

Remarks by  
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Thank you for the opportunity to join you at this important conference. Over many years, the OCC and the AICPA have built a fine collaborative relationship—and a necessary one, given the complementary and mutually reinforcing roles that bankers, external auditors, and bank examiners play in supporting, and reporting on, the health and stability of our financial institutions. These roles are spelled out in both law and practice: from the provisions of FDICIA that require a bank to certify, and an independent auditor to attest to, GAAP compliance of banks' financial reporting; to the review of internal control functions over financial reporting that is an essential part of every OCC examination. I'm committed to advancing our relationship through open communications, and it is in that spirit that I am with you today.

Since 2012, the OCC's National Risk Committee has been publishing a *Semiannual Risk Perspective*, a report that evaluates threats to bank safety and soundness. It is a document well worth reading for anyone with an interest in the health of the financial system.

The most recent of these reports was published in the spring, and it identified three areas of particular concern to us. The first is strategic risk, which we define as the

adverse financial consequences that can result from poor business decisions or poor implementation of business decisions. Where we especially see strategic risk rising is in the decisions of some banks to venture into new lines of business with the potential to generate higher profits—but also bigger losses—than in their traditional activities. As supervisors, we intend to make certain that when they expand into new products and services, banks are not reaching beyond their technical competence, risk tolerance, and capital adequacy.

The second area, which is a particular concern of mine, is operational risk—the risk that arises from failure in the performance of bank systems and bank personnel. During the financial crisis, many banks cut back their investment in this area, making it harder for them to keep up with emerging challenges in such areas as cyber security and regulatory compliance. We will continue to drive home to the industry the importance of operational vigilance—and continue to take appropriate supervisory action when we find that bank systems and controls are wanting.

Finally, there is the risk associated with the current environment of sustained but slow growth. In such times, we often see banks reaching for yield, taking on more interest rate or credit risk to maximize returns. In this environment, it is particularly important that banks maintain appropriate allowances for loan losses, and that is what I'd like to spend the rest of my time discussing with you today.

To begin, let me go back to last year, when the OCC, in public and behind closed doors, called attention to the decline in the allowance relative to the volume and value of the loans banks were charging off. We raised questions about the methodologies banks were employing to justify these reductions and whether the pace of reserve releases was

sustainable. And we expressed concern about the rate at which banks were reducing allowances as compared to observations about the current loan portfolio.

Of course, it is to be expected that banks will release reserves accumulated during difficult times as underwriting standards, loan performance, and the economic climate improve. Given the improvement that has taken place since the financial crisis, releases are certainly warranted. And, to the extent that higher profits enable banks to generate additional capital, they contribute to safety and soundness.

But for some banks, the ease with which the allowance could be repurposed as earnings has proved habit-forming. Last year we noted a growing disconnect between the pace and magnitude of allowance releases and underlying credit trends. Of particular concern to us was that significant reserve releases were continuing despite reports from our examiners that credit risk, as I mentioned earlier, was once again on the rise, with relaxed underwriting standards, pricing for risk, and more risk layering. It seemed to us a singularly bad time for banks to be scrimping on their allowances against their loan losses.

This was the message the OCC rolled out last fall. I spoke about it and so did the OCC's Chief Accountant, Kathy Murphy, in her presentation to this conference last year. Senior OCC experts joined other banking regulators and the accounting and audit oversight bodies in conducting outreach meetings with banks of all sizes, and their external auditors, to address trends, methods, and supervisory concerns about the appropriateness of allowance balances.

With these and other concerns in mind, the OCC also conducted a horizontal review of home equity lending, where we find repayment risk high and rising. Many of

the home equity loans originated before the financial crisis required interest payments only for a certain number of years, usually ten, before the loan either matured or began amortizing. As a result, many home-equity borrowers today face one of two disconcerting prospects: a balloon payment that will require them to refinance or substantially higher monthly payments. Refinancing may not be an option in the case of houses that are still under water, while higher monthly payments will impose a significant burden for people who, in the sluggish economy, have been unable to replace the jobs and salaries lost during the financial crisis. So we continue to remind lenders with significant exposure in this area that they need to prepare for the possibility of repayment problems down the road.

The OCC's initiative to flag imprudent allowance practices seemed to get the industry's attention. In the fourth quarter of 2012 and the first of 2013, the pace of provisioning expenses slowed at about the same rate as the decline in net charge-offs. But this appears to be an anomaly in the longer downward trend. During the subsequent quarter, the decline in loan-loss provisions again exceeded net charge-offs. And, again, this is happening despite loosening credit underwriting standards, which suggests that risks are increasing that may result in larger charge-offs.

I want to be clear: we are not talking about an imminent crisis. But there are steps we need to take to be transparent about the current impairment of the loan portfolio. These steps include reaffirming our commitment to supervisory vigilance and maintaining open and constant communication with key industry players like you. At the same time, we expect to see uniformly strong risk management, including prudent

allowance practices consistent with GAAP and regulatory guidance, in our banks--and especially in our largest institutions.

What we have seen also highlights the need for revisions in the way banks account for impairment so that bankers can start to increase—or at least maintain—reserves as the risks in their loan portfolios increase. That is why the OCC supports the thrust of the new standard on impairment measurement proposed by FASB in December 2012. I want to say a few words about why we believe the approach at the heart of FASB’s proposal—the “expected loss” model—is not only sound but preferable to the existing “incurred loss” regime. I also want to comment on what we think the impact of the new model, if adopted, will be on the institutions we supervise.

As you know, current accounting rules prevent banks from provisioning for an impaired asset until a “triggering event” occurs. In other words, banks must wait until the event has already occurred to recognize the loss. Banks use different methodologies to calculate asset impairment amounts after such an event takes place, and auditors and examiners both play a key role in evaluating and assessing the adequacy of the methodologies banks use to make these assessments.

The financial crisis revealed a distinct flaw in the incurred loss model. By requiring banks to wait for an “incurred” loss event to recognize the resulting impairment, the model precludes banks from taking appropriate provisions for emerging risks that the bank can reasonably anticipate to occur. The result too often has been the need for banks to make large loan loss provisions in the midst of a credit downturn, often when earnings and lending capacity are already stressed. This leads to pro-cyclicality and results in delayed loss recognition.

The simple fact is that no loan loss methodology would have kept us out of trouble during the financial crisis. Nonetheless, while forecasts must be used with caution, we should not dispense with them altogether, which is what the incurred loss model essentially requires us to do.

Don't get me wrong: past performance matters a great deal. No government agency knows this better than the OCC, which is marking its 150<sup>th</sup> anniversary this year. Without the perspective of history, we miss a key piece of the complex puzzle of understanding financial risks and how to deal with them. We need all the best tools at our disposal, looking back as well as looking forward, in an honest effort to get things right.

I believe that the basic principles behind the proposed FASB standard take us an important step in that direction. It would replace the current incurred loss approach with a new Current Expected Credit Loss model—CECL, for short—that would require banks to use historical information, current conditions, and reasonable and supportable forecasts to estimate expected shortfalls over the life of a loan. Further, the proposal would create one consistent measurement approach for all financial assets not accounted for at fair value through net income, thus simplifying the system of multiple credit loss models.

After careful review, the OCC and other banking regulators expressed broad support for the FASB draft. We remain concerned, however, about the operational impact the proposed standard may have on community banks, and have urged FASB to provide adequate implementation time for these smaller, less complex institutions and to modify disclosure requirements in light of the resource constraints these institutions face. We also have questions about how the model will work for debt securities, which we would hope that FASB will soon be able to answer.

Nonetheless, we have concluded that the FASB proposal is consistent with the goal of supporting and reporting on the balance-sheet integrity and the ability of financial institutions to fully consider all information, past, present, and future, and to do it early, when risks are building, in determining what amount of allowance is the right amount. In that respect, it mirrors the approach that has long defined the OCC's risk-based, forward-looking approach to supervision, an approach with which national banks and federal thrifts are thoroughly familiar. That familiarity alone should make the transition easier for national banks and federal thrifts.

Banks have viewed the FASB proposal with some trepidation, not only in regard to the implementation challenges involved, but also, and perhaps primarily, to the impact of the new regime on their allowance and capital levels. Some industry groups have suggested that the new standard will necessitate an increase of 200 or 300 percent or more in the allowance. Considering that many banks have already had to add capital in order to meet new regulatory requirements, such concerns are understandable.

But we believe they are exaggerated. There is no question that implementation of the FASB proposal will require most banks to boost their allowance. But the OCC's impact analysis showed that the increases would be far more modest —perhaps in the neighborhood of 30 to 50 percent system-wide if applied today. For some banks it will be more; for others, less depending on the loan portfolio and environment at the time of implementation.

Still, these numbers are significant, and I don't want anyone to think that we aren't sensitive to the cost and inconvenience of transitioning to the new system. But I want to point out that banks obtain important advantages in return: an allowance that is

more transparent and consistent with business results and risk management, and greater simplicity about how different kinds of financial assets are treated for that purpose. I also believe it would enable bankers to increase reserves as they see risk building in their portfolios. If the CECL model is implemented properly, the data it uses could assist banks in better pricing loans and pre-purchase assessments of investments. It could also lead to improved credit risk management and transparency to investors. We hope the industry will agree that these long-term benefits are worth the sacrifice today.

In any case, we have commented to the FASB that all financial institutions should be afforded sufficient transition time to train their people and reprogram their systems.

President John F. Kennedy used to say that “the time to repair the roof is when the sun is shining.” It’s an expression that has special resonance for bank examiners. Few of us would go so far as to call today’s uncertain environment “sunny,” but we have undoubtedly come a long way over the past five years in addressing the big backlog of deferred maintenance in bank regulation. Indeed, we are well down the road with perhaps the most comprehensive overhaul of the banking rules in the nation’s modern history.

None of this comes with a guarantee for a crisis-free future. But the steps proposed in the new accounting standard improve the chances that when credit quality turns down and risk turns up, as they are certain to do in the future, banks allowance levels will appropriately reflect the risks retained in their loan portfolios. We look forward to working with the AICPA to achieve those ends.

It has been a pleasure speaking to you today, and I will be happy to take your questions.