It would be a gross understatement to say that the past year has been a trial for our country. Yet I’m firmly convinced that we’re stronger today than we were before the terrorists struck on September 11 – and before the string of corporate collapses that have done such grave damage to public confidence in our markets. Around the world we’re confronting our enemies. At home we’re coming to terms with abuses of corporate power that have cost many Americans their jobs, their pensions, and their investments – and, worst of all, their faith in the fairness and rationality of our economic system.

Crisis has always been a powerful catalyst for reform, and that’s no exception today. Major companies in every field are cleaning up their balance sheets, facing up to previous shortcomings, improving the quantity and quality of the information they disclose, and embracing a variety of other measures aimed at restoring public trust.

A notable example has been the growing number of corporations that have said that they would start accounting for stock options as an expense. Their competitors will almost certainly face pressure -- from the marketplace if not eventually from those who enforce the securities laws -- to follow suit.

Sometimes small things can make a difference, and I believe that this issue of the proper accounting for options may be one of those cases. For quite a few years I have been encouraging bankers to focus less on short-term performance and more on long-term value and the stability of
their institutions. Similar concerns have been voiced by many of my colleagues throughout the regulatory community. But it’s sometimes difficult to make that case when executive compensation is closely tied to current stock prices. I recently read of one large institution whose CEO said with some pride that his sole compensation came in the form of stock options. That does not seem to me to be a very wise approach. To be sure, when the market for the company’s stock is booming, such a CEO may bask in the glow of great wealth, at least wealth on paper. But there may be perverse incentives when the stock price falls – such as the incentive to reach further out on the risk spectrum in order to bolster earnings, or to engage in questionable accounting practices for the same purpose rather than hunkering down and addressing fundamentals, or taking actions that may preserve value for the future even at the cost of short-run hits to earnings.

It’s also difficult to take the long-term focus when stock analysts are preoccupied with quarterly earnings targets and the market exacts severe penalties when targets are missed by a few pennies a share. But history shows us that those institutions that have taken the long view – that have been willing, for example, to accept an impact on current earnings in order to build up prudent loan loss reserves – are the ones that come through periods of economic stress in the best condition.

The primary impetus for corporate reform, however, is not coming from individual corporations, but from government at various levels, as well as from leading industry organizations. On July 30, as you know, the President signed into law the Sarbanes-Oxley Act - perhaps the most important piece of corporate reform legislation since the Depression. It amounts to a sweeping new framework for corporate governance: requiring, for example, that CEOs and CFOs return incentive-based compensation and trading profits following accounting
restatements; accelerated reporting of insider transactions, whistleblower protections, better disclosure of off-balance sheet transactions, auditor independence and rotation, increased frequency of SEC review, and much more.

Couple that with President Bush’s initiative to root out financial crimes and stiffen sentences for corporate criminals and the recent actions of the SEC – including the requirement that senior officials personally certify the accuracy of financial statements – and I think we’ve sent an unmistakable message that previous standards of corporate conduct need to be reexamined.

It’s important to keep in mind, of course, that the objective here is not simply corporate morality, in the abstract. The primary purpose is to preserve the confidence of investors and the public generally in the integrity of our markets – markets whose depth and transparency have been envied around the world.

High on the list of current concerns – and properly so – is the role of boards of directors in the overall picture of corporate governance. In many cases there’s a gap between what the board is supposed to do and the role it actually plays. In the past it was not uncommon for outside directorships to go to people having connections that might be useful to the company and who were not likely to rock the boat. And it’s just as troublesome when companies appoint competent and experienced people to their boards and leave them there to languish – unheeded, unnoticed, and uninvolved. “In all the years I’ve spent on various boards,” one frustrated and disillusioned corporate veteran has written, “I’ve never heard a single suggestion from a director that produced any result at all.”

But attitudes have clearly been changing and that disillusioned directors’ experience may not be typical today. The best corporate managers have come to realize how important a
conscientious and knowledgeable outside director can be, and particularly in today’s environment I believe there is a much higher level of awareness in corporate America of the significant contributions that first-rate directors can make. And there are heartening signs of responsiveness from standard setters -- once again crisis has been the catalyst for action. One of the key recommendations in the package recently released by the New York Stock Exchange calls for listed companies to ensure that a majority of board members – instead of at least three, as mandated under present rules – are independent of the company. Furthermore, the Exchange recommends that the audit, compensation, and nominating committees should consist entirely of independent directors. And it calls for independent directors to meet at regularly scheduled executive sessions – without the presence of management.

Financial services firms, of course, are just as vulnerable as any to managerial misconduct – maybe more so, given the nature of their business. That’s why bankers like you operate under the most stringent and comprehensive regulation of any industry in the country. That includes a host of very specific provisions defining and restricting the relationship between financial institutions and their insiders, including directors.

That’s also why some industry leaders – including the leadership of the ABA – have argued that some of the initial proposals of the New York Stock Exchange regarding the independence of directors should not apply in all cases to banks. The Exchange has already modified its proposed rules to reflect the peculiar circumstances of the banking industry and I commend the ABA for continuing its constructive involvement in this process.

The fact that the relationship between bank directors and the financial companies on whose boards they sit are already defined and circumscribed by law and regulation is not the only salient difference between financial institutions and non-financial companies. For most of
corporate America, it generally doesn’t matter how the members of a corporate family relate to one another – at least where they are wholly owned subsidiaries of a publicly owned parent and do not have their own debt obligations held by outsiders. Intercompany transactions wash out in consolidated financial statements, and investors in the parent have no reason to be concerned whether transactions wholly within the family are on an arm’s-length basis or whether one sub is being taken advantage of by another.

But, as the ABA noted in its comments to the Stock Exchange, banking organizations are different. Banks are federally insured, they are supported by a federal safety net, and they play a critically important role in their communities and in our economy. That’s why there is a host of laws and regulations governing such things as how banks may lend to, swap assets with or engage in concerted transactions with their affiliates and insiders; when they may pay dividends to their owners; and what expectations they should have for support from their parent company.

As regulatory rulings and statutory enactments have broadened the range of activities that can be conducted in financial conglomerates owning banks, the opportunities for intra-family dealings have been significantly increased. In fact, one of the motivating forces behind the Gramm-Leach-Bliley Act was to provide financial companies with greater opportunities to realize the “synergies” that might flow from being financial supermarkets, and to offer “one-stop shopping” to customers.

Thus, today we see bank securities and insurance affiliates prospecting for new customers in the bank’s customer lists or seeking to exploit the bank’s relationships to market nonbank products and services. Indeed, the bank in a diversified financial holding company is very likely to have the most extensive and enduring roster of customer relationships in the family, thus making it the major focal point for joint marketing programs. In the ordinary world of
nonfinancial corporate enterprise, such prospecting for customers among affiliates obviously makes good sense. But in the world of depository institutions things are different – or should be. There is another set of interests that has to be taken into account: the public interest, represented by the interests of the banking supervisors and the FDIC as insurer of deposits. In this context it is important to assure that the interests of the bank are being properly regarded when affiliated companies seek to take advantage of their relationship with the bank.

This is not at all a new concern, and it arises in a multitude of circumstances. Let me give you a few examples of situations where caution is warranted:

- An individual controlling a bank causes the bank to maintain correspondent balances at another bank that agrees in return to make him a loan.
- A bank holding company that contributes operating loss deductions to a consolidated tax return causes the bank to pay upstream the amount of taxes the bank would have paid on a stand-alone return.
- A bank is charged fees by a holding company or controlling shareholder for providing various management services.
- Bank insiders operate an insurance agency that receives commissions on the sale of insurance to bank customers in connection with loans made by the bank.
- A bank shaves rates on a loan or agrees to less demanding covenants to please a customer of the bank’s investment banking affiliate, or in the hope of attracting new business for an affiliate.
- A bank relationship manager provides information and customer access to an insurance or securities affiliate to promote the sale of the affiliate’s products.
• A bank contracts to buy a product or service from a third-party vendor in which a large shareholder or insider of the bank holds an ownership interest.

• A holding company under financial stress is being pressed by regulators to invest capital into a subsidiary bank, while bondholders threaten to sue if the holding company dissipates assets by plowing more funds into a bank that might fail anyway.

I don’t mean to suggest for a moment that all of these situations are examples of impropriety. Indeed, a few of them are very common and, in principle, entirely appropriate. On the other hand, some may skirt the bounds of legality. But the common thread is that they all present an occasion for heightened concern about the interests of the bank – heightened because in each case the bank is dealing with a related party under circumstances in which the bank’s interests could potentially be subordinated to the interests of that party.

In some cases the reason for concern may be the failure of insiders to recognize that intangible assets of the bank may be at risk of being transferred without appropriate compensation to the bank. A bank’s customer relationships are assets of the bank, for example, and if the bank is going to give an affiliate a license to mine those assets it should be compensated. Certainly no bank would provide an unrelated third party with access to its customers without protecting its own interests – both its financial interest and its interest in maintaining a healthy relationship with its customers.

While this concept is occasionally overlooked, it is not rocket science. The notion that a company, and not its insiders, has the right to benefit from a variety of intangible assets that come into being simply because of its existence is grounded in a long history
of legislative and judicial pronouncements. It underlies the requirement in the Securities Exchange Act of 1934 that insiders must turn over to their corporation any profit they make on short-swing transactions in the company’s stock. And it underlies court decisions holding that corporate opportunities cannot be diverted to insiders and that premiums reaped on the sale of corporate control belong to the corporation.

Nonetheless, we are now being treated to a variety of lurid stories recounting, for example, how insiders were given lucrative opportunities by investment bankers to invest in IPOs in exchange for steering their company’s business to that investment bank. The Attorney General of New York has, in my view, very properly asserted that such opportunities belong to the company, not to the insiders, and that they must account to their company for their unjust enrichment.

As I consider the relevance of today’s corporate scandals to the world of insured depository institutions, I am reminded of a story I used to read to my kids, “The Lorax,” by the late Theodore Geisel, better known as Dr. Seuss. The Lorax was the forest creature who defended the trees, the Truffula trees, “the touch of whose tufts was much softer than silk.” That made them irresistible to the rapacious Once-ler, who “built a small shop and chopped down the Truffula trees with one chop.” At intervals – and as the forest and all the creatures that depended on it slowly disappeared under the ax – the Lorax would angrily appear “with a sawdust sneeze,” saying, “I am the Lorax, I speak for the trees.” Alas, too late. That story probably did more to create a generation of environmentalists than anything else I know of.

And so, with apologies to Dr. Seuss, I ask this question: When an insured depository institution engages in transactions involving its parent or affiliate or insiders,
“who speaks for the bank?” Who in the corporate family is looking at these situations solely from the perspective of the bank, with an independent view and with undivided loyalty to the bank? And how should we as regulators assure ourselves that the interests of the bank – and thus ultimately the interests protected by the federal safety net – are being properly regarded?

Some have suggested that we adopt a requirement that all insured banks have some number of truly independent directors – that is, directors who are not officers or employees of the bank and who do not sit on the board of the bank’s holding company or some affiliate. This would clearly be a significant change from present practice for many banks. Yet what I perceive to be the currently prevailing patterns – either replicating all or part of the holding company board at the bank, or using bank officers, who may also be holding company officers, to comprise the bank board – does not assure the kind of independent view that I believe is needed.

Another approach might be to require that in situations in which a bank wants to enter into transactions with an affiliate, the bank’s management engage some completely independent party – a special counsel or other outside advisor – to opine, from the bank’s perspective, on the fairness of the transaction or on a procedure established for a series of such transactions. Still another approach might be to make clear to responsible bank officers and directors that in the absence of any independent review sanctions may be addressed to them personally if it is later determined that the bank’s interests were not properly regarded.

I appreciate that any new approaches to corporate governance procedures such as these are not likely to be warmly embraced. Many bankers might – quite understandably
– feel that they already have their banks’ best interest at heart -- and I believe that is most frequently the case. On the other hand, we have over the years seen enough situations in which the interest of a bank have been subordinated to other interests in the corporate family to give us concerns on this score. Moreover, the evolution of financial conglomerates, offering a variety of nonbanking products for which the bank’s customers may be viewed as prime prospects causes me to want to be sure that the interests of our banks are being properly regarded.

This is another one of those situations – and we have seen many of them over the years – that cries out for an industry-generated solution. Time and time again we have seen legislative or regulatory initiatives adopted that might have been avoided or mitigated if the industry had had either some credible program of self-regulation or at least some standards of conduct expressing an industry consensus as to what is acceptable conduct. One need only recite the list of “compliance” laws enacted in the last 25 years - - about which many bankers complain bitterly -- to see the force of this point.

But where has the industry been in this time of turmoil in the field of corporate governance? If only out of enlightened self-interest, the industry could provide a useful service by expressing its own expectations and values, demonstrating that it recognizes -- as I am confident it does -- the importance of basic principles that have not been universally observed. Such an expression could have a material impact on investor confidence, among other things. At best it could have an impact on the need for even more legislation and regulation.

Consider this my challenge to you. But to be credible you’ve got to move quickly and with force. If you don’t, the process of government policymaking will inevitably
move forward, resulting in new requirements that will add to your costs and compliance burdens, and you will have passed up yet another opportunity. I don’t mean to suggest that we will be sitting by waiting for you, for we have our own responsibilities to assure that the interests of the banks we supervise are properly protected. But what the industry itself can contribute could have a significant influence on what might emerge from the agencies or from Congress.

The kind of self-scrutiny we’re going through today in so many areas of our economic life is never easy or comfortable. It exposes fallacies in some of our assumptions about the conduct of business and about human nature. It’s teaching us things – about associations and about ourselves – many of us, given the choice, might prefer not to know.

But I believe there is no choice – not if we’re to profit from our mistakes, restore confidence in our markets, and rebuild our productive capacity. Perhaps our greatest strength as a nation is the courage to confront our problems bravely and forthrightly and see them through to a solution. You have an enormously important role to play in the process.