Remarks by

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Thank you and good morning. It is always a pleasure to be with The Bankers Roundtable to discuss the most important issues of the day facing the financial services industry.

Many of you will remember the time when banking issues were essentially of interest to bankers and bankers alone, and we could assume that most of what we said and did would not be reported beyond the financial press. For better or worse, that is no longer the case.

The fact is that banking issues have never been more central to the health and prosperity of our nation and the whole global economy than they are today.

The nations whose economic difficulties now dominate the headlines differ in most respects. They are advanced nations like Japan, developing nations like Indonesia and Thailand, and reorganizing nations like Russia. Their cultures and histories vary widely. But they all share at least one thing in common: a troubled banking sector.

The recent misfortunes of these countries illustrate two important points: that national economies are little or no stronger than their banking systems, and that systemic weaknesses in the financial sector can foil even the most carefully crafted efforts to achieve economic recovery and reform.

What does it take to build the sound and competitive banks that are so essential to economic opportunity and growth in this country? I believe that it takes the right symmetry of inward and outward focus. By inward focus, I mean paying attention to the bank's internal fundamentals: the strength of its underwriting standards, the adequacy of its internal controls, and of course, its readiness to operate in the Year 2000 and beyond.

Outward focus means thinking about your customers -- current and potential -- and what products and services -- current and potential -- to offer and how best to offer them. This means utilizing the powers of your bank creatively to provide new products and services, recognizing evolving customer expectations, treating customers in ways they regard as fair, and learning to serve -- profitably serve -- currently untapped or underserved customers and markets.
When the balance of these elements goes awry, the future stability

-- and viability -- of a bank's business may be imperiled. Losing sight of customers' needs and expectations is one of the surest ways of withering a franchise, even though it may start with a sound internal footing. And lagging too far behind the competition in terms of product and service offerings, convenience, and price, usually produces the same unhappy result.

This morning I would like to talk about one of those internal fundamentals that I mentioned -- one which, today, appears to be under much stress.

For some time now, I and other banking regulators, economic policy makers, and some of our most distinguished bankers have been pointing to weakening discipline and slipping standards in commercial and retail lending.

This past summer, in a speech before a credit conference in Chicago, I announced the preliminary findings of the OCC's latest annual survey of national bank underwriting standards. As you may recall, we found continued slippage in commercial lending practices: broader and more generous concessions to business borrowers, relaxed collateral requirements, and less rigorous provisions governing covenants, guarantors, and tenors. And bankers were not getting paid for assuming this additional risk -- pricing has been very tight. We found this deterioration occurring in virtually every commercial line of business, with standards tightening only in international lending. And we found bankers who were well aware of their own increasing credit risk and regretted it, and yet felt pressures to continue so as not to lose critical market share. We released the final 1998 underwriting survey to the industry and to the public just yesterday, and a copy will be sent to all national banks. It is not a pretty picture.

The reaction to my Chicago speech -- and to other warnings by the OCC and other agencies on the same subject that preceded it -- has been mixed. On the one hand, many bankers expressed strong support for our efforts to highlight and reverse these trends. They indicated that our regulatory admonitions and the supervisory measures that accompanied them were proving to be of assistance to them in resisting internal pressures for more lending at any cost. On the other hand, some bankers insisted that it was "the other guy" -- not their bank -- that was responsible for driving underwriting standards down.

But, in addition, in my recent discussions with industry representatives -- including some of you in this room today -- I heard it suggested again and again that one of the most effective things we could do to encourage bankers to firm up underwriting standards would be to provide more details about the types of deals that we are finding that cause us such concern about slippage in underwriting standards. This is a fair comment, since the underwriting survey simply aggregates our examiners' qualitative assessments of underwriting trends. Clearly, if we want to send the most effective message to the industry, it is important that we be as specific as possible in signaling our concerns -- without, of course, compromising the confidentiality of the banks under review.

So, this summer, I assembled a team of the OCC's most experienced credit analysts to undertake what we sometimes call a "horizontal review" of a sample of loans at the larger banks around the country to specifically identify loans of the sort that make us worry. Although some of these loans are currently performing, they are structurally flawed, and very likely to produce losses in the event that the optimistic expectations they rely upon regarding the borrower's prospects, future market conditions, or the economy in general do not materialize. We call loans with fundamental structural weaknesses "ugly loans." And that is why, around the OCC, this exercise has come to be known as the Ugly Loan Project.

In the interests of specificity, let me describe a few examples of what we found. The first involves the owner of a chain of franchise stores in the southwestern United States. For years it had enjoyed a mutually profitable relationship with its bank, from which it obtained working capital and long-term financing for the acquisition of new properties. The loans were secured by the acquired real estate at acceptable margins, amortized over reasonable periods, and leverage and capital expenditures of the borrower were controlled by covenants.

Eighteen months ago, the borrower received an offer that looked almost too good to be true. A competing bank proposed to extend a multimillion dollar increase in the firm's credit line, to be secured not by additional hard assets but by intangible "enterprise" values -- management expertise, trademark and franchise value, market position, and so forth. The would-be lender proposed not only to turn a largely secured loan into a largely unsecured loan, but also to do it for less than the original lender was charging in interest and fees. Further, the borrower was required to pay only interest for the first five years. When these terms were brought to its attention, the original lender felt compelled to match them lest it lose the customer. The new deal was consummated just a year ago, with pricing 45 basis points less, and the annual fee reduced one quarter of a percentage point below the terms of the original loan. And the loan covenants were much less restrictive, with no limits on the borrower's capital expenditures and far less control on leverage.

The bank also chose to grant the loan despite the following financial facts about the borrower's business. Competition in the borrower's principal market had increased dramatically, causing deterioration in the borrower's sales and profits. In the face of this change, not only had the bank increased its exposure -- and, incidentally, given the borrower the wherewithal to engage in further expansion of its business -- but also reduced the return on its investment.

Let's turn to another case. This one involves a company with zero working capital, negative net worth, and over 50 million dollars in operating losses during 1997. What it also has is a brand-new revolving line of credit and multi-million dollar term loan totaling almost $500 million. One would think that this kind of borrower would be paying a stiff premium for this credit, if it could find a loan at all. But the contracted price was LIBOR + 150 basis points, currently 7.2 percent. Moreover, the loan terms require interest payments only for the first four years, and then graduated repayment of the principal starting in year five. Consider also that two years ago this same borrower sold hundreds of millions of dollars in subordinated debentures with similar maturities and had to pay as much as 14 percent -- junk bond rates.

Given this borrower's weak financial condition and risk profile, one might ask the basis upon which the lender expects to be repaid. In this case, repayment is based on projections that the borrower's cash flow will increase 300 percent over a ten year period, when both the revolver and the term loan come due. These projections are speculative at best, and presume not only retention of the company's current market advantage, but an increase in market penetration and a significant increase in profit margins. These very same projections form the basis of the bank's collateral evaluation, which is calculated at an optimistic nine times future cash flow multiple.

Finally, consider this. Many banks have policies that forbid loans to new companies where repayment is dependent on the future issuance of public debt or equity. It is a prudent policy, because, as the events of recent weeks have shown, the capital markets and prospects for initial public offerings can be highly volatile and nearly impossible to predict.

That certainly raises questions about the national bank that recently extended a 20 million dollar loan to a start-up company engaged in manufacturing a single product for a specific industry. According to the bank's own analysis, the product that the firm markets has not received accreditation from the industry it aims to serve and faces stiff competition in a limited market. Moreover, in 1997, the company lost more than 100 million dollars. Current liabilities exceed current assets by almost two-to-one, and the company has a negative net worth in the millions.

All of these ugly loans -- and others that came to the attention of our review team as it criss-crossed the country -- are reflective of the trends identified in our underwriting survey. Our retail franchise operator capitalized on the lender's willingness to accept intangible enterprise values in lieu of tangible assets to collateralize the increase in its credit line. The start-up, one-product firm -- at best a highly speculative enterprise -- obtained financing on terms once reserved for the highest-rated, blue chip borrowers. In the final example, the borrower, although technically insolvent, received a loan package based on the most generous possible assumptions about its financial future.

All of these borrowers benefitted from the fact that competitive pressures to maintain loan volume are driving the marketplace. Thanks to the extraordinary levels of liquidity recently in the financial system and the aggressive entrance of non-bank financial firms into the commercial lending arena, borrowers can demand -- and receive -- concessions on prices and terms. And, as our examples show, that's exactly what they did.

When we bring these ugly loans to the attention of the bankers responsible for them, they often protest that they're simply following the market. And we turn around and ask: following the market where and to what end? It is time -- indeed, past time -- to reject the herd mentality in lending. It's time to follow your own good judgment -- not "the other guy" -- when it comes to sound underwriting and risk management.

In the meantime, bankers with ugly loans on their books should be taking steps to deal with them -- as well as preventing other loans from joining them on the ugly list. They should be increasing the scope and frequency of loan reviews as a critical part of a bank's credit risk control process. They should be augmenting workout staff, and involving workout experts in loan monitoring efforts. They should be periodically reassessing their own strategic portfolio objectives and risk tolerance limits, resetting them to more protective levels at a time when the economic climate is becoming less favorable. And they should be carefully examining the adequacy of capital and loan loss reserves in light of credit risk ratings. If a bank has eased its underwriting standards, the assumptions upon which allowance adequacy is based should be reevaluated to reflect the likelihood of increased loan losses.

For our part, we at the OCC will be maintaining supervisory vigilance. Within the next two weeks, our examiners will begin implementing the changes to our examination procedures that I announced in my speech in July. In particular, as examiners identify loans with structural weaknesses -- like those I have discussed this morning -- we will capture key information about those loans through a new on-line system into which our examiners will enter key data on loan characteristics. This system will enable us to track lending trends with much greater specificity and timeliness than ever before, both as to the types of structural weaknesses that we are finding and the types of loans in which those weaknesses appear to be most prevalent. But, ultimately, it is your responsibility to identify and confront the problems that can affect your future -- before they reach the stage where the regulators must react more forcefully.

There is a fairly widespread view these days that the good times of the past eight years cannot endure. Perhaps so. But the gains that banks have registered during most of this decade were not the result of good luck alone. Bankers have prospered very largely because they did what it took to get the fundamentals right. We look to you now for the leadership to keep those fundamentals sound.

It is not too late to deal with the slippage in standards that I have described. As we see other nations' economies bobbing in turbulent waters, it is doubly important that, here in the United States, bankers address and correct any weaknesses in their loan underwriting, mindful of the possibility that our own economic seas could also turn stormy. Taking care now is important to the future of each of your banks -- and to the health of our nation's economy.