Remarks

By

Darrin Benhart

Deputy Comptroller for Credit and Market Risk

Before the

Mortgage Bankers Association's Risk Management and Quality Assurance Forum 2013

Phoenix, Arizona
September 11, 2013

Good morning. Thank you for that kind introduction. It's a great pleasure to be with you today here in Phoenix. I am proud to be joining Deputy Assistant Secretary Coulter from the Department of Housing and Urban Development to discuss how risk and risk management are evolving in our industry. I say "our industry" because whether you are a regulator, a mortgage banker, a mortgage servicer, or a mortgage customer, risk has a way of affecting all of us. As Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency (OCC), I have a particular interest in the evolution of risk associated with housing finance because we supervise some of the largest players in the industry as well as community banks and savings associations that are instrumental in the recovery of the market. As the last crisis showed, the health of the mortgage market is an important barometer of the economy as a whole, and that is why assessing risk in the mortgage area is a key focus of mine. My group helps ensure our policies appropriately address concerns regarding these risks, so examiners are focused on the behaviors and practices national banks and federal savings associations need to mitigate risks, and so the institutions we supervise understand their responsibilities for managing those risks. I know all of you are keenly aware of the responsibility you have to manage the risks associated with the products and services you offer and the investments you make in the industry. While you may not always see it this way, regulators also want a strong, stable housing industry – and we believe understanding and managing risks are critical to achieve that goal. That is why the OCC provides a number of resources that can help you understand the risks facing both your institution and the industry. For national banks and thrifts, your local examiners-in-charge and associate deputy comptrollers can share their perspectives based on their knowledge of practices and risks across a wide number of banks. We also publish a number of valuable resources that pull together insights from the more than 2,000 national banks and federal savings associations we supervise and data from a variety of other sources. Two particular resources I'll highlight for you throughout my remarks today are the OCC's *Semiannual Risk Perspective*[1] and the OCC's *Mortgage Metrics Report*.[2]

This morning, I want to spend some time discussing insights from these two reports—I'll first talk about the risks facing the broader banking industry and then trends we are seeing specific to mortgage lending. Then I'll conclude by discussing some of the regulatory reforms underway aimed directly toward mortgage lending.

The OCC's Risk Perspective for the Industry

Within the banking industry, there is a great deal of data to be optimistic about. The financial performance of federally chartered institutions improved in 2012 and the first half of 2013. Profitability increased to its highest level since 2006, and asset quality improved at both large and small banks as problem assets continued to decline from their peaks of early 2010.

[1] See http://www.occ.gov/publications/publications-by-type/other-publications-reports/index-semiannual-risk-perspective.html.

[2] See http://www.occ.gov/publications/publications-by-type/other-publications-reports/index-mortgage-metrics.html.

There is moderate loan growth, although it remains concentrated in commercial and industrial (C&I) loans, and stronger capital and liquidity levels have positioned banks to support a recovery.

But this is not a speech about opportunities, it is a speech about risk, and despite the progress we've seen, the overall forecast for the banking industry remains partly cloudy. Slow growth in revenue and core profits continue to weigh heavily on banker optimism. Low interest rates, narrow loan demand, and lower fee income hinder stronger revenue gains. Short-term interest rates remain at or near historic lows and continue to squeeze net interest margins, while the recent uptick in longer-term rates has heightened concerns about increasing interest-rate risk and has significantly slowed the mortgage refinance market.

Given this environment, the OCC highlighted three key risk themes in our most recent *Semiannual Risk Perspective* banks should understand and seek to mitigate (See figure 1). First, strategic risk continues to increase as bank management searches for ways to generate acceptable returns. Some banks are looking to new products and services that can present unfamiliar risks for which they may lack the requisite expertise, management information systems, and risk controls. Specific to the mortgage industry, more players, especially some community banks, are entering the mortgage origination business to generate loan volume and more fee revenue. Banks are also strategically exiting or reducing their servicing businesses in response to heightened compliance expectations and earning considerations.

The second broad theme is the challenges that arise in a period of sustained but slow growth as we are now experiencing. In this environment, many banks and investors begin to "chase" yield, often taking on more interest rate or credit risk to maximize return. We are beginning to see signs of the classic cyclicality in banking where traditional lagging indicators are improving so bankers start to layer risk back into the system. For example, as competition for limited C&I lending opportunities has intensified, we have seen underwriting standards slip and pricing for risk reduced. This is especially pronounced in the leveraged-lending market. Similarly, while originations in the conforming mortgage market remain very high quality, the average rate on jumbo mortgages, a traditionally riskier product, recently dipped below conforming mortgages. These are both examples of changing risk appetite in the market.

The third broad risk theme involves operational risks. Operational risk has been a focus of the Comptroller since taking office last year and continues to be a major challenge facing banks of all sizes. Among the operational risks growing in the system today are increasingly sophisticated cyber threats, expanding dependence on technology, and changing regulatory requirements. Some of the failures that really brought operational risk to the forefront of regulators' attention came in the mortgage industry itself. This was a particularly dark chapter in the mortgage industry, but it was an informative one. Lessons from that experience are helping to improve risk management processes and systems used today, and in some ways you may have a leg up in your appreciation of operational risk over other lines of business.

Outlook for Mortgage Lending

Let me shift my focus to trends in mortgage lending and the performance of mortgage portfolios among the banks and thrifts we regulate.

Overall, the industry continues to experience an unprecedented period of runoff in residential mortgages but that trend is moderating (See Figure 2). Through the end of 2012, the contraction of residential mortgage credit had extended for 19 consecutive quarters (from the second quarter of 2008 through the end of 2012), and the total volume is down 12 percent since peaking at over $11trillion at the end of March 2008.

What's driving the contraction? Households are reducing their mortgage debt through payoffs and, more significantly, through elevated defaults as troubled mortgages continue to work through the system. These effects far outweigh any increase in new mortgage demand. Although existing home sales have shown recent growth, these sales often result in a transfer of debt, rather than new growth. Many of you know all too well how competitive the market remains.

While trends in originations have improved since the crisis (see figure 3), originations and refinancing have begun to slow as key mortgage rates have ticked upward. Data from this conference's host—the Mortgage Bankers Association—show refinancing applications have dropped 62 percent since early May. Over that same time, applications for loans to purchase a home fell 16 percent (see figure 4).

As regulators, we focus not only on trends in originations but also on the performance of existing loans. In recent years, the performance of mortgage loans has served more as an anchor than an engine to growth, but there are signs of that turning around.

In 2012, the housing market showed improvement from increased investor demand and the limited supply of new and existing homes for sale. New-home inventories remain at a 50-year low, and many markets are back in balance as the large surplus of distressed mortgages has diminished. The S&P/Case-Shiller National Index shows home prices up over 10 percent year-over-year through June 2013. Nonetheless, the 20 city composite index remains almost 23 percent below the 2006 peak, and distressed sales continued to account for a large percent of sales. In addition, home price appreciation in some large MSAs is increasing at a pace that isn't consistent with other economic indicators. This situation raises potential questions about the sustainability of the pace of appreciation, a factor that we will be monitoring.

There has been steady improvement in the performance of mortgages serviced by the banks and savings associations we regulate as reflected in data we report quarterly in the *OCC Mortgage Metrics Report*. While the report only reflects the performance of mortgages serviced by eight institutions, these institutions comprise 55 percent of all mortgages outstanding in the United States. The next report comes out this month, but numbers from the first quarter of this year showed slightly more than 90 percent of mortgages were current and performing at the end of the quarter. The last time the percentage of current and performing loans was above 90 percent was the third quarter of 2008. On balance sheet delinquency numbers are slightly above those in the servicing portfolio.

Seriously, delinquent mortgages—those mortgages that are 60 or more days past due or held by bankrupt borrowers whose payments are 30 days or more past due—also fell to their lowest level in five years to 4.0 percent of the overall portfolio. While these numbers have improved, there are still more than 900,000 loans in the process of foreclosure, which will remain a significant risk to the housing recovery, especially in judicial foreclosure states.

Another concern is the performance of junior liens (See Figure 5). To-date, delinquency levels for this product line have remained relatively steady. However, we believe delinquency rates may soon tick sharply upward as a significant number of HELOC loans reach the end of their draw period—when borrowers no longer have access to credit lines and when their monthly payments will increase because of amortization. I'll talk more about this issue when I cover some of our areas of emphasis for next year.

In summary, the condition of mortgage lending is a mixed bag: improvements in first-lien performance, some growth on the horizon, but significant headwinds from growing risk associated with junior liens, elevated delinquencies and higher interest rates.

Regulatory Reform and Mortgage Lending

Now, let me shift from discussing the condition and risks of mortgage lending to the topic I think you may be most interested in—the variety of regulatory changes facing the mortgage industry and some emerging areas of supervisory emphasis. I know many of the conference sessions will cover the regulatory reforms in more detail, but I also wanted to mention them because of their risk management implications. As you well know, the list of mortgage related reforms is extensive, ranging from updates to Regulation Z, Regulation X, compensation parameters, appraiser independence, to two of the most significant reforms, Qualified Mortgage (QM) and servicing standards that are finalized and slated to go into effect in January. One additional rule, the Qualified Residential Mortgage (QRM), which is part of the broader risk retention rule, is still proposed, and a number of proposals are before Congress on GSE reform.

These reforms mean you will need an even greater emphasis on risk management techniques that not only look at credit risk but also encompass operational and compliance risk. Many of you are making strategic decisions around how your institutions will participate in the mortgage industry going forward. A key part of your decision-making process needs to include the build-out of a strong risk management function to ensure compliance with the myriad of new rules. In the past, credit risk, operational risk, compliance, audit, and quality control functions sometimes worked in silos. As a result, the systemic nature of problems across different products, platforms, or risk areas often went unnoticed until the issue was significant. Risk management groups today need to be multi-dimensional, and banks need a culture that promotes risk identification across business lines. I would also point out that complying with the new rules doesn't negate the need for other safety and soundness controls in place. For example, the

QM standard establishes an ability to repay safe harbor, but it does not address other relevant underwriting criteria such as loan-to-value (LTV) or credit history, which are key drivers of long-term loan performance.

Let's briefly move onto QRM. While I can't say much about QRM since the rule was just re-proposed on August 28, I do want to point out that the re-proposed rule has some very significant changes as a result of the thousands of comments we received. The most important change is the alignment of QRM with the CFPB's QM. The QRM re-proposal also solicits comments on an alternative definition of QRM that incorporates certain credit underwriting standards not included in the CFPB's definition of QM. This alternative, called the QM-plus approach, uses the core QM criteria to define QRM but requires lenders to evaluate three more aspects of the loan's underwriting. These relate to requirements for first-lien status on a borrower's principal dwelling—a 70-percent LTV and assessment of a borrower's credit history. I encourage all of you to speak your minds about the re-proposal through the comment period that runs through the end of October.

In addition to finalizing new rules, there are a couple other areas of focus for the OCC in the coming year I want to highlight for you. First, we have done extensive work in our largest institutions to assess the risk associated with the HELOC end-of-draw issue I highlighted earlier. (See figure 6). This was on our radar since early in 2012, and we first highlighted this to the industry in our Spring 2012 *Semiannual Risk Perspective.* Institutions are in varying stages of preparing to respond to this risk, so there is still work to do. We have stressed that banks offering HELOC products should establish processes to quantify and address this risk of increased delinquencies and losses. Taking action now will provide greater flexibility for borrowers and will allow banks to manage this portion of their risks more effectively.

Second, we have recently completed reviews in a number of institutions of all sizes—community, midsize, and large banks—of the collateral valuation process. Much of the industry's focus over the last several years was on modifications, foreclosure processes, and servicing issues. The appraisal and evaluation areas probably didn't get as much attention, which may be one of the reasons, in a number of institutions, we found weak governance of these programs. (See figure 7). These weaknesses ranged from concerns about the qualifications of the personnel charged with implementation to a lack of audit, quality control, or internal control functions to assure the appropriate performance of the program.

I'm not going to touch on each of the weaknesses you see on the slide but I did want to give you a couple of examples. We sometimes found little oversight of appraisal management companies (AMCs). In some cases bankers didn't understand how appraisers were selected and engaged on behalf of the bank. This is a critical function where effective oversight was missing especially when the function was outsourced.

We also found shortcomings in the development, reporting, and review of evaluations. Prepackaged products, some of which claimed to be "guidelines compliant," lacked even the basics—no opinion of "market value," unsigned and undated reports, even generic assumptions about the actual physical condition of the property, items we specifically addressed in the 2010 guidelines. We saw the output of an automated valuation model or AVM stapled to a third-party report without any real evaluation, analysis, or validation of the automated valuation model itself, placed in the file.

Lastly, we found deficiencies in the review process for both appraisals and evaluations. Problems ranged from independence, qualifications, and training of reviewers to the scope and depth of reviews. These findings resulted in several matters requiring attention for these banks and show the need for risk management to remain focused on the basic blocking and tackling items in addition to the new regulatory requirements.

Conclusion

Let me close by stressing that not all the news is bad. There is steady improvement in the performance of mortgage portfolios overall, and banks are well positioned to participate in an economic recovery. However, we must remain vigilant not to let unmanaged risks slip back into the industry. Communication with your regulator is key especially as new regulatory reforms come online. Finally, you need to ensure your risk management function is multi-dimensional and looks at all risk across the entire bank. That requires work both by regulators and by industry participants. Thank you.

OCC Presentation to the Mortgage Bankers Association Risk Forum

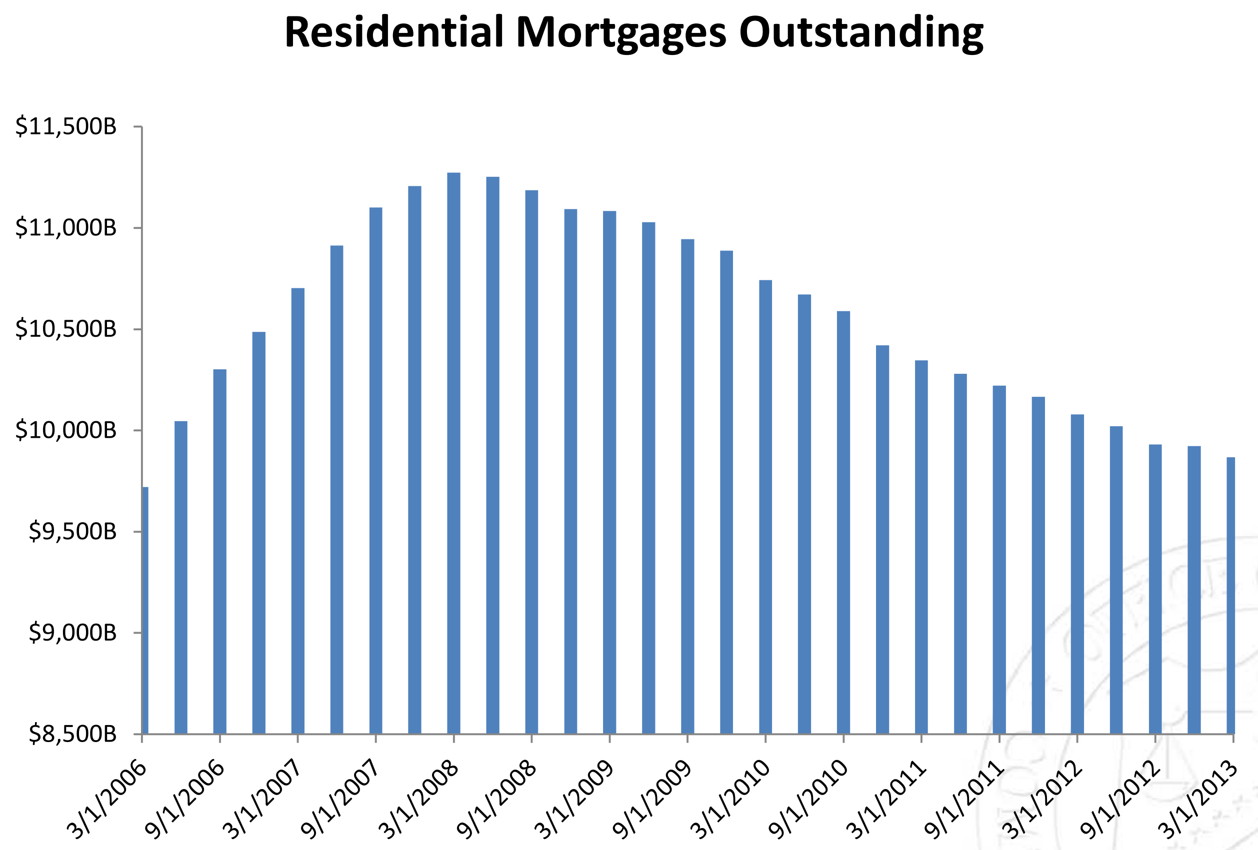
September 11, 2013

Figure 1

OCC Semi-Annual Risk Perspective

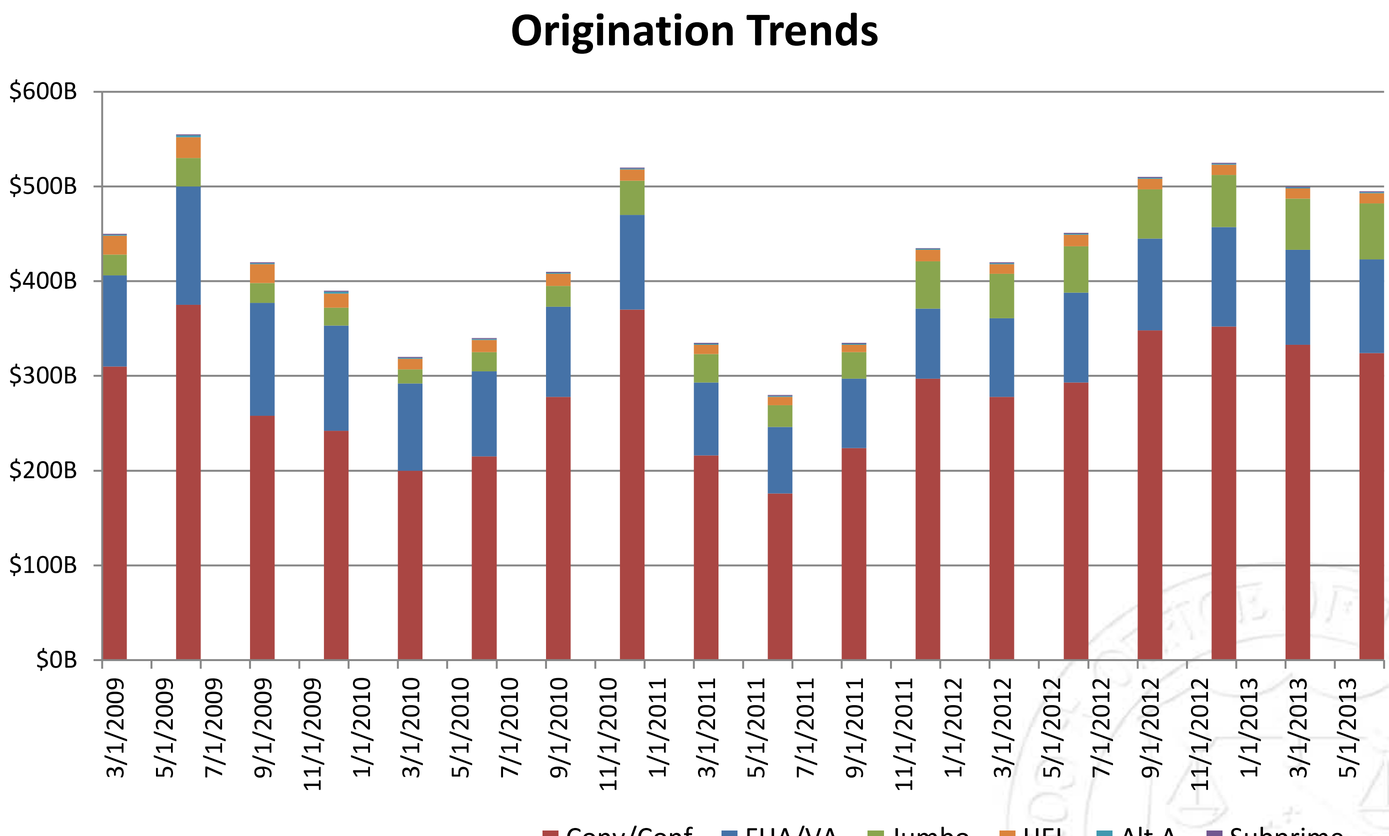
- Strategic Risk
- Reach for Yield
- Operational Risk

Figure 2. Mortgage Trends



Source: FRB Financial Accounts

Figure 3. Mortgage Trends



Source: Inside Mortgage Finance

Figure 4.
Applications for Refinancing and Origination

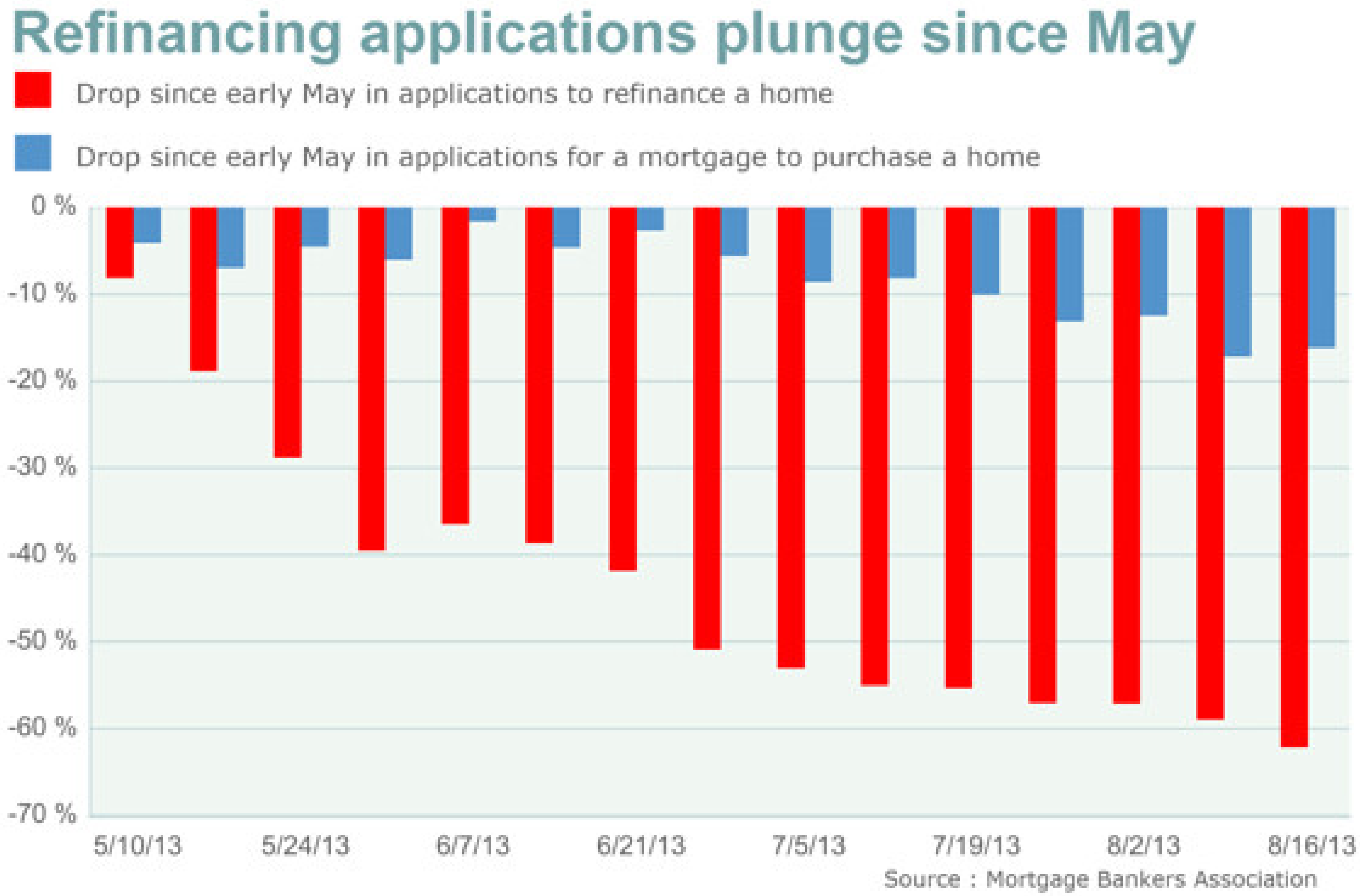
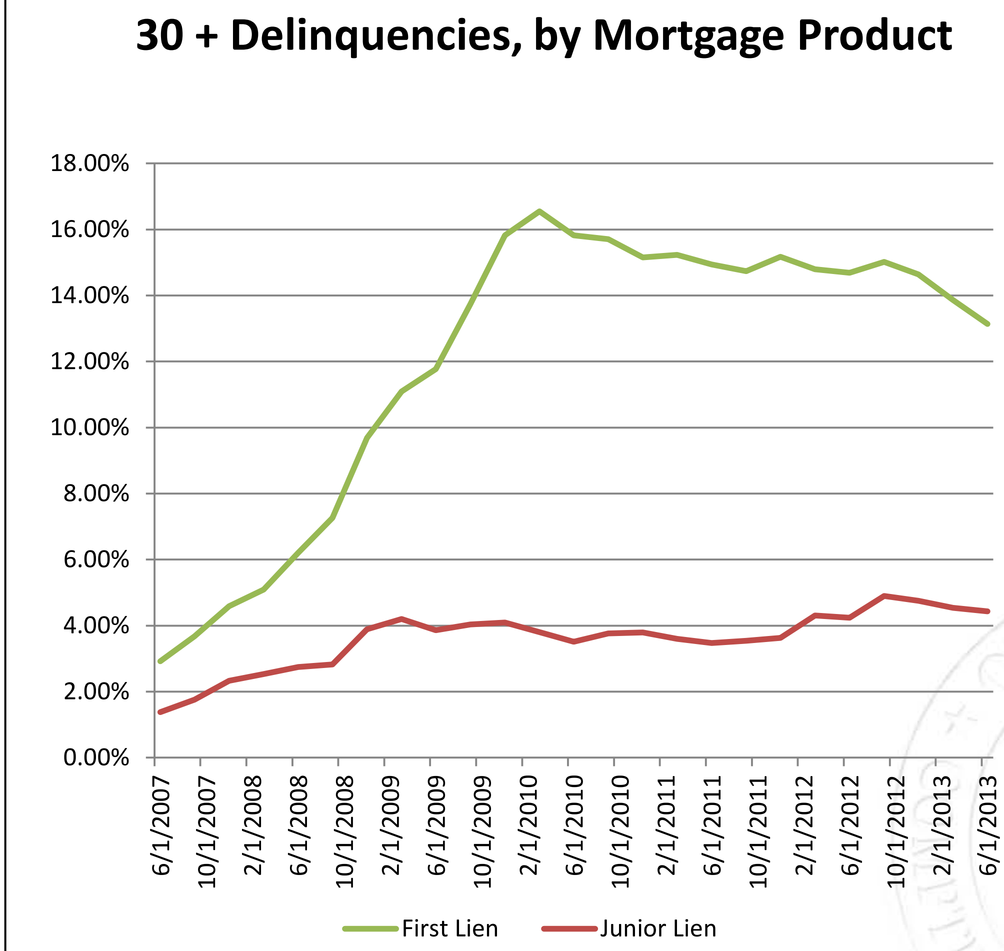
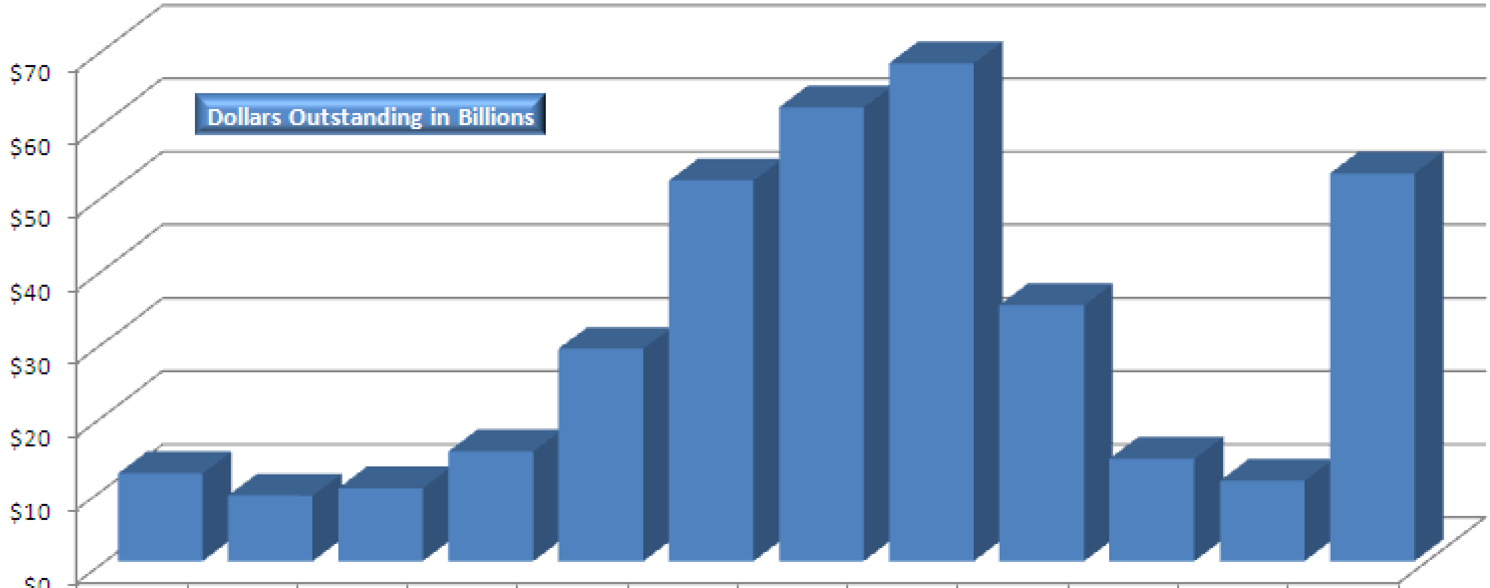


Figure 5. Mortgage Delinquency Rates



Source: OCC Integrated Banking Information System

Figure 6. HELOC End of Draw



	<= 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 +
EOD Year	$12	$9	$10	$15	$29	$52	$62	$68	$35	$14	$11	$53

Figure 7.
Residential Real Estate Collateral Valuation

Most common issues include:

- Weak governance
- Inadequate appraisal/evaluation policies
- Staffing/Organizational Issues
- Inadequate oversight of third party appraisal management companies (AMCs)
- Shortcomings in evaluation development and reporting
- Issues with AVM Validation
- Deficiencies in appraisal and/or evaluation review process