

Remarks  
by  
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Before  
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Of  
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It is a pleasure to be here with you today in San Diego for my third consecutive ABA convention since I took office as Comptroller in August 2005. It has been an interesting two years for me, to say the least, with a considerable number of credit issues, especially in the mortgage industry. In fact, both of my previous speeches before this convention dealt to a significant extent with credit, so it should come as no surprise that my remarks today will focus on recent problems in credit markets.

Needless to say, there has been a lot going on in these markets in the last six months, with several areas of severe disruption, and a number of residential mortgage lenders sustaining large losses that sometimes have led to bankruptcy. Fortunately, the banking system has weathered this period remarkably well thus far. I say this from the OCC's perspective as the primary supervisor of a quarter of the nation's commercial banks, including nearly all of our largest banks. Taken together, national banks hold approximately 70 percent of the total assets in our banking system, which gives us broad and deep perspective on your industry. So, it means something when I say, as I did in congressional testimony last month, that, despite recent turmoil in the markets for mortgages, asset-backed

commercial paper, and leveraged loans, the national banking system remains safe and sound. The combination of diversified earnings streams, stable sources of liquidity, sound risk management – and yes, what we believe is effective supervision – all of this has made it possible for banks to navigate through the shoals of current credit problems while continuing to make loans to their customers.

Does that mean we have no concerns going forward? Of course not – we’re regulators. It’s our job to have concerns, and we do have concerns, and that’s what I want to talk about today. In particular, I’d like to return to a familiar theme that I hope to cast in some new light based on recent events: the need for stronger underwriting. Or put another way, what I want to talk about is the need to return to what is perhaps the most basic credit underwriting principle of all: the need to underwrite loans so that they have a reasonable prospect of being repaid. That may sound incredibly obvious to you – it certainly does to me – but the events of this summer provide real evidence that banks, at least in some of their activities, have strayed too far from this first principle. Let me explain what I mean.

Two reports recently issued by bank regulators include important measures of underwriting quality. Both evaluate credits that banks had on their books in 2006 and early 2007, before the current market disruptions.

The first, issued jointly by the federal banking agencies, is the annual review of shared national credits – in essence, large syndicated corporate loans, including, but not limited to, the leveraged loans that have been so much in the news lately. In addition to our usual work in examining the classifications of these credits, we added a new twist this year: our expert teams of credit examiners reviewed the quality of underwriting of a representative

sample of loans in the survey, on a transaction-by-transaction basis. Taken together, the results were striking.

In terms of the usual review of classified and criticized loans – which I view as a “lagging” indicator – the results were not much different from what we had found the previous year. That is, the proportion of criticized and classified loans remained at historically low levels, reflecting the relatively excellent credit conditions prevailing through the end of last year. But the analysis of recently underwritten loans – a more forward looking indicator – was quite different. Here, examiners found that a surprisingly high proportion of the loans reviewed demonstrated what they described as “weak underwriting” – which in examiner-speak is quite strong criticism indeed. In fact, our examiners took to calling this part of their work their “ugly loan review,” which gives you a better sense of what they really thought about some of these credits -- that is, the ones that demonstrated weak to non-existing covenants, so-called “revolvers” with exceptionally lengthy tenors, and other indicia of the borrower being in the driver’s seat, not the lender.

Separately, just last week the OCC issued the results of our annual survey of OCC examiners regarding underwriting quality across a whole range of products – not just the large corporate credits covered by the shared national credit review, but also small business, commercial real estate, credit card, consumer, and residential mortgage loans. The fundamental results were consistent with both the findings of the shared national credit review and previous examiner underwriting surveys; that is, underwriting standards had eased once again in key parts of the loan portfolio, including leveraged lending and residential mortgages.

Now in some sense this is hardly a news flash – credit performance had improved over time, so lenders competed for customers by offering more relaxed underwriting terms to borrowers, and regulators, in turn, sounded a note of caution. The difference, however, is what actually happened to some of these credits during 2007, and especially in recent months. It began with significant losses on weakly underwritten subprime mortgages. That in turn precipitated concern and downright fear among credit market investors about the quality of underwriting in other products, for example, products where terms were perceived to have relaxed most – leveraged lending – or products where investor tolerance for relaxed underwriting was lowest – commercial paper backed by assets – or products where confidence in the credit rating agencies’ ability to accurately measure credit risk was most shaken – mortgage-backed securities of all kinds other than those guaranteed by the GSEs, especially those in complex structures such as collateralized debt obligations, where risk can be both opaque and magnified.

Given these observations, that is, weak underwriting leading to severe disruptions in the credit market, I have two questions: First, why haven't banks suffered worse losses? And second, what lessons have we learned about underwriting – that is, what are our “takeaways” for the future?

In terms of the first question, I’ve already mentioned part of the answer – banks have suffered fewer devastating losses in this period of stress because of better sources of liquidity, diversified lines of business, and stronger balance sheet capacity. But losses have also been mitigated by the simple fact that banks sold much of the credit risk they originated to third party investors – the so-called originate-to-distribute model – rather than holding the risk on their balance sheets.

In many ways, the originate-to-distribute model is positive. It allows banks to shed risk by transferring it to willing third parties; it disperses risk from a smaller group of originators to a much larger group of investors; and it enables loans to be extended to somewhat less creditworthy borrowers in those cases where investors are prepared to assume greater risk than the banks and other lenders that originate the credits.

Nevertheless, the originate-to-distribute model can also have decidedly negative effects, especially on underwriting standards, and that's the second issue that I want to focus on today. If banks as originators really believe they are shedding credit risk when they sell mortgages or leveraged loans to third parties, then their incentives to use caution and prudence in underwriting those loans can relax significantly. In other words, when a bank makes a loan that it plans to hold, the fundamental standard it uses to underwrite the loan is that most basic of credit standards that I've already talked about: the underwriting must be strong enough to create a reasonable expectation that the loan will be repaid. But when a bank makes a loan that it plans to sell, then the credit evaluation shifts in an important way: the underwriting must be strong enough to create a reasonable expectation that the loan can be sold – or put another way, the bank will underwrite to whatever standard the market will bear.

Now, in a perfect world with perfect markets, these two different approaches might not produce significantly different results in terms of the strength of the underwriting of a given loan or pool of loans. After all, investors don't want to purchase loans that are likely to default; they, too, will want to have a reasonable expectation of being repaid. Of course, some investors might be willing to take and hold more credit risk than a bank, which would allow the bank to underwrite a loan for sale with somewhat more relaxed terms than it would

for a loan it held on its books – but the underwriting could never be too much more relaxed, because the probability of default would increase too much.

Unfortunately, we don't live in a perfect world with perfect markets, as the events of this summer demonstrated. There plainly can be other, less benign reasons that cause underwriting standards for loans sold to investors to relax substantially from what they would have been if the lender had held the loan on its books.

For example, investors may not understand the credit risk of a loan or pool of loans as well as the originating bank – even when the investors are large and sophisticated and presumably capable of fending for themselves. That issue has come especially to the fore as sold loans have been packaged in ever more complex structured products such as multi-tranched securities, collateralized debt obligations, and combinations of these instruments. Not only do investors have to understand the risk of the underlying loans, but they also have to understand which slice of that risk they are actually assuming, and how much their risk has been transformed by the process of that slicing.

All of this sounds complicated, which it is, and that's exactly why investors as a market have demanded the services of a third party to help assess the risk of the securitized loans they purchase, which of course led to their very heavy reliance on the credit rating agencies.

Now, I am not going to provide an in-depth critique of the work of these agencies, which have done a great deal to promote increased liquidity and efficient markets, and indeed, have been indispensable to the development of the securitization markets and the benefits they provide. But I think it is fair to say that legitimate questions have been raised about just how well they assessed and understood the risks of some of the complex

securitized products they rated – especially where subprime loans were the underlying collateral – and that the subsequent losses experienced by these products have been considerably higher than expected.

My point is this: if investors that purchase loans have to rely heavily on the judgments of credit rating agencies, and if these judgments prove to be significantly wrong, then the loans these investors purchase may end up having much weaker underwriting than would have been the case if the originators of the loans had held them on their books. And in fact, recent events seem to suggest strongly that this was indeed one significant factor in the substantial decline in underwriting standards for subprime loans in 2005 and 2006.

Now, I'm not here to suggest that credit ratings were the only factor, because clearly others were at work. For example, with respect to subprime lending, investors appeared to overestimate the prospect of continued house price appreciation, and unregulated mortgage brokers in a number of states engaged in seriously questionable practices.

Nor am I here to suggest that securitization is “bad” or that the originate-to-distribute model is fundamentally flawed. To the contrary, as I said before, securitization has brought tremendous liquidity to credit markets, and it has made it possible to accommodate a broader range of risk appetites, which in turn has benefited borrowers at every income level. That is, many loans were made at a lower cost to a broader range of borrowers than would have been possible under the traditional buy-and-hold model alone. Moreover, to the extent that we have experienced significant problems with securitization and the originate-to-distribute model – as we plainly have over the last several months – markets are now taking steps to correct that problem, however sharp and painful.

And finally, I am most definitely not here to suggest that banks are primarily responsible for the worst abuses and losses arising from subprime credit, which have occurred largely outside the commercial banking sector.

But I am here to say that the originate-to-distribute model has created real pressure to relax underwriting standards in a broad swath of credit products that banks provide.

I am also here to say that bank underwriting standards for these products, in many cases, moved too far away from what they would have been if the bank had held those loans on its own books.

And perhaps most importantly, I am here to say that banks need to strengthen their underwriting standards so that they move back towards the fundamental principle of maintaining a reasonable expectation that loans will be repaid, even if the loans are to be sold to third parties – and that goes for mortgage loans, leveraged loans, or any other syndicated credit.

That does not mean that credit standards should be identical to what they would be if banks held the loans on their books – because there are differences in risk tolerances that are legitimate and useful in matching willing lenders to riskier borrowers. But it does mean that banks simply cannot cede underwriting standards to the market. Instead, there must always be that first principle of underwriting – the credible prospect of repayment – at the heart of their lending decisions.

Having said all this, a critic might ask this question: why should banks care about relaxed underwriting standards if sophisticated third parties are willing to assume the risk by purchasing the loans? I think there are many reasons, but let me offer three:

- Because they could be stuck holding a pipeline of weakly underwritten loans when markets seize up – as some banks have learned the hard way with leveraged loans over the last several months.
- Because banks often retain some part of the risk when they sell loans to third parties, as is true in the syndicated loan markets.
- And because reputation risk and concern for future market access may cause banks to take back loans or their risk in times of stress, as we've seen with some of the pools of subprime loans sold to third parties.

At the OCC, we are already taking steps to address these issues. For example, along with other regulators, we have issued guidance on both subprime and nontraditional mortgages. Where such loans are originated for sale to the secondary market, our examiners expect banks to use the guidance as their benchmark in not ceding underwriting standards to the third party purchasers of the loans -- they can deviate, but only so long as the risk differences are manageable.

We have also asked our large bank examiners to encourage agent banks to underwrite funding commitments in a manner that is reasonably consistent with the standards they would use if holding the loan on their own books. As I said, the standards don't have to be identical, but banks using the originate-to-distribute model should have risk management systems that measure, monitor, and control the underwriting differences between this and the more traditional buy-and-hold model.

In addition, with respect to leveraged lending, we have asked our examiners to review with banks the expectations we have set forth in existing supervisory guidance. We want examiners to communicate areas of noncompliance to bank management and, if appropriate,

to cite them as Matters Requiring Attention in exam reports to achieve improvement in underwriting standards and risk management practices. Moreover, examiners will scrutinize loan commitments that are underwritten without an adequate assessment of the borrower's capacity to repay to determine whether they should be subject to supervisory criticism. And they will ask national banks to assess the impact of weakened underwriting standards on the assumptions used in calculating loan loss reserves.

In the end, there are a number of sound reasons for banks to avoid straying too far from sound underwriting – and if that's a lesson that we take away from recent market disruptions, as simple as it sounds, then we will all have learned a great deal.

Thank you very much.