Remarks by
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I come to you this morning with some good news and some bad news. I'm going to start with the good news, in the interests of putting you in a positive frame of mind -- and of putting what follows into more meaningful perspective.

It's almost impossible these days to avoid reports about the decline in asset quality in bank portfolios. You can track this decline in the press, in its migration from the sidebars to the headlines and into the consciousness of some of the nation's senior pundits and economic policy makers. Almost every week, some bank announces a new round of write-downs and charge-offs, followed by solemn pronouncements from the analysts that things are going to get worse before they get better.

At the OCC, our own data, reflecting the experiences of commercial banks of all sizes, confirm this weakening. The year 2000 was the third consecutive year of increase in the volume of large syndicated credits that were criticized in our annual interagency review. And that increase came about in a rapidly growing economy. Econometric models show a rise in default risk among publicly traded U.S. companies -- and, therefore, a rise in credit risk in the banking system at large. Now, with the economy in a slowdown, one investment firm projects a 50 percent increase in loan losses this year over last. And with that increase, the overall ratio of loan loss reserves to loans has eroded -- from about 2.5 percent in 1993 to just over 1.5 percent last year. Future earnings will almost certainly be impacted by the need to bolster loan loss allowances.

You're probably thinking, "if that's the good news, I don't want to hear the bad news." But there is good news for you here. First, we believe that the banking industry generally is better positioned to withstand these problems than it's been at almost any other time. Second, community banks are generally much better positioned than their larger counterparts.

Certainly, the capital strength of the industry is now far better than it was ten years ago. Total equity capital today stands at more than twice what it was a decade ago, and the related ratios -- capital to assets and capital to loans -- are also much healthier. Clearly, bankers have internalized a key lesson of the 1990s -- that it's possible to meet all the regulatory capital requirements and still not have the level of capital you need to weather a time of great stress. Indeed, at a recent OCC conference, the highly respected former CEO of one of our major banks said that one of the great lessons he learned over the past decade was the critical importance of maintaining capital ratios appreciably in excess of what we bank supervisors required. Never again, he said, would he let capital fall to even the highest level defined by the regulators.

We also believe that the industry is structurally stronger. Consolidation over the past ten years has given us a banking system that should be more stable and more resistant to downturns. Certainly the whole industry is more diversified than it was a decade ago. Although community banks are still subject to some inherent limitations in this regard, the kinds of deep sectoral and geographic concentrations we saw in the early 1990s -- concentrations that proved fatal for many banks -- are much less common today.

In addition, noninterest income has come to play an increasingly important role in the composition of bank earnings. The industry has taken advantage of changes in the law and regulations to offer new products and services, thus diversifying their income streams and reducing their dependence on volatile net interest income.

This movement toward diversification has come as part of a dramatic overall improvement in most banks' risk management and mitigation capabilities. Bankers today -- and not only the largest banks -- are using more sophisticated analytical tools and computer models to manage increasingly complex risks. And bankers, even community bankers, have far greater opportunity through the use of syndication and credit derivatives, and through the securitization markets, to design and structure the types of balance sheets and business franchises they desire.

We in the regulatory community have given a great deal of thought to the lessons of ten years ago. Our handling of the crisis of the early '90s was widely criticized for inconsistency -- for undue supervisory forbearance when problems first appeared, followed by draconian reactions when those problems had matured to the point where they could no longer be ignored. When banks showed reluctance to provide credit even to creditworthy borrowers, supervisors were blamed for creating a "credit crunch." I happen to believe that credit crunches are caused by conditions in the economy, and by banks that make economic decisions based on their own self-interest, and not by bank examiners. I also recognize that regulators can become an easy scapegoat for bankers to point to when they have decided for their own reasons to tighten up.

Nonetheless, we learned a lot from that experience, and we recognize the value of a supervisory approach that is more modulated and predictable. Since becoming

Comptroller, I've emphasized the importance of fashioning a carefully calibrated response to changes we see taking place in the banks we supervise. But that does not mean sitting by silently as conditions deteriorate. It means addressing problems as we see them developing -- while we still may be able to do something about them -- and doing so consistently and in a measured way. Both in public and in our private meetings with bankers, we have addressed issues of declining underwriting standards and eroding credit quality, and we will continue to address these issues, keeping in mind the need to do so in a balanced manner. The greatest contribution we as bank supervisors can make to the maintenance of a healthy economy is to do what we can to help preserve the ability and capacity of our banks to extend credit to creditworthy borrowers.

Clarity is a hallmark of good communications, and we're certainly spending more time talking to the industry, explaining our policies, and providing opportunities for bankers to raise questions and express their concerns. Today, if bankers think something has gone wrong in the examination process, they can seek review by the OCC Ombudsman -- an option that did not exist ten years ago. More recently we have introduced National BankNet -- an extranet web site available exclusively to national bankers. BankNet now not only provides useful analytical tools, industry and risk updates, "best practices" presentations, and internal OCC reports, but a means of communicating directly with me, by e-mail. It will soon enable national banks to prepare branch and relocation applications on line and submit them electronically. And in the very near future, BankNet will handle the majority of routine transactions between the OCC and national banks, and give the industry the power to file electronic comments on regulatory proposals. This is a major improvement in the ability of bankers and regulators to communicate with one another, and it should result in improved understanding and cooperation as we enter these more challenging times.

Technology has also enhanced our ability to spot problems brewing in the banking system so that we can call early attention to them. Early in my tenure as Comptroller, I initiated a major effort to improve our early warning tools. We dubbed it "Project Canary," alluding to the practice of coal miners who brought canaries down into the mineshafts with them to detect dangerous gases. Through this effort we have developed a series of financial ratios and measures that correlate with high levels of credit, liquidity, and interest rate risk. By applying these measures to our population of banks, we can make better judgments about what problems may arise and how we can deploy supervisory resources more efficiently.

Our approach to identifying, rehabilitating and resolving banks under stress is described in detail in an excellent new OCC publication dealing with problem banks. It represents the distillation of year's of experience, and should be especially useful to examiners -- and to bankers -- who haven't lived through times of banking turmoil.

Inevitably, the deterioration in the quality of bank portfolios that I mentioned earlier has affected some banks more than others. Few community banks, for example, hold many of the speculative-grade, highly-leveraged, and poorly underwritten assets, especially those backed by so-called enterprise value, which have been hardest hit of late. Indeed, the level of troubled loans at community banks has been relatively stable. While the percentage of non-current commercial loans at national banks with over $1 billion in assets nearly doubled over the last three years -- from 0.73 percent to 1.38 percent -- it dropped from 1.63 to 1.59 percent at smaller banks over the same period. Similarly, loss rates at large banks have gone from 0.17 percent to 0.63 percent, which is just about where they've been for small banks since 1997.

I'm sure you have your own theories to account for this discrepancy in the performance of large and small banks, and I have a few theories of my own. It may well be that community banks are especially conscientious when it comes to minding the fundamentals of sound banking -- keeping your ear to the ground, being responsive to your customers, working with borrowers in a hands-on way at the first signs of strain, pricing loans and other products for risk, and establishing a rigorous internal control environment. Most community bankers do not have the kinds of pressures faced by large institutions with widely held share holdings -- including a battery of analysts who follow your stock and punish you for missing earnings targets by as little as a penny a share. As a result, you are better able to focus on long term values in a way that will bring enduring benefits to your shareholders.

But let me caution that no one become too smug or complacent. It is not difficult for the problems afflicting larger banks to spread from big borrowers to small ones and from employers to employees -- in other words, to your customers. The sequence is a familiar one: a big company defaults on its debt, or implements austerity measures, or lays off workers, and the purchasing and debt servicing power of those workers is reduced. That's when the pain is likely to start showing up in your portfolio and bottom lines.

So what you've got, really, is a window of opportunity -- time to take prudent, pro-active steps to prepare for what may come, and to mitigate the effects of future adverse changes. How much time depends, of course, on the length and severity of the slowdown in the economy. If it turns out to be a mere interlude before the economy regains its momentum, you may be able to escape with only minor bruises.

For many community bankers, the test will be in how you use this window of opportunity. It may mean doing more of what you've already been doing -- paying closer attention to your customers and their individual financial condition, and tightening board and management oversight; continuing to build capital and reserves; identifying and addressing vulnerabilities and excesses in the loan portfolio; making fuller use of whatever risk mitigation tools are available, including government guarantee programs. And, to prepare for the possibility that credit problems do materialize significantly, it makes sense to evaluate your work out capabilities to ensure that problem loans can be resolved in an orderly way.

This is also probably a good time to review your contingency funding plans. I know how difficult it's been for many community banks as core deposits have dried up and reliance on wholesale funding has grown. While this transition has not been without its benefits, including greater diversification and flexibility, it also exposes banks to volatility in the event that the market turns against them. That's another reason why it's so important that community banks act decisively to put their houses in order now, to gain and keep the confidence of the financial community.

While some bankers might prefer that examiners ease off in their criticisms of problematic loans, the task of bank supervision is to give you our best assessments of the quality of your portfolios. I think we have been doing that extremely well, and a number of bankers, representing large and small institutions, have told me that the OCC's balanced and consistent approach has helped them to focus on credit risk problems and to improve deficiencies in risk identification and risk management. You can count on us to maintain this consistent and carefully modulated approach -- calling things as we see them -- in the coming months.

In business as in sports, defense usually trumps offense. This year's Super Bowl champions reminded us of how true that is. For bankers, too, success in challenging times begins at home, with strong risk management, robust internal controls, and a no-nonsense approach to credit quality. There's still time to make sure that your defenses are in order, so that next year, there will only be good news for us to share.