Remarks by

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Thank you, it's a pleasure to be here with you today, although perhaps I should say, it's a pleasure to be here once again. This is my fourth appearance before this group, including three times as Comptroller of the Currency. I guess that means I haven't worn out my welcome – at least not yet. And I'm glad that's the case, because the Exchequer Club has long been an important forum for the discussion of major issues facing the financial services industry, and the conversation that takes place here plays an important role in informing the Washington policy debate. So, I look forward to these opportunities, and I'm glad I was invited back by Jerry Buckley for this fourth appearance.

The first time I spoke here as Comptroller of the Currency was in May 2012, just a few weeks after my Senate confirmation. With the memory of the financial crisis still fresh, I know that some were surprised when I focused my remarks on operational risk, rather than derivatives, credit underwriting, or some other aspect of financial risk. But in 2012, the industry was on the mend. Credit quality was improving, loan losses were falling, and capital was building to historically high levels. I thought it was time – in fact, I thought it was long past time – to move beyond the issues that were so prominent during the crisis and turn attention to operational and compliance risk.

I thought then that it was past time for that discussion because the industry was already paying a heavy price for dropping the ball on operational and compliance risk. We saw that in several areas, including foreclosure processing, Bank Secrecy Act compliance and trading controls. You might recall that I was greeted with news about the London whale almost as I was first walking through the door into the OCC. What I think was clear is that we all need to do a better job at identifying significant operational risks that otherwise seem mundane. If these activities or processes have the potential to pose significant or serious reputational, legal or financial risks, just like credit risk and cybersecurity, they cannot be neglected no matter how pressing other needs may seem at the time.

So, while I have no intention of letting up in our emphasis on operational risk, we are clearly reaching the point in the cycle where credit risk is moving to the forefront. That shouldn't surprise anyone. While the economy is far from fully recovered from the recession, we've had several years of steady loan growth. As a result, we're now at the stage in the cycle at which banks are reaching for loan growth. They've already extended credit to their best customers and are now trying to bank less creditworthy borrowers, with all of the increased risk that entails.

It's the point in the cycle where we customarily see an easing of loan underwriting standards, as banks drop or weaken protective covenants, extend maturities, and take other steps to build market share. It's also a time in which we see banks develop larger loan concentrations, without concurrent increases in reserves. It's a natural byproduct of competition during the later stages of the economic cycle, and so it's a time when supervisors and bank risk officers need to be most vigilant.

We should not be surprised that we are seeing all of that seven years into an economic recovery. The OCC's annual survey of credit underwriting standards documents rising credit risk. So do all of the other assessments from our examiners on the ground. We are not yet seeing a uniform or comprehensive industry response to these early warning signs. We are encouraged, however, by those institutions that are building loan loss reserves or, in some cases, reducing credit risk by avoiding or reducing their exposure to higher risk loan products.

It’s all too easy to overlook increasing credit risk and continued loan growth when asset quality is still strong and lending is profitable. In the fourth quarter of 2014, asset quality metrics in OCC-supervised banks nearly matched the historically strong levels achieved in the fourth quarter of 2006, right before the start of the financial crisis. Those numbers have basically stabilized, but at levels that can easily breed a sense of complacency.

The same is true for loan growth, which shows no sign of abating. Commercial and industrial loans have now increased for 18 straight quarters, with the fastest growth occurring in loans for businesses, non-depository financial institutions, multifamily housing, energy, and municipalities. Loan growth in community banks has been particularly strong.

These facts are impressive. But they can also be a misleading indicator of the fundamental health of the banking system. Credit quality, after all, reflects the outcome of decisions made when loans are originated, perhaps months or years earlier, possibly under tougher standards than those in effect today. So the indicators that many are looking at most closely actually say little or nothing about the risk now embedding itself in bank portfolios. We won’t see the results of those decisions for many months to come.

But given the trends in underwriting and risk selection that I’ve already mentioned, we should be asking whether banks have the appropriate risk management processes and structures in place to measure, monitor, and control the increased credit risk they are taking on.

I am not suggesting that bankers or regulators have been indifferent to rising credit risk. To the contrary, we’re seeing some noteworthy improvements in risk management as a result of steps we took a year and more ago in several key areas.

The first relates to leveraged lending. Responding to the rapid growth in aggressively structured leveraged loan products, the OCC and other financial regulators issued guidance in March 2013 requiring banks to review their portfolios and, where necessary, make changes. In particular, we directed the institutions we supervise to upgrade their risk management capabilities and review their underwriting, risk-rating standards, pipeline management, loan participation policies, and stress-testing capabilities. I'd like to tell you that we saw immediate changes, but some of these changes take time, which is all the more reason regulators should engage early and be prepared to turn up the pressure as needed.

The 2014 review of shared national credits some months after our guidance was issued found little improvement in the quality of large leveraged loans. In fact, more than 10 percent of the reviewed assets contained material weaknesses. So, the OCC, along with the Federal Reserve and the FDIC, issued supervisory letters to the banks in question, stepped up monthly monitoring of their loan commitments, and closely tracked their progress in implementing the guidance. Although we continued to find material weaknesses in the months that followed, the 2015 SNC review found lower levels of leverage and improved repayment capacity in bank leveraged loan portfolios. It seems clear that our guidance and follow-up helped mitigate the build-up of excessive risk in this market.

Regulators and bankers also deserve credit for addressing the risk in the home equity lines of credit, or HELOCs, that were originated between 2004 and 2007, before the residential real estate market collapsed. Many of these loans had a 10-year interest-only draw period, which meant that approximately $150 billion in HELOC balances would come due, or adjust to fully amortizing payments, between 2014 and 2017.

As regulators, we were faced with a choice. We could wait to see how many HELOC borrowers were able to either make the fully amortized payment or refinance the credit line, and then deal with the fallout from those who could do neither. Or we could reach out to banks with significant HELOC exposures, and press them to begin working with borrowers and take other steps to strengthen their risk management for these products. We chose the second course of action, and began working very closely with federal banks and thrifts that had significant HELOC portfolios. For further emphasis, we clarified our expectations through interagency guidance issued in July 2014.

Banks responded constructively to this guidance. They began conversations with their HELOC customers to explain what was coming and to apprise them of their options. Many banks enhanced their reporting systems to provide more detailed metrics on HELOC performance. So while the risk remains, it is being better managed today.

Auto lending is another area of credit risk that we've had our eye on for several years. It's good news for automakers and for the economy as well that sales are rolling along at record levels. It's also good for banks, which have supplied a significant amount of the financing that makes this activity possible, either directly to purchasers or indirectly through car dealerships. At the end of the second quarter of 2015, auto lending represented more than 10 percent of retail credit in OCC-regulated institutions, up from 7 percent in the second quarter of 2011. And, increasingly, banks are packaging these loans into asset-backed securities rather than holding them in a portfolio. These securities are being greeted by strong demand from investors, who no doubt remember that securities backed by auto loans outperformed most other classes of asset-back securities during the financial crisis.

But what is happening in this space today reminds me of what happened in mortgage-backed securities in the run up to the crisis. At that time, lenders fed investor demand for more loans by relaxing underwriting standards and extending maturities. Today, 30 percent of all new vehicle financing features maturities of more than six years, and it's entirely possible to obtain a car loan even with very low credit scores. With these longer terms, borrowers remain in a negative equity position much longer, exposing lenders and investors to higher potential losses. Although delinquency and losses are currently low, it doesn't require great foresight to see that this may not last. How these auto loans, and especially the non-prime segment, will perform over their life is a matter of real concern to regulators. It should be a real concern to the industry.

Neither auto loans nor home equity loans are inherently unsafe. That's true for most asset classes. However, what is inherently unsafe are excessive concentrations of any one kind of loan. You don't need a very long memory to recall the central role that concentrations—whether in residential real estate, agricultural land, or oil and gas production—have played in individual bank failures and systemic breakdowns. It's an old movie that's been reprised on a regular basis. That's why we're closely watching growing exposures in commercial real estate loans, especially in the construction and multifamily housing sectors, as well as in loans to non-depository financial institutions.

Now all of that may sound very different from the concerns I highlighted during my first speech as Comptroller, but I would like to suggest that they are all of the same piece: a conscious strategy of identifying emerging concerns before they become entrenched problems. The two hallmarks of that strategy are transparency and accountability.

If you've followed our news releases, then you're familiar with our Semiannual Risk Perspective, which spotlights areas of risk that we're most concerned with. That report is more than just a roadmap to help the banks and thrifts we supervise steer clear of problems. It's also an effort to improve the transparency of our supervision and to hold ourselves accountable. When we identify a risk, we expect institutions to address it. But we also expect Congress, the media, and the public at large to hold us accountable and ask what we've done to ensure that the banks we supervise are managing those risks.

Likewise, we are now publishing our supervision operating plan, which is the foundation for the development of individual bank supervisory strategies and policy initiatives. The operating plan guides development of individual bank supervisory strategies, and its publication helps the banks we supervise understand what our priorities are. And again, it also provides a means for the public to hold us accountable.

And so do speeches like this. I've used my speaking opportunities to focus on the issues that are most important to those of us at the OCC: operational risk, reserve releases, HELOCs, leveraged lending, credit underwriting, concentrations, subprime auto, cybersecurity, and our heightened expectations for large bank risk management and director engagement.

The OCC will hold the banks and thrifts we supervise accountable for managing those risks, and I expect the public to hold us accountable for ensuring the safety and soundness of the federal banking system.

Looking back, it's clear that all of us made mistakes in the run up to the financial crisis – regulators and financial institutions alike. And I believe all of us recognize we have to do better. The direction we have charted at the OCC involves laying out high expectations in a transparent way and holding ourselves, as well as the banks we supervise, accountable for meeting those standards. I can't promise you that we'll never again face a serious financial crisis. But the best way to avoid major disruptions down the road is to take sensible and tough-minded steps now. And that, I can promise you, we are doing.

Thank you.