Remarks by

Darrin Benhart
Deputy Comptroller for Supervision Risk

Before the

GARP 16th Annual Risk Management Conference

New York

February 25, 2015

Good morning. Thank you for asking me to be part of your event. I'd like to acknowledge the Global Association of Risk Professionals for its leadership in promoting the training, education, and best practices of risk professionals worldwide. This annual conference is a good opportunity to share knowledge with a wide array of risk professionals and learn more about the latest trends in risk awareness and management.

While some of you in the room may be very familiar with the OCC, it may be useful for others to know that the OCC charters, regulates, and supervises national banks and federal savings associations. We work to ensure that banks and thrifts operate in a safe and sound manner and comply with applicable laws and regulations, including those requiring fair treatment of consumers and fair access to credit and financial products.

Congress established our agency in 1863 and since then we have supervised national banks, and more recently, federal thrifts of all sizes. These institutions range from community banks and thrifts with a few million dollars in assets to the very largest banks with more than $2 trillion in assets. Together, the almost 1,700 national banks and federal savings associations hold $10.6 trillion in assets or about 69 percent of all assets in U.S. commercial banks and thrifts. The federal banks and thrifts service 46 percent of all first-lien residential mortgages, and issue 64 percent of all credit cards in the country. We accomplish our important mission with the effort of about 3,900 employees working from more than 60 cities throughout the country, including our headquarters in Washington, D.C., and district offices in Chicago, Dallas, Denver, and New York city.

With that mission in mind, the OCC shares a commitment with this organization and all of you here today to foster a culture of risk awareness at all levels of our organizations. Promoting a healthy risk culture is something that we have been speaking a good deal about at the OCC. It is in our DNA. I have examined institutions of all sizes—ranging from assets of a few million to our largest national banks. They all have one thing in common, the need for sound risk management processes. Comptroller of the Currency Thomas Curry, last year, stressed, "[s]ound risk management, supported by a healthy organizational culture, aims at protecting the bank's reputation and shelters it from credit losses, litigation risk, and the kind of breakdowns in operational risk that, as we have seen, can have very significant consequences."[1]

Earlier this month, the *Wall Street Journal* highlighted the attention regulators are paying to risk culture. The *Journal* quoted the Comptroller, who said that culture is a "critical component of a sound management team" and the new emphasis on effective culture has real teeth that could affect bank ratings.[2]

In my role at the OCC, as the Deputy Comptroller for Supervision Risk Management, I spend my workdays, thinking about how healthy risk cultures promote responsible business practices and guard against excessive or improper risk-taking. In the time we have together this morning, I hope to share a little about some of the risks we see building up in the financial services industry and touch on some of our efforts to improve our ability to identify, monitor, and respond to emerging risks facing national banks and federal savings associations.

At the OCC, we commit a tremendous amount of time and resources to identifying, assessing, and communicating risks of all kinds—operational risk, credit risk, concentration risk, compliance risk, and reputation risk. At the individual bank or savings association level, OCC examiners throughout the country use our Risk Assessment System, or RAS, a tool we created to help institutions identify and manage their risks.[3] The RAS assesses eight kinds of risk in terms of their quantity, quality of risk management, aggregate level, and direction (whether risk is increasing or decreasing). The tool makes changes in risk practices more visible at an early stage, allowing boards of directors and managers more time to develop and implement strategies to mitigate the risks. While our RAS is designed for banks and thrifts, the principles behind the tool can assist any type of organization seeking to improve its risk management, and I encourage

[1] See "Unwritten Rules: The Importance of a Strong Risk Culture," *Banking Perspectives.* The Clearing House. Q3 2014 (https://www.theclearinghouse.org/publications/2014/banking-perspective-q32014/unwritten-rules-the-importance-of-a-strong-risk-culture).

[2] See "As Regulators Focus on Culture, Wall Street Struggles to Define It." *The Wall Street Journal*. February 1, 2015 (http://www.wsj.com/articles/as-regulators-focus-on-culture-wall-street-struggles-to-define-it-1422838659).

[3] See the *Comptroller's Handbook on Community Bank Supervision* (http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/cbs.pdf) and *A Common Sense Approach to Community Banking* (http://www.occ.gov/publications/publications-by-type/other-publications-reports/common-sense.pdf).

you to take a look at it in our *Common Sense Approach to Community Banking* and our *Comptroller Handbooks* on our agency's Web site—OCC-dot-gov.

Our examiners have an in-depth view of the risks within the individual institution or portfolio of institutions they supervise. As a national regulator, we have first-hand access to the inner workings of the banks and thrifts we regulate. We also aggregate that mountain of data and insights to create a comprehensive view of the risks facing the financial services industry as a whole. We share that broad perspective, including best practices, across the industry.

The job of integrating that field-level data and information falls to my new group, the Supervision Risk Management team. My team works with the OCC's National Risk Committee (NRC), to monitor the condition of the federal banking system and emerging threats to the system's safety and soundness. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from our law, policy, accounting, and economics departments.

Since 2012, the NRC has summarized the agency's holistic view of the risks facing national banks and federal savings associations in our *Semiannual Risk Perspective*, also available to everyone on OCC-dot-gov.[4] Prepared every six months, this report addresses key issues facing banks of all sizes and describes the OCC's supervision priorities to address those risks.

We published our most recent *Semiannual Risk Perspective* in December of last year. The report noted the ongoing earnings pressure causing some banks to reach for yield and take on additional strategic risk. We also reported competition for the limited lending opportunities that exist in the current market environment is intensifying and resulting in weaker underwriting standards, particularly in indirect auto lending, leveraged lending, and commercial and industrial loans.

The prolonged low interest rate environment continues to encourage strategies and actions that could contribute to future vulnerability. Banks that extend asset maturities to pick up yield, especially if they rely on the stability of non-maturity deposit funding, could face significant earnings pressure and capital erosion depending on the severity and timing of interest rate moves.

[4] See *Semiannual Risk Perspective* (http://www.occ.gov/publications/publications-by-type/other-publications-reports/index-semiannual-risk-perspective.html).

Operational and compliance risks are also a concern. Rapidly evolving cyber threats and information technology vulnerabilities became household concerns over the last two years as the number of major breaches escalated. Cybersecurity requires heightened awareness and appropriate controls to identify and mitigate the associated risks. The same is true for Bank Secrecy Act and Anti-Money Laundering risks that remain prevalent across the industry as money-laundering methods evolve and electronic bank fraud grows in sophistication and volume.

Many banks are re-evaluating their business models and risk appetites and are seeking new ways to generate returns against the backdrop of low interest rates. This raises strategic risks. OCC examiners are focusing on this risk to ensure that banks and thrifts establish and follow appropriate risk management processes as they explore new products, partnerships, and opportunities. I would like to spend the rest of my talk focusing on three key risk management tenets that bank management should consider when evaluating new opportunities or expanding existing competencies. These are concentration risk management, correlation risk, and over-reliance on historical performance. I'd like to use three current products in the news to talk about these risks.

First, consider what happened with the Swiss franc. On January 15, the Swiss National Bank decided to end its three-year cap on the value of the franc. While the action by the Swiss bank was in response to developments in the euro, the action shocked many people. It reverberated in equities and currency markets around the world. The franc appreciated dramatically, as much as 41 percent during intraday trading, and the Swiss benchmark market index declined 9 percent.

Major Swiss companies that depend on stable foreign exchange and exporting goods felt the weight of the decisions. The stock value of the watchmaker Swatch dropped 16 percent and Holcim Ltd., the world's biggest cement maker, plunged 10 percent. Both companies attributed the drop to the SNB policy shift. Analysts have described the event using the words no risk manager enjoys hearing—"seismic" and "surprise." Suddenly, the Swiss franc became more volatile than the ruble, even if temporarily.[5] On January 29, Bloomberg reported that four of 10 economists now predict a recession for the Swiss economy—defined as two consecutive quarters

[5] See "Swiss Franc Is Now More Volatile Than the Ruble," Bloomberg. January 19, 2015 (http://www.bloomberg.com/news/videos/2015-01-19/swiss-franc-is-now-more-volatile-than-the-ruble).

of contraction—in 2015.[6] The shockwaves rippled across borders, stressing the $5.3 trillion-a-day foreign-exchange market. Even the giant Deutsche Bank AG was among the dealers that suffered disruptions to its electronic trading.

While this is an extreme example of a shift in value over a single day, it shows the need to understand concentrations in your institutions. We saw a very similar story from 2008 to 2010 where a number of institutions failed because of concentrations related to residential real estate. The reality of the world is that even seemingly stable values can change by 20, 30, or even 40 percent quickly. That is why our *Comptroller's Handbook on Concentrations Risk* booklet stresses the need to monitor and set risk limits for concentrations relative to capital or earnings.[7]

Managing concentrations has long been a focus of sound risk management. Concentrations can introduce a variety of risks including credit risk, interest rate risk because of maturity concentrations, liquidity risk from funding concentrations, or operational risks associated with concentrations of certain lines of business.

All banks and thrifts have concentrations. Sometimes an institution chooses to develop expertise in a particular niche to exploit strengths and business advantages. In other cases, mergers or acquisitions may create a concentration. A concentration may simply result from a lender's limited geography combined with its market's dependence on a relatively few employers or industries. Regardless of the cause, management and boards of directors must ensure that banks recognize the concentrations within their portfolios and have effective processes to identify, measure, monitor, and control the risks.

Boards also need to make sure the institution has adequate capital relative to all of its risks, and stress testing can help. When someone mentions stress testing, most people think of testing at the enterprise level as required by the Dodd-Frank Act for large financial institutions. The kind of stress testing I am talking about is testing at an individual portfolio or product line level that all institutions can conduct. To be clear, the requirements for stress testing in Dodd-Frank do not apply to community banks and thrifts with less than $10 billion in total assets. However, federal banking agencies have emphasized that all banking organizations, regardless of size, should be able to analyze the potential effects of adverse events on their financial condition

---

[6] See "Thank the Central Bank: Chance of a Swiss Recession Just Jumped," Bloomberg. January 29, 2015 (http://www.bloomberg.com/news/articles/2015-01-29/thank-the-central-bank-chances-of-a-swiss-recession-just-jumped)

[7] See *Comptroller's Handbook on Concentrations of Credit*. OCC. December 2011 (http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/Concentration-HB-Final.pdf).

as part of sound risk management practices. This type of stress testing can help management and boards understand the risks associated with concentrations.[8]

We also talk about the need to conduct stress testing to assess and inform those limits as bank management and the board make strategic decisions. The most valuable and often most difficult risk management decision is knowing when to say "no" because you have exceeded your risk limits.

The second risk management tenet I'd like to talk about is correlation risk management. Consider the dramatic decline in the price of crude oil. Towards the end of June last year, Brent crude peaked at $107.48 per barrel. Since then, the price has fallen dramatically, and continued through the end of January, when we saw rates below $44 per barrel. That is nearly a 60 percent drop over just seven months.

That may be good news for some consumers and businesses, but if oil prices remain deflated for an extended period it presents a whole host of issues for industries and communities directly involved in oil and gas as well as those indirectly tied to supporting the boom in parts of the country and globally. Much of the recent discussion has rightfully focused on oil producers and concentrations to those borrowers, but I'd like to shift the focus today to the correlated service industries. This impact is much more difficult to capture but potentially more meaningful in the near term. These include exposures to commercial real estate such as office space or hotels and residential real estate built to support the expansion of the oil industry in some areas. You also have commercial loan exposures to trucking companies, restaurants, or equipment companies that could be affected as the oil producers reduce operations, stop new exploration or lay off workers. It is easy to focus on the obvious risk, but sound risk management also needs to think broadly about other, sometimes more nuanced correlated risks. These risks are often more difficult to measure and understand. Many times, you need to rely on your data systems to help you identify these exposure levels. Then you need to actively monitor these exposures, and in some cases, reach out to borrowers. This will allow you to understand your risk, and to work out a plan to deal with the exposures, rather than react to negative financial results or a missed payment that may not occur for three to 12 months. At that point, the options for dealing with the risk are often more limited for the borrower and the bank.

---

[8] See OCC Bulletin 2012-33, "Community Bank Stress Testing," October 18, 2012 (http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-14.html), and OCC Bulletin 2012-16, "Guidance for Evaluating Capital Planning and Adequacy," June 7, 2012 (http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-41.html).

The third risk management tenet I would like to discuss with you deals with an acknowledgement that the past, while providing us with good information, will not predict the future. This inherent limitation is where risk management needs to provide perspective by looking more broadly at how the environment has changed to protect against an overreliance on historical data. One particular risk highlighted in our *Semiannual Risk Perspective* reflects some of our concerns in this area. As the *Perspective* shows, auto lending has changed significantly and rapidly over the last few years, yet much of the justification for entering or expanding this product line is based on historical performance and consumer behaviors. Competition and the reach for revenue and yield has lowered underwriting standards and introduced new product features that may adversely affect the performance of these loans over time. Let's talk about a few of these changes.

Lenders are now extending repayment periods up to 84 months on new and used vehicles, compared with the 60 months we have seen traditionally. In the past two years, the share of 73- to 84-month loans for new cars doubled as a percentage of the total market—from 12 percent to 24 percent. The share of long-term loans for used vehicles also doubled from 7 percent to 14 percent.[9] Lenders also are making loans with higher loan-to-value ratios and to borrowers with lower overall credit scores.

Let that sink in for a moment. That means it is not uncommon today for a family with subprime credit to take a loan at 110 percent of a used car's value that they will be paying off for seven years. That means if the family bought a used car on these terms when their daughter celebrates her ninth birthday, they will still be paying for it when she takes it for her first drive on her 16th birthday.

At the same time that the auto-lending product has changed, tools used by banks and thrifts to underwrite loans and qualify borrowers have also changed. Credit ratings now exclude or downplay the impact of certain debt, such as medical debt. While the changes in the ratings may be warranted, banks must understand what these changes mean relative to evaluating a borrower's total ability to manage new debt.

While credit ratings remain a valuable tool, banks must use other tools to get a more comprehensive picture of a borrower's ability and willingness to repay debt in a timely fashion.

---

[9] See page 30 of OCC' *Semiannual Risk Perspective* for Fall 2014 (http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-fall-2014.pdf).

Changes in loan products at the same time changes in underwriting occur can compound risk in unpredictable ways.

At an individual loan and consumer level, the weaker underwriting of low rates, higher loan to value, bundling add-on products, and longer terms creates loans that focus on payment affordability rather than long-term sustainability. Many people point to the fact that some borrowers defaulted on home loans while keeping car payments current during the last crisis. As we have seen from some of the other examples I have discussed, paradigms can shift and it is unclear if this paradigm will persist in the future. With lower payments during periods of economic stress, the lender and borrower have even less room to manage credit difficulties in the event of delinquency caused by short-term credit impairment. When the borrower experiences difficulties, they are more likely to default and the loss will likely be greater for the lender and investors.

We are starting to observe deterioration in auto lending portfolios, and banks are seeing the average dollar losses per vehicle rise. Sixty-day auto loan delinquencies rose 8.6 percent in the third quarter of 2014 compared with a year earlier, according to Experian. So far, rapid growth in auto loan volume and low payments have offset the full impact of the risk by masking delinquency and loss rates as a percentage of total volume. We will have to wait and see how those investments perform over time, but institutions should take care to manage these risks carefully.

After an extended period of relatively low volatility, we are seeing volatility creep back into the system, often exacerbated by specific, discrete events. This volatility reminds us that past performance is not a complete predictor of future returns, as the disclaimer in every prospectus tells us.

Whether it is the Swiss franc, oil-price declines, or indirect auto lending we all know that the environment we operate in can change quickly. My remarks today have primarily focused on credit risk examples, but we all know that other risks such as liquidity, operational, or compliance risk are also critical and these same tenets apply to those risks.

Before closing, I also want to share some of the work our agency is doing to improve its own approach to risk management. In 2013, Comptroller Curry invited a group of senior international bank examiners to review OCC practices related to its supervision of midsize and large national banks and savings associations. Called the International Peer Review, this effort led to several recommendations that involved the agency's ability to identify, assess, correlate, and communicate risks facing the industry and the agency itself.[10] The agency has taken a variety of actions to implement these risk management recommendations.

One set of actions involve enhancing the agency's National Risk Committee function I mentioned earlier. Those actions included establishing my current position as a Deputy Comptroller for Supervision Risk Management, but it also involves enhancing our staffing to better assess industry-wide risk. This effort includes establishing an analytics team and a dedicated leadership team. The analytics team is made up of employees from across the agency, who will develop and coordinate supervision risk analysis to support our oversight of the federal banking system. The team will develop and present reports on existing and emerging risks and will serve as a centralized supervision risk analysis unit within the agency.

While the supervision risk management team focuses on emerging supervision risks within the industry, another set of recommendations involve enhancing the agency's ability to assess and manage the risks it faces. Does all of this start to sound familiar? This effort goes toward establishing a level of enterprise risk management (ERM) at the OCC that is commensurate to the ERM practices we expect of the institutions we supervise—a practice that we believe will make us an even more effective regulatory agency.

I could go on even longer discussing the risks facing the federal banking system and how we are working to promote more effective risk management, but I also want to be sure to leave time for a few questions. So let me end by thanking everyone again for joining me this morning and thanking GARP for hosting this event. These events make an important contribution to our awareness of risk management issues and practices and help to reinforce the importance of effective risk analysis to our individual institutions as well as the industries and communities they serve.

Thank you very much. I'd be glad to take your questions.

[10] See OCC News Release 2013-184, "OCC Releases International Peer Review of OCC Supervision of Large and Midsize Institutions." December 5, 2013 (http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184.html).