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TESTIMONY OF

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Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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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 Moore, Ranking Member Biggert and members of the Subcommittee, my name is Bert Otto and I am the Deputy Comptroller for the Office of the Comptroller of the Currency's Central District. I appreciate the opportunity to appear before the Subcommittee to discuss commercial real estate (CRE) lending in Illinois and other parts of the country.

I have been a National Bank Examiner with the OCC for almost thirty-seven years and have served in a variety of positions in the field and in our Washington, D.C. headquarters. For almost my entire career, I have been involved in the direct supervision of community and midsize national banks. In my present capacity, I am responsible for the oversight of nationally chartered community banks in ten states in the Midwest, including Illinois.

To put the OCC's regulatory role in Illinois in perspective, we supervise approximately 20 percent of the banks headquartered in the state, representing about 38 percent of the bank and thrift assets. The 128 nationally chartered community banks headquartered in Illinois hold aggregate assets of roughly $91 billion. In addition, several large national banks supervised by OCC do a significant volume of business in Illinois, but are headquartered in other states.

The OCC's core mission is to ensure that national banks remain safe and sound and meet the credit needs of their communities and customers. In carrying out our mission, we strive to ensure that banks have the systems and capital in place to support their lending activities. A critical part of our job is determining when potential risk exposures or weaknesses in risk management practices require corrective action by bankers. Knowing when to make these calls requires judgment and a balanced supervisory approach. Moving too quickly or too strongly when problems begin to arise can impede economic growth and access to credit, while waiting too long or not requiring appropriate controls can lead to excessive risks that will ultimately impair a bank's overall financial condition – and its ability to lend. The OCC strives to get this balance right through strong, thoughtful and consistent supervision, and clear two-way communication with the banks we supervise. It is especially important in today's economic environment to ensure that our actions do not discourage national banks from making loans to creditworthy borrowers.

II. Overview of Commercial Real Estate Conditions

To put my remarks into context for today's hearing, it is helpful to look first at the general economic and commercial real estate conditions in Illinois and Chicago. Like much of the United States, Illinois is currently facing serious economic challenges. The recession hit the Chicago metropolitan area and the state of Illinois harder than many other areas of the county. While job losses have decelerated since the beginning of 2010, they have not ended, and unemployment in both the Chicago metropolitan area and Illinois as a whole is well above the national average. We are seeing signs of improvement in some sectors of the state's economy, but exports, which are concentrated in two industries agriculture and manufacturing, continue to suffer. The state's agricultural exports are down 45 percent from their peak value compared to 38 percent nationally, and manufacturing exports are down 26 percent from the summer 2008 peak compared to a similar 24 percent decline nationally.

Local economic performance and the general drag of the national and global downturns are having a significant effect on CRE in the metropolitan area. All types of commercial real estate are experiencing vacancy rates well above historical averages, and some are at record levels. Without job growth, this trend is likely to continue. For example, Grubb & Ellis reported that office demand in the Chicago metropolitan area declined by 1.4 million square feet in the first quarter of the year. This same source reports that more than two dozen recently completed industrial buildings of 200,000 square feet or more are vacant or nearly vacant. This competitive supply will continue to put pressure on the level of operating cash flows that such projects can generate. These cash flows have a direct impact on the value of the project and the amount of debt it can support.

Issues confronting the Chicago market mirror what we are seeing on a nationwide basis. For example, vacancy rates are still rising nationally, albeit at a slower rate than in past quarters, and cash flows produced by CRE properties are projected to decline well into 2011. Nationally, the CRE markets still face significant headwinds, and we expect that many banks will experience further deterioration in their CRE loan portfolios. Vacancy rates are nearing their expected peaks for the cycle but stand at or near record-high levels which is continuing to place downward pressure on rents. Cash flows produced by CRE properties are projected to decline well into 2011. There are, however, some signals of a slight improvement in the CRE capital markets and according to Moody's/Real Commercial Property Index, property values rose three of the last four months (through February). Thus after dropping 44 percent between the peak in October 2007 and October 2009, commercial property values now stand 42 percent lower than their peak. Lower prices and historically attractive yields are encouraging new investment. CRE sales activity inched higher in each quarter of 2009, and sales volume in the first quarter of 2010 was up 16 percent from average quarterly activity last year. Well-leased assets in larger markets in particular have garnered relatively strong interest from investors. Additional signs of stabilization include tightening CMBS spreads and rising REIT share prices. REITs also raised $24 billion in equity in 2009, and the first quarter of 2010 was the first time in almost two years that they purchased more property than they sold. Despite these positives, we expect CRE losses to remain elevated for an extended period, much as we saw in the early 1990s downturn.

These conditions and market forces have strained both CRE borrowers, and the CRE loan portfolios at many banks, and we expect these trends may continue for some time. The OCC fully recognizes the important engine that CRE plays in the overall health and vitality of Illinois and the United States economy. We have taken steps to help ensure that bankers do not become unduly conservative and that they continue to make loans to creditworthy borrowers, including CRE borrowers. For example, through the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* issued in November of 2008, the federal regulatory agencies reiterated how important it is for banking organizations to meet the needs of creditworthy borrowers.[1] OCC management and examiners are reinforcing this message in outreach meetings and in industry and interagency forums with bank directors, chief executive officers, and senior credit officers.

[1] *See:* “Interagency Statement on Meeting the Needs of Creditworthy Borrowers” at: http://www.occ.gov/ftp/release/2008-131.htm.

III. Commercial Real Estate Lending

Notwithstanding these efforts, a number of bankers, including those in Illinois, have expressed concern that examiners have become overly conservative and are constraining CRE lending as a result. Before addressing some of the specific concerns that we are hearing, let me first provide a brief overview of our supervisory approach in this area.

We have been addressing the build up of risk in the CRE market through our examination and supervisory activities for a number of years. We know from experience that CRE concentrations can become a significant strain on banks' performance when the economy slows down. Indeed, 99 percent of national banks designated as problem banks, including those that have failed, have significant concentrations of credit, most often in CRE. Our goal in focusing on CRE exposures early in this credit cycle has been to ensure that bank management recognizes and addresses potential problems at the earliest stage possible, when risk mitigation actions are likely to be most successful.

Specifically, over the past six years, we have been conducting a series of targeted examinations at banks that we believe are at significant risk due to the nature and scope of their CRE activities. 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.

In 2005, to assist bankers in identifying and assessing potential CRE vulnerabilities, we developed and made widely available via our National BankNet Web site, a CRE stress test tool for bankers. Although BankNet is only open to national banks, we make our CRE tools available 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 Commercial Real Estate Stress Testing Worksheet is another Excel-based tool that requires only some basic loan underwriting criteria to provide a concise analysis of the potential credit quality deterioration posed by the embedded risks. The worksheet shows the progression of the potential impact to debt service coverage and loan-to-value 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.

Throughout this credit cycle we have stressed to our examiners the need to take a balanced and consistent approach in examinations, to clearly communicate and explain their actions and recommendations, and to provide bank management reasonable timeframes to implement any needed corrective action. 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 reiterated the need for examiners to take a balanced approach in their supervision and to maintain open communications with bankers during examinations. Given the increases in troubled CRE loans that examiners were seeing, in April 2009, we issued supervisory guidance to examiners on factors that they should consider when evaluating banks' workout programs and risk ratings for problem CRE loans.

In October 2009, we and the other banking regulators issued guidance on CRE loan workouts to provide greater clarity and certainty to the industry and examiners on the agencies' policies and expectations, and to promote greater consistency across the agencies in our evaluations of these credits.[2] Many of the principles discussed in this guidance build upon the principles that our examiners already were applying based on the earlier, internal guidance we had provided, including our longstanding policy that examiners will not criticize prudent loan workout arrangements. The guidance also stresses that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower, and examiners should not criticize banks for engaging in an effective workout program even if the restructured loan has a weakness that results in an adverse credit classification. The statement also reiterates our policy that a loan should not be classified simply because the underlying collateral value has declined to an amount that is less than the current loan balance. Instead, classifications must be based on an analysis of the borrower's ability and capacity to repay.

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 changes that will adversely affect the cash flow available to service or repay the loan. In such cases, classification will generally be appropriate.

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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.

Given the concerns and questions we were hearing about how examiners differentiate between performing and non-performing loans, the guidance includes a series of examples with various fact patterns and describes the appropriate classification, accrual, and accounting treatment for each different scenario. The varying examples underscore that every loan must be evaluated on its specific facts and circumstances. Drilling down into these specifics is a basic tenet of our loan review processes. The simple fact is that loans or borrowers that initially appear to be similarly situated often have significant differences that will affect their ability to perform as structured.

We and the other agencies conducted a nationwide teleconference with the industry to explain the guidance and to walk through the various examples. We have also followed up with our examination staff on the guidance through internal supervisory guidance and conference calls. We also worked with the other federal banking agencies to develop an interagency training program for examiners who are reviewing CRE credits in the agencies' shared national credit program. The objective of the training was to ensure that examiners apply the October guidance in a consistent manner. We and the other federal banking agencies also have agreed to collect feedback from bankers on the effectiveness of our guidance and areas where further clarifications may be needed as part of our upcoming on-site examinations.

I want to address a couple of specific concerns that we are hearing about how examiners are evaluating CRE loans.

Some bankers have contended that 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.

We have also received questions about whether 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. As previously noted, the agencies' October 2009 policy statement on CRE loan workouts addresses these situations and provides examples of when classification is and is not appropriate.

Finally, we also hear concerns that examiners prohibit bankers from extending additional credit when the loan has been classified. To clarify – our examiners do not dictate loan terms, and we do not prohibit bankers from extending additional credit to classified borrowers. We recognize that within the context of a prudent, well-defined workout plan, extending credit may be the best course of action. However, if the extension of additional credit merely prolongs the inevitable and the borrower has no reasonable chance of repaying the debt, then the lender is just increasing the ultimate probable loss of the loan. Examiners will and should be critical of this latter practice. This is why we expect certain conditions to be met before renewals, modifications, or extensions are made to a borrower whose loans are criticized or classified. These conditions include: a majority of the bank's board or a designated committee must approve the credit in writing and find that it is necessary to promote the best interests of the bank; the bank must perform a written credit and collateral analysis of the borrower and credit; and the board's formal plan to collect or strengthen the credit will not be compromised by the new loan.

IV. 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 lend to creditworthy borrowers.

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, using prudent underwriting standards; 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 have also remained consistent. 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 portfolio in their financial statements.

While there are a variety of forces that have made businesses, consumers, and bankers more cautious and that have contributed to a slowdown in lending, 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.