind eye to increasing losses and mounting credit problems. Last year, 140 banks failed, 25 of which were national banks, the most since the record numbers of failures in the late 1980s and early 1990s. Thus far in 2010, 20 banks have failed, three of which were national banks. Estimated losses to the deposit insurance fund since the start of the crisis two years ago are over $57 billion and growing, with nearly $7.5 billion coming from failed national banks. The FDIC's problem bank list has swelled to 706 as of December 31, 2009, and we are likely to have even more failures in 2010 than we did last year.

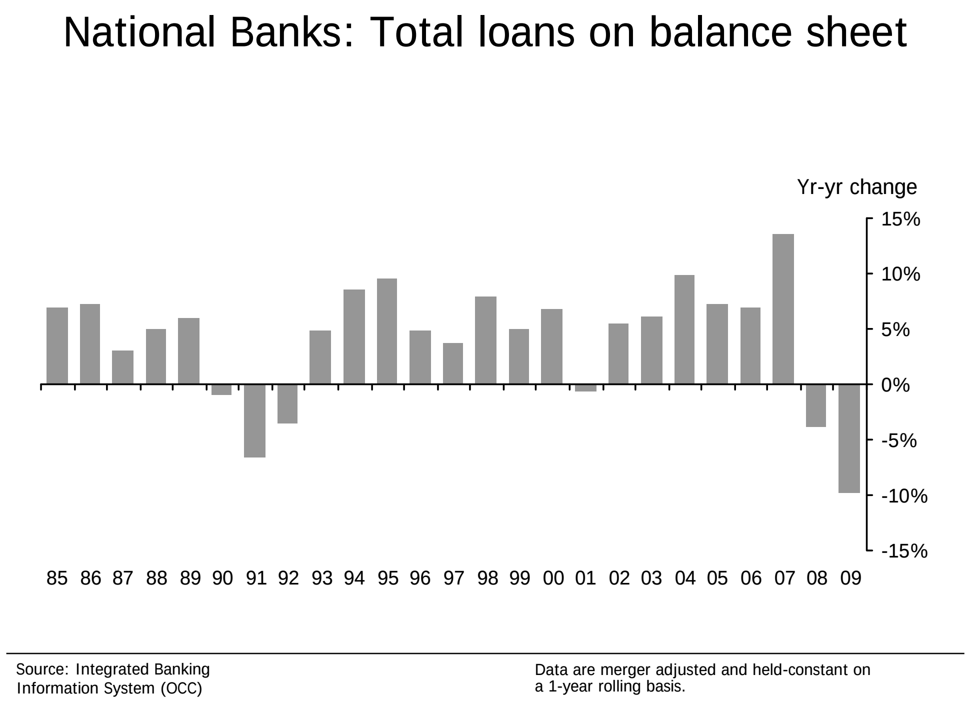
In this environment, some have talked about the need for regulatory "forbearance," where supervisors allow troubled banks to ignore credit problems in the hope they will go away over time. Unfortunately, we know from the painful experience of the savings and loan crisis of the 1980s that regulatory forbearance can and has made problems far worse, causing the deposit insurance fund and the taxpayer to sustain tens of billions of dollars more in losses than would have resulted from prompt regulatory action. That experience caused Congress to enact the Prompt Corrective Action regulatory regime in the Federal Deposit Insurance Corporation Improvement Act of 1991, or "FDICIA." This statutory regime expressly rejected regulatory forbearance, and reinforced to supervisors how important it is for institutions to realistically recognize losses and take the necessary steps to repair themselves to avoid further problems – and ultimately be in a better position to make loans to creditworthy borrowers.

In short, the right supervisory approach to promote sound credit availability is, by all means, to avoid excessive conservatism. But it is also to avoid the kind of forbearance and tolerance for loss deferral that can lead to bigger future losses, more severely troubled banks, even more constrained lending, and increased bank failures.

II. Trends in National Bank Lending

After two years of extreme economic stress and financial disruption, there has been a notable decline in the level of loans outstanding within the commercial banking sector. This decline has occurred at banks of all sizes, both for national and state-chartered banks. While such declines are common in recessions, this recession has been much more severe than the typical downturn. The resulting slowdown in bank lending has been especially pronounced, including for national banks, as measured by the annual percentage change in loans outstanding shown in Chart 1. This decline is particularly striking because it followed a decade of sustained credit expansion – including the largest increase in 25 years during 2007 – an expansion that financed economic growth, but also reflected increasing use of leverage by businesses and consumers.

Chart 1



Drilling down to specific loan categories reveals some variety in the timing and scale of reductions in outstanding loans by category (see Table 1). In 2008, the decline was led by a reduction in residential mortgage loans, concentrated in the largest banks, which were the predominant on-balance sheet lenders for such loans (although the overwhelming majority of first mortgage loans are held by third parties as the result of securitizations by both government-sponsored enterprises and private financial institutions). This decline continued at a substantial, if somewhat slower pace, during 2009. Construction loan balances at national banks also fell during 2008, by $6.3 billion, and the decline accelerated to $45 billion in 2009. Other major loan categories, including commercial and industrial (C&I) loans, commercial mortgages, and consumer loans – home equity, auto, and credit cards – increased in 2007 and 2008 before declining in 2009, with a particularly notable $223 billion decline in C&I lending. Commercial mortgage loans (including loans for multifamily housing) actually continued expanding on a year-over-year basis through September 2009, but then fell off sharply in the final quarter of the year.[4]

Table 1

National Banks
Yr-Yr Change in Loans Held on Balance Sheet, $ Billions

	2007	2008	2009
Commercial and industrial	171.5	5.9	-223.0
Commercial mortgage*	29.5	12.1	-7.3
Construction	24.4	-6.3	-45.3
Residential mortgage	91.2	-183.7	-100.8
Consumer	74.5	22.8	-48.9
All other loans	65.9	-47.0	-32.9
TOTAL	457.0	-196.1	-458.4

*includes multifamily and nonresidential property

Data are for FDIC-insured national banks. Historical data for growth calculations include non-national bank loan balances acquired by national banks via mergers.

National banks are significant providers of small business credit, but discerning trends in small business lending is more difficult due to the variety of lending facilities that small business owners use for financing. One proxy for a portion of small business lending is the data collected every June – soon to be collected every quarter – on commercial loans of less than $1 million, which tend to be to smaller businesses. The June 2009 data showed national banks providing $292 billion dollars of credit in this form, including C&I loans, agriculture loans, and commercial mortgages (see Table 2). Agricultural loans were only three percent of this total, with the remainder about evenly split between commercial mortgages and C&I loans. Larger national banks, those with assets over $1 billion, accounted for eight out of

[4] These loan growth figures and those in Table 1 reflect the following methodology: Loan balances that were originally on the balance sheets of non-national banks (thrifts, state banks, investment banks, etc.) that converted, merged, or were acquired by national banks, are added to historically reported national bank loan balances to achieve a true measure of loan growth without the confounding influences of charter changes. This merger-adjustment process does not adjust for the transfer of loan balances that occur outside of charter acquisitions or conversions.

every ten dollars of small commercial loan volume provided by national banks. Based on the most recent data, smaller national banks showed a modest year-to-year increase in total small denomination commercial loans, whereas these loans declined about five percent at the larger banks. The modest gain at smaller national banks was entirely due to growth in commercial mortgages. Small C&I loans declined at both small and large national banks – a trend that mirrored commercial banks as a whole.

Table 2

National Banks
Small Denomination Commercial Loans

	June 2009, $ billions			Yr/Yr change		
	Commercial Mortgage	C&I	TOTAL*	Commercial Mortgage	C&I	TOTAL*
Banks with assets under $1 billion	28.7	18.4	52.8	3.2%	-4.0%	0.2%
Banks with assets $1 to $50 billion	28.5	28.5	58.4	-0.2%	-10.3%	-5.5%
Banks with assets over $50 billion	79.2	98.9	180.4	-3.7%	-5.8%	-4.7%
TOTAL	**136.4**	**145.8**	**291.7**	**-1.6%**	**-6.5%**	**-4.0%**

* Total includes agriculture loans under $500k   C&I = commercial and industrial loans

Source: June Call Reports, Sched. RC-C. Data are merger-adjusted and for banks in continuous operation from June 2008 to June 2009.

Of course, the category of "commercial loans of less than $1 million" reflects only a portion of the overall small business credit provided by banks, as many small business owners have relied on credit cards and their personal home equity lines of credit as primary sources of credit financing. The use of such loans for small business lending is not currently captured by the Call Report, but as shown in Table 1, there has been a reduction in consumer loans in the aggregate. More granular data that we obtain through our on-site supervisory activities suggests some of this decline in consumer loans is attributable to a decline in small business credit use.[5]

Several important qualifications apply to using a decline in outstanding loan balances at banks as the direct equivalent of a decline in the amount of credit made available by those banks. First, because this is a point in time measure, changes in outstanding balances do not fully reflect the volume of loans being originated, since some loans are being paid down through normal reductions in loan principal.[6]

Second, part of the decline in reported outstanding loan balances results from the amount of troubled loans that banks charge off. Such actions, which are necessary when repayment becomes unlikely, have nothing do with the amount of new credit being made available to creditworthy borrowers. As shown in Chart 2, net charge-off rates have exceeded recent peak levels for nearly all major loan categories at national banks, and the total net charge-off rate for commercial banks is on track to be the third highest annual rate on record.

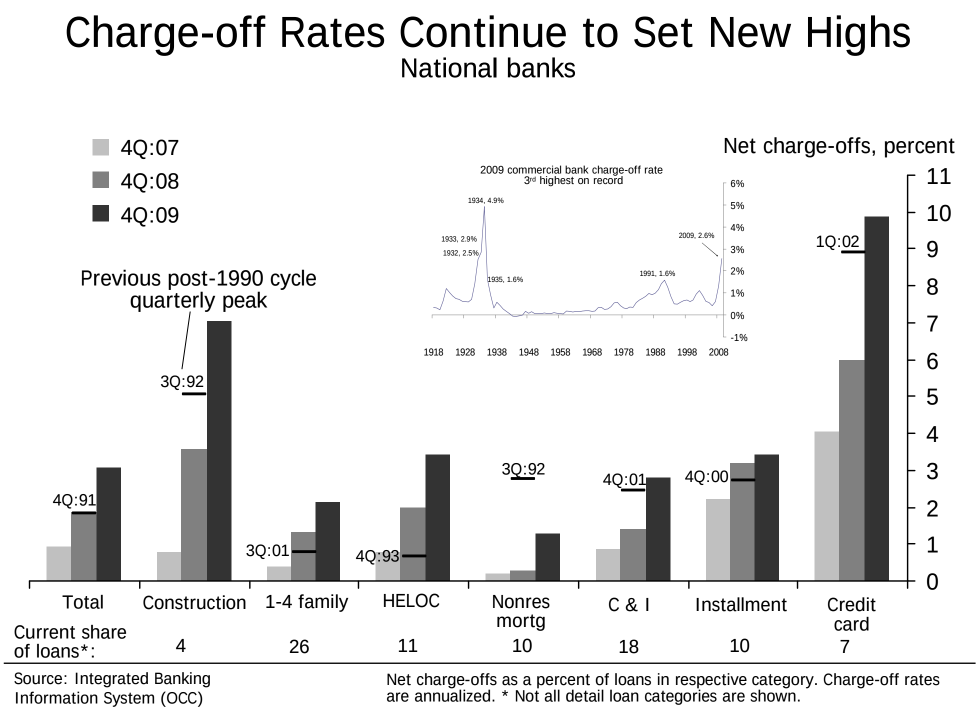
When banks charge off loans, the loans are no longer reported on their balance sheets, even though the loans have not been extinguished. During 2009, national banks charged off $126 billion in loans, an amount equivalent to 27 percent of the total decline in outstanding loans for the year. For certain types of credit, the impact has likely been greater; for example, the $49 billion decline in non-mortgage consumer loans during 2009 includes the impact of $45 billion in charge-offs. We believe that charge-offs to address asset quality problems are a painful, but critical, step in restoring the health of banks' balance sheets and their capacity to

[5] The largest TARP recipients are required to submit monthly data to the U.S. Treasury on their lending activity. The February 2010 report for the 11 large institutions that as of June 2009 had not repaid their TARP funds showed that the total loan balances for small business loans declined by $9 billion from July to December 2009 (from $178 billion to $169 billion). *See*: "Monthly Lending and Intermediation Snapshot," February 16, 2010.

[6] For example, although the monthly TARP data reported to Treasury show a decline in small business loan balances of $9 billion from July to December 2009, the data also show $34 billion in small business loan originations during that period at those same firms. *See*: "Monthly Lending and Intermediation Snapshot," February 16, 2010.

lend – but they do not result in an actual decline in borrowers' credit obligations to banks, even though they are reported that way, and they are not really relevant to whether banks are extending new loans to creditworthy borrowers.

Chart 2



Finally, the level of outstanding loans on banks' balance sheets understates the amount of credit that banks have made available to borrowers as it does not capture the amount of unused credit lines. These credit lines reflect commitments of credit that banks have extended to customers, allowing them to decide exactly when and how much to borrow by drawing down the line. While it is true that many banks have reduced unused credit lines, the level of unused credit lines at national banks remains substantial, totaling $4.4 trillion at year-end 2009. The level of untapped lines of credit means that many retail and commercial borrowers have access to additional credit beyond the reported amount of loans outstanding. Unused credit card lines and home equity lines of credit at national banks totaled $2.5 trillion and

$376 billion, respectively, at the end of 2009. Likewise, national banks had $1.5 trillion in unused commitments for loans other than credit cards and home equity lines, an amount that far exceeds the $781 billion in total C&I loans outstanding.

III. Demand and Supply Factors Affecting Bank Lending

As previously mentioned, credit availability is affected by both demand factors – the extent to which borrowers seek new credit – and supply factors – the extent to which lenders are willing and able to supply that credit. As discussed below, the recent decline in bank lending reflects a significant decline in both credit demand and credit supply.

A. Demand Factors

A variety of measures and reports indicate that, as a result of the sharp decline in underlying economic conditions, the demand for credit by both businesses and consumers has correspondingly declined. While it is difficult to apportion with certainty the extent to which a particular factor has caused a decline in credit availability, most bankers point to slack demand as the single most important factor. For example, although respondents in the Federal Reserve's most recent Senior Loan Officer Survey reported some improvement in loan demand, many of the demand measures remain very weak. For commercial loans, 34 percent of the banks reported weaker loan demand, while only nine percent reported stronger demand. On the consumer side, weakness was even more pronounced; for example, nearly half of the banks reported weaker demand for home equity lines of credit, with only seven percent reporting stronger HELOC demand from consumers.[7]

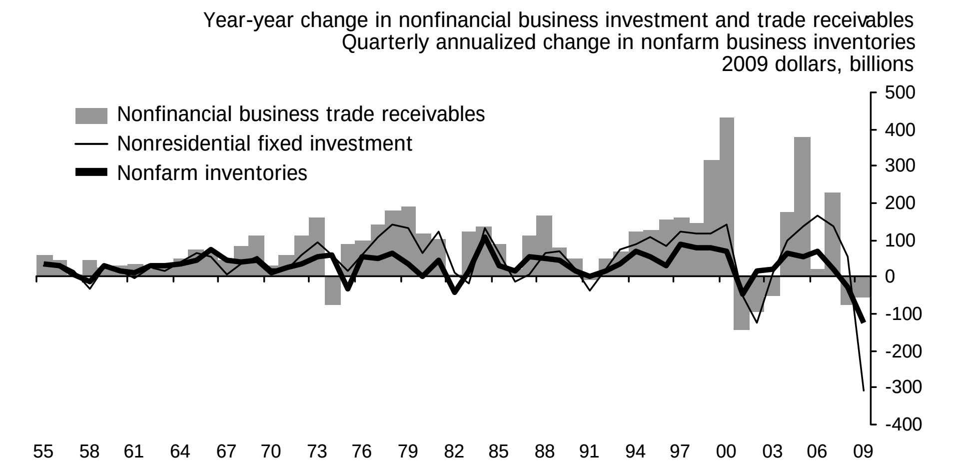
Many businesses have cut back on activities that are typically funded by bank loans, such as inventory investment and capital expenditures on plant and equipment, and have less need to fund accounts receivable due to the weak pace of sales. As shown in Chart 3, the

[7] *See*: The Federal Reserve Board, "The January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices," at: http://www.federalreserve.gov/boarddocs/snloansurvey/201002/fullreport.pdf.

recent reductions in fixed investment and inventories is unprecedented over the past 55 years of historical data, while the decline in accounts receivable by U.S. nonfinancial companies also has been quite pronounced.

Chart 3

Business Pullback in C&I Funded Activities is Unprecedented in Past 55 Years



Sources: Federal Reserve, Bureau of Economic Analysis

Data are inflation adjusted using GDP deflator. 2009 observation for trade receivables is YTD average through 3Q.

These three activities are the predominant drivers of commercial loan demand, and help to explain the abrupt decline in C&I lending by national banks during 2009. In addition, many larger companies have taken steps to strengthen their own balance sheets and lock in low funding costs by replacing short-term bank borrowings with longer-term corporate bonds, thereby tending to further reduce the overall demand for traditional bank loans.

Similar factors are evident in commercial real estate lending, as major segments of the income producing commercial real estate sector have experienced rising vacancy rates, falling rental rates, and weak sales. Likewise, demand for residential construction loans has weakened substantially due to the considerable overhang of housing supply.

Weak sales and uncertainty about the economy are also factors affecting small business lending. Reports issued by the National Federation of Independent Business Research Foundation (NFIB) over the past two years have consistently indicated that underlying business conditions, rather than access to credit, is the primary problem facing many small business owners. For example, the percentage of respondents that have reported "finance" as their number one business problem has held remarkably steady over the past two years, at only two to six percent.[8] In its most recent report, released this week, the NFIB reported that only five percent of small business owners reported financing as their top business problem, whereas 31 percent cited poor sales. This is in contrast to pre-1983 when as many as 37 percent cited financing and interest rates as their top problem. The report further states "[H]istorically weak plans to make capital expenditures, to add to inventory and expand operations also make it clear that many potentially good borrowers are simply on the sidelines," and that while 11 percent of owners reported that their borrowing needs were not satisfied (up three percent from December), the remaining 89 percent "either obtained the credit they wanted or were not interested in borrowing."[9]

Similarly, more cautious consumers are contributing both to the lack of loan demand by commercial borrowers and to the slowdown in overall consumer loans. Households are saving more and spending less (see Chart 4), and many have taken steps to reduce their use of debt. High unemployment and the general uncertainty about the economy have also taken a toll, as reduced spending has led to lower levels of revolving credit use (see Chart 5), both for borrowers who pay off their balances in full every month, as well as for those who regularly carry a balance.

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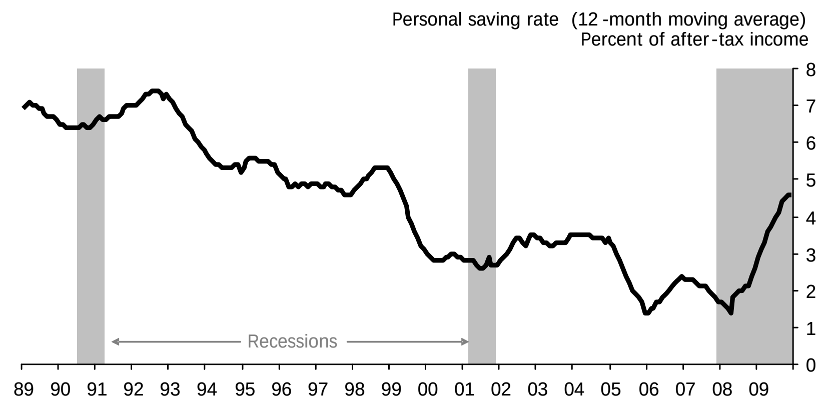
[8] See for example, NFIB Small Business Economic Trends *Monthly Report*, February 2010, pages 2 and 18.
[9] NFIB Small Business Economic Trends, *Monthly Report*, February 2010, page 2.

All of these indicators of loan demand gibe with what we hear consistently from bankers: demand from creditworthy borrowers continues to be weak. As previously noted, these reports mirror the findings of the Federal Reserve Board's latest Senior Loan Officer Survey. Indeed, in response to a survey question about the number of inquiries from potential business borrowers for new credit or increases in existing credit lines, only 12.7 percent of the banks reported seeing any increase, with roughly twice that many reporting a moderate or substantial decline in the number of inquiries from potential borrowers.[10]

Chart 4

Consumers' Increased Saving Means Less Spending and Use of Consumer Debt

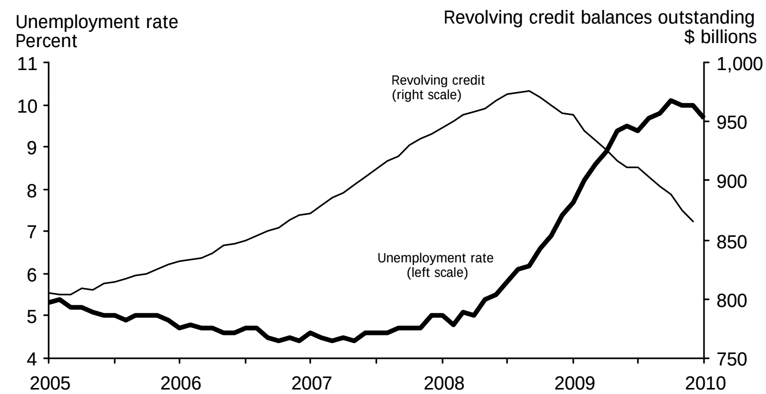


Source: Bureau of Economic Analysis, data through December 2009

[10] *See*: The Federal Reserve Board, "The January 2010 Senior Loan Officer Opinion Survey."

Chart 5

Weak Labor Market Weighing on Personal Spending and Revolving Credit Use



Sources: Federal Reserve (G.19), Bureau of Labor Statistics

Revolving credit data through Dec 2009; unemployment data through Jan 2010

B. Supply Factors

Reduced loan demand has not been the only contributor to reduced bank lending, however. Banks have also reduced the supply of credit through tightened underwriting standards.

In response to deteriorating credit and economic conditions, many bankers have become more risk averse and selective in their lending. Many borrowers that may have been able to make debt payments when the economy was expanding now face constrained income, cash flow, and debt service capacity that limits their ability to take on additional debt and, in some cases, to meet existing debt obligations (see Chart 2). Faced with a riskier pool of current and potential borrowers, some bankers have elected to reduce their risk exposures. They have also taken steps to reduce excessive concentrations that built up during boom conditions, particularly with respect to commercial real estate. As reflected in the OCC's annual underwriting surveys of national bank examiners and the Federal Reserve Board's quarterly senior loan officer surveys, both national banks and commercial banks more generally have tightened their underwriting standards over the past two years.[11] Our 2010 survey is underway, but we expect that we will see similar trends to those found in the Federal Reserve's most recent Senior Loan Officer Survey, *i.e.*, that for many, but not all, types of loans, much of the adjustment in underwriting standards has been made.

As would be expected, evidence shows that the more stringent underwriting standards are having an adverse effect on small businesses' ability to access bank credit. For example, the previously mentioned NFIB surveys indicate that some regular borrowers (those accessing capital markets at least once a quarter) continue to report difficulties in arranging credit, with a net 14 percent (down one point from December) reporting that loans are harder to get than in their last attempt.[12] The NFIB reports that while this is the highest frequency since 1983, "this is not nearly as severe as the financial distress reported in the pre-1983 period."[13] Part of this difficulty may stem from the increased risk in some small business credits. According to the Federal Reserve's most recent Senior Loan Officer Survey, nearly 65 percent of surveyed domestic banks indicated that at the end of the fourth quarter of 2009, the delinquency rate on their outstanding loans to small firms was higher than the rate on outstanding loans to large and middle market firms.[14]

With the significant increase in non-performing and delinquent loans, many bankers have shifted substantial resources from loan generation to working with troubled borrowers. In addition, banks struggling with serious asset quality issues are less likely to have the

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[11] See for example, OCC's Survey of Credit Underwriting Practices, 2007 and 2008, available at: http://www.occ.gov/cusurvey/2008UnderwritingSurvey.pdf and http://www.occ.gov/cusurvey/2009UnderwritingSurvey.pdf.
[12] NFIB, February, 2010, page 2.
[13] NFIB, January 2010, page 2.
[14] Federal Reserve Board, January 2010 Senior Loan Officer Opinion Survey, page 9.

capacity to be strong lenders. In fact, among national banks with less than $10 billion in assets, those with a lower percentage of noncurrent loans[15] – specifically, the 937 with a noncurrent loan ratio below three percent of total loans at the end of 2009 – actually *expanded* their lending as a group during the year. In contrast, total loans at the 406 national banks with higher noncurrent loans ratios fell by 10 percent during 2009.[16]

In general, we believe banks' stronger underwriting standards reflect a return to more prudent practices. But these changes have affected the ability of some borrowers to obtain credit. In many cases, riskier borrowers will be required to have higher down payments for home mortgages, have more cash equity in a project, provide additional collateral, or face additional loan covenants. Rather than cut off credit to commercial borrowers who are facing strains, some national banks are expanding their asset-backed lending programs. These programs allow companies to use their inventories and accounts receivable as collateral to obtain credit, although at higher rates of interest. Because this type of lending entails more risk, it tends to be very resource intensive and requires strong internal controls and frequent contact with borrowers.

While much of the tightened underwriting that banks have engaged in to respond to recent market developments and asset quality problems is appropriate and to be expected, it is also very possible that in some cases they have overreacted. With the uncertainties banks have faced in the severe downturn and stressed financial markets, some may have become too conservative and denied credit to truly creditworthy borrowers. And some may also have tightened too much in response to supervisory actions that they perceive to be inappropriate – a serious concern addressed in the next section of the testimony.

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[15] Noncurrent loans are loans that are 90 days or more due or are on nonaccrual.
[16] These figures are based on a set of national banks with assets under $10 billion, excluding trust and credit card banks, that is "held-constant" to adjust for the effects of entry, exit, and mergers and excludes banks in operation less than three years.

The natural counterweight to excessive conservatism is that bankers have a strong self-interest in making loans, because lending is the core of the commercial banking business and the main source of income for most banks. Over the past 25 years, loan income has accounted for about 60 percent of gross revenue at national banks; this share is even higher for smaller banks that do not generate significant non-interest income.[17] If banks don't make loans, they forego their primary source of profitability. And indeed, most national banks are extending credit and making new loans, just not at the pace or level that preceded the economic downturn.[18]

Bankers also recognize an obligation to meet the credit needs of their communities and customers. In this regard, a number of the largest national banks have recently made public commitments to increase their lending to small- and medium-size businesses. This includes a pledge to increase lending by $5 billion by Bank of America, and by up to $4 billion by JPMorgan Chase. Similarly, Wells Fargo has indicated that it will increase its new loan originations to small business by 25 percent.

In summary, we have been in a phase of the credit cycle where many businesses, consumers, and lenders took steps to repair their balance sheets, reduce their leverage, and rein in excesses that built up during the last credit cycle. Restoration of bank lending to more normal levels will require adjustments to a variety of supply and demand factors and ultimately hinges on improvements to the underlying economy and renewed confidence by businesses, consumers, and bankers. In some sectors, most notably C&I lending, such a

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[17] Although capital markets activities are an important source of revenue for a few of the very largest national banks, trading and investment banking fees have accounted for less than five percent of gross revenue for the national banking system since 2000.

[18] For example, the February 2010 Monthly Lending and Intermediation Snapshot report for the 11 largest TARP recipients indicates that total monthly loan originations by these institutions was 17 percent higher in December 2009 than had been the case one year earlier. During this twelve-month period, loan originations and loan renewals by the largest national banking organizations included in the report (Bank of America, Citigroup, PNC Financial Services Group, Key Corp, and Wells Fargo) totaled $1.9 trillion. This data is not merger adjusted. *See*: "Monthly Lending and Intermediation Snapshot," February 16, 2010.

rebound could occur relatively quickly as firms start to replenish their inventories. For other sectors, most notably construction and commercial real estate, the recovery will likely be more prolonged, and may not occur until lease rates and cash flows stabilize.

IV. Role of Regulators in Fostering Credit Availability

One of our primary goals as a bank supervisor is to ensure that national banks will have the balance sheet capacity and financial strength to meet renewed increases in loan demand. Over the past two years, we have directed national banks to strengthen their capital and loan loss reserves, to recognize and deal with their asset quality problems at an early stage, and to address risk management and underwriting weaknesses. A key objective of our directives is to provide a strong foundation within the national banking system to support renewed economic growth. Net capital levels in the national banking system have increased by roughly $141 billion over the last two years, and net increases to loan loss reserves have exceeded $97 billion. While additional reserves may still be needed by some banks as they work through their asset quality problems, we believe the increases in capital and reserves that have occurred have greatly strengthened the capacity of the national banking system.

Some have questioned whether our actions have become a further impediment to banks' ability or willingness to lend. We are acutely aware that our actions – both on the policy side in Washington and in the field through our on-site examinations – can and do influence banks' behavior and their appetite for taking risk. We also have heard complaints that overzealous regulators and examiners are exacerbating the contraction of credit. Given these concerns, I want to more fully explain our approach to supervision; steps we have taken to ensure we maintain a fair and balanced approach; and mechanisms we have in place when a banker may disagree with our examination findings. I then will explain in some detail the role of examiners in evaluating credit and, finally, actions that we are taking to facilitate and encourage small business lending.

A. OCC's Approach to Balanced Supervision

One of the lessons we learned from the early 1990s was the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. We also learned that it is critical that our expectations for bankers be clear and consistent, that the "rules of the game" under which banks operate not be changed abruptly, and that changes in regulatory policies are made in an open and transparent manner that provide bankers with reasonable timeframes to make necessary adjustments.

Throughout this credit cycle, we have strived to take a balanced and measured approach in our supervision, alerting banks as early as September 2003 when we started to see signs of increasing risk embedded in their loan portfolios. These alerts were followed by more specific and targeted supervisory guidance and on-site examinations. We conducted numerous outreach sessions with bankers and bank directors to discuss our concerns and outline our expectations. Our goal in taking these actions was to ensure that bankers recognized potential problems at an early stage so that they could take steps to mitigate potential risks that were building up in banks' portfolios.

Equally important are the steps we take with examiners to ensure that they understand and apply our policies in a consistent manner across the country. While our examination force maintains a local presence in the communities national banks serve, our examination policies and emphasis are established and coordinated on a national level. Our examiners are alerted to new policy issuances via weekly updates. When warranted, we supplement these issuances with targeted supervisory memos that provide additional direction on how examiners should implement those policies or guidelines on a consistent basis across the country. The messages are reinforced and clarified through periodic national teleconferences that our senior management team in Washington holds with our field staff. In addition, we have national commercial and retail credit committees that bring together field examiners and policy staff to exchange information, discuss emerging issues, and promote consistency in the application of examination policies.

We also have various mechanisms in place to help ensure consistency in our examination findings and any attendant supervisory actions. For example, each report of examination is reviewed and signed off by the applicable deputy comptroller or assistant deputy comptroller before it is finalized. Supervisory enforcement actions are reviewed by district and, for certain cases, headquarters supervisory review committees. We have quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies and procedures. These reviews are augmented by independent oversight conducted by the OCC's Enterprise Governance unit.

Because bank examination requires judgment, there will be instances when reasonable minds may differ on certain conclusions drawn from examination activities, or where there are additional facts and circumstances that a banker believes were not given full consideration. I and my management team have stressed a policy of open communication with bankers. I encourage any banker that has concerns about a particular examination finding to raise those concerns with his or her examination team and with the district management team that oversees the bank. Our assistant deputy comptrollers and deputy comptrollers expect and encourage such inquiries. Should a banker not want to pursue those chains of communication, we have an independent Ombudsman's office that bankers may use to appeal a supervisory action or decision. In addition to receiving formal complaints or appeals, the Ombudsman's office provides bankers with an impartial ear to hear complaints, and a mechanism to facilitate the resolution of disputes with our supervisory staff.

B. OCC's Examination Messages and Actions

As we work through this stage of the credit cycle, our messages to examiners continue to be these: Take a balanced approach; communicate concerns and expectations clearly and consistently; provide bankers reasonable time to document and correct credit risk management weaknesses; and encourage bankers to work with troubled borrowers in a prudent manner and to extend new credit to creditworthy borrowers. This does not mean that examiners are giving bankers a "free pass" to ignore or delay recognition of their credit problems. If a banker does not or cannot identify and take appropriate action to manage the risks in the bank's credit portfolio, examiners will direct bank management to take corrective action. At some institutions where bank management has not sufficiently identified or addressed their loan problems, our reviews may result in a bank needing to make additional loan loss provisions; to charge off loans that are deemed loss; or to place loans on nonaccrual where full collection of principal and interest is in doubt. Similarly, some banks may be directed to strengthen their credit underwriting or risk identification and management practices.

With this background, let me address some of the specific concerns and allegations I have heard about examiners' actions.

- *Examiners are barring loans to certain borrowers or industries, or are criticizing loans simply because they are located in a state with a high mortgage foreclosure rate or to an industry experiencing problems.*

Deciding which borrowers or businesses a bank should lend money to is not part of our examination process, provided the business is lawful and the bank is meeting the credit needs of its communities. We do expect banks to have robust credit underwriting and risk management processes, which among other things, monitor and control the bank's overall exposure to a particular borrower and industry segment. We also expect bankers to assess how borrowers and industries may perform in stressed economic environments to ensure that they will continue to have the capacity to perform under the terms of their loan obligations. However, examiners do not criticize loans simply because a borrower is located in a certain geographic region or operates in a certain industry. Each loan must be evaluated based on its own structure, terms, and the borrower's willingness and ability to repay the loan under reasonable terms. Market conditions, however, can influence a borrower's repayment prospects and the cash flow potential of the business operations or underlying collateral, and these are factors that we expect bank management to consider when evaluating a loan.

When bankers say that the examiners are telling them not to extend credit to certain borrowers or businesses, what they often mean is that the examiners are "classifying" certain loans. When a borrower's ability to repay its loan deteriorates or becomes impaired, we expect the bank to "classify" the loan to recognize the increased risk. This means that they move the borrower from a "pass" designation into one of four other categories, ranging from a potential problem to a more serious actual one. Loans falling into one of these categories generally require more rigorous loan review and administration. Although some bankers may infer that they are no longer allowed to extend credit to those borrowers, this is simply not the OCC's position. We expect and, in fact, encourage bankers to continue working with "classified" borrowers who are viable. An increase in classified loans does not automatically trigger supervisory action – we expect banks to have higher classified loan ratios during economic downturns – provided that bank management is being realistic in its assessments, has reasonable workout plans, and is maintaining adequate loan loss reserves and capital ratios.

- *Examiners are classifying loans to borrowers that are current and can meet their debt obligation – what has sometimes been referred to as "performing non-performing" loans.*

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 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. The agencies' October 2009 policy statement on CRE loan workouts addresses these situations and provides examples of when classification would and would not be appropriate.

- *Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined and are forcing bankers to write down loans to current distressed market values.*

Examiners will not classify or write down loans solely because the value of the underlying collateral has declined to an amount that is less than the loan balance – a point that we reiterated in the October 2009 CRE policy statement and the recent statement on small business lending. For many CRE projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage, current collateral values can be an important indicator of the project's viability and can signal adverse changes that will adversely affect the cash flow available to service or repay 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 applying the concepts of market value (a valuation concept with a foundation in appraisals) and fair value (an accounting valuation concept), we follow the standards set forth in GAAP and appraisal regulations. These standards direct that these values should reflect the probable price expected to be received if the property were to be exposed to sale in the current market for a time to allow for typical marketing efforts. Thus, these valuations are expected to reflect the overall state of current market conditions and not simply ignore them or assume them away.

- *Examiners are unduly overreaching and are second guessing bankers and professional independent appraisers.*

One of the areas of greatest controversy during the last significant real estate downturn was the practice of examiners making adjustments to real estate appraisals. We have taken steps to minimize the need for such adjustments during the current cycle. In 2008, in a nationwide teleconference and supervisory memo, we reiterated to examiners that it is management's responsibility to have updated borrower information and current real estate appraisals. We also noted that a new appraisal may not be necessary in instances where an internal evaluation by the bank appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis. As noted in the October 2009 CRE policy statement, appropriately supported assumptions are to be given a reasonable degree of deference by examiners. Provided that the appraisal is reasonable, our examiners will not make adjustments or apply an additional haircut to the collateral.

- *Examiners are arbitrarily applying de facto higher regulatory capital requirements, constraining banks' ability to lend.*

In anticipation of rising credit losses, over the last two years the OCC has urged banks to build loan loss reserves and strengthen capital. It is our longstanding policy that the regulatory capital levels are minimums, and that some banks may need to hold higher capital levels to adjust for risks such as significant credit concentrations. Indeed, if a bank simply maintained its capital at the minimum level defined by regulation and then incurred unexpected losses, the resulting decline in its capital ratios would immediately trigger the provisions of Prompt Corrective Action that would constrain the bank's activities. Thus, there are instances where we have directed, and will direct, bank management to maintain higher capital buffers if they choose to have significant risk concentrations. Such decisions, however, are not made unilaterally by a field examiner. Any such directive is reviewed and approved by our district supervision management teams.

C. Facilitating Small Business Lending

The OCC recognizes the vital role that small and medium size businesses play in our nation's economy and the need for these businesses to have access to credit. We have therefore taken a number of steps to encourage lending to these businesses. For example, as previously noted, on February 5, 2010, we and the other financial regulators issued a statement reinforcing the importance of small business lending to the economy. In addition, the number and dollar volume of loans to small businesses, particularly those with annual revenues of less than $1 million, are considerations in our evaluations of a national bank's performance under the Community Reinvestment Act (CRA). And through our *Community Development Investment* newsletter and *Community Development Insights* reports, we have highlighted opportunities for national banks to provide credit to small businesses; for example, our Fall 2008 edition of the *Community Development Investment* letter illustrated various ways multi-bank community development corporations have collaborated to provide financing to small businesses.[19]

We actively encourage national banks to participate in various government programs that are designed to support small business lending. The SBA loan guarantee program is one of the best known of these programs. Last fall we convened a meeting with bankers who are active small business lenders and representatives from Treasury to discuss ways that SBA programs could be enhanced. A number of the recommendations that bankers made for enhancing these programs were addressed in the American Recovery and Reinvestment Act of 2009. These included eliminating and reducing fees for borrowers on 7(a) loans and lenders on 504 loans, and raising the guarantee on 7(a) loans. Late last year we sponsored a national telephone seminar in partnership with the SBA to promote bank participation in these two flagship programs and to alert bankers to these important program changes. Based on feedback we have heard from examiners and bankers, these changes have been well received.

To enhance our ability to monitor credit conditions facing small businesses, effective March 31, 2010, the OCC and other federal banking agencies will be requiring banks to report small business loan data on a quarterly, rather than an annual, basis in the Call Reports that each bank must file. In addition, the agencies will begin collecting data on unused credit card

[19] A copy of this report can be accessed at http://occ.gov/cdd/resource.htm.

lines in two separate components: unused consumer credit card lines and other unused credit card lines that include businesses and other entities. This information will allow us to better monitor credit flows in this important sector.

V. Conclusion

The OCC is acutely aware of the pivotal role that bank credit plays in the health of our nation's economy, and we are encouraging bankers to make loans to creditworthy borrowers. As I have described, there are a variety of forces that have made businesses, consumers, and bankers more cautious and that have contributed to a slowdown in lending. While many of these are beyond the direct control or influence of bank supervisors, it is incumbent upon us to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. We are committed to do just that. We have and will continue to take steps to ensure that our policies are clear, and our supervision balanced and fair.