

Remarks by
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California is much in the news these days, for all the usual reasons and some new ones. Indeed, the size of California's economy, accounting as it does for nearly 14 percent of the U.S. gross domestic product, makes it inherently newsworthy. When your economy is larger than that of the smallest 22 states combined; when you've been responsible for creating a quarter of all of the nation's new jobs; and when you're home to one out of every eight of our people, it's hard not to be noticed. To paraphrase old Prince Metternich of Austria, when California sneezes, America catches cold. So it's natural for Americans to have more than a passing interest in the state's well being.

But this interest goes beyond the numbers. California's influence transcends its size, and that's because of the unique role the state has always played in our nation's cultural, as well as its economic, life. The Golden State could easily be renamed the Bellwether State, so long has it been a leader in shaping the trends that define our times.

It's not surprising that more than the usual attention has focused on California lately. There's always the sense in looking at California from the outside that the rest of us are catching a glimpse into our own futures. And these days, that prospect makes many of us more than a little nervous. Are the state's energy woes a harbinger of rolling blackouts and gasoline lines throughout the country? Is the double-digit growth of the new economy a thing of the past? Are we consigned to a lifetime of resource constraints and diminished expectations?

If we're going to draw such sweeping -- and depressing -- inferences from the facts, we'd better be certain that we have the facts right. I think it's particularly important at this critical stage that we not succumb to the doom and gloom that fills the media these days, because I believe it exaggerates the challenges -- real though they are -- that your state faces.

Let's not forget that while the California job engine may have downshifted some, it's still running on all cylinders. In the first quarter of this year, job growth exceeded 3 percent, still the fifth fastest in the nation. Unemployment was 4.6 percent, the lowest level since the 1960s. Consensus projections call for continued growth in personal income, retail sales, and single family housing permits. And although the projected growth is much weaker than it has been in recent years -- and certainly weaker than we'd like to see -- no recession is in sight.

The condition of the banks you represent will be crucial in determining whether and for how long that remains the case. So far, most indicators look positive. Bank capital and profits are strong. Aggregate return on assets for California banks was 1.18 percent in 2000 -- exactly the same as a year earlier. In contrast, ROA for non-California institutions fell in 2000 from 1.20 percent to 1.10 percent in 1999.

The same pattern holds with most other key ratios. California banks are still performing well, and even when their performance is falling short of previous years, they're still outperforming their peers in all other parts of the country, where there's no talk of a "crisis."

While these statistics point to a fundamentally healthy industry, there's little doubt that this strength will be tested in the coming months. Liquidity and credit quality

are two areas of significant concern. Like banks throughout the country, California banks have come to rely heavily on wholesale funding to support robust loan growth. From 1993 to 2000, the ratio of non-core liabilities to assets increased from 14 to 24 percent among California community banks, compared to a current ratio of 20 percent among non-California community banks. This could pose challenges for banks that are dependent on such funds in the event that the market turns against them.

And the deterioration in credit quality that began last year shows no sign of abating. Although noncurrent loans to total loans for all California banks are still only in the 1 percent range -- low by historical standards -- that represents an increase of nearly 50 percent from 1999 to 2000. For California community banks, the increase was smaller -- from .68 percent to .72 percent.

The biggest danger, of course, is that a further surge in nonperforming loans could make it more difficult for banks to continue supplying the new credit that's so essential to keeping the economy on track. Indeed, both Federal Reserve and OCC surveys indicate that banks are tightening their credit underwriting standards in many parts of the country. But that seems to be more the result of prudent risk selection in a slowing economy, as well as an increasing volume of problem loans, rather than of any fundamental impairment in banks' ability to lend.

The question is how do we keep things that way? What steps should you be taking now both to ensure that you're able to continue making good loans and to preserve and enhance long-term shareholder value, in the event the economy worsens. And what kind of oversight and support can national banks expect from the OCC as banks attempt to cope with the real challenges of today's economy?

First, here's what you can do: above all, you should focus anew on the fundamentals of risk identification and risk management.

That focus should include a reassessment of the adequacy of your bank's loan loss reserves, as well as your loan workout capabilities, which may well be tested in the coming months. And it should include an evaluation of the reliability of management information systems and portfolio risk management capabilities, for they, too, will be crucial in determining how your bank fares in difficult economic times.

Our concerns about loan loss reserves are not limited to the amounts of provisions. We also want to work with you to review your provisioning policies, and the methodologies you employ to determine an appropriate level of reserves. These methodologies, while rooted in historical experience, must be adjusted for current conditions and be based on observable information -- including historical loss percentages, loan growth, macro and microeconomic conditions, changes in bank risk selection and underwriting standards.

There is clearly no "right" number for a loan loss provision. The amount of the provision should reflect management's best estimate of losses, using a methodology that has integrity, and recognizing that there is a range within which a reasonable provision can be set. We believe that given trends in credit quality and in the course of the economy, this is a time to set reserves conservatively within that range. We have had extensive discussions with accounting standards setters on this subject, with the objective of apprising them of our concerns about deteriorating credit quality and encouraging them to bring the relevant accounting standards into better alignment with the way that

modern banks actually assess the risks of loss in their portfolios. Working together, I think we have made significant progress.

No bank should make the mistake of skimping on their loan loss provisions out of a fear that some accountant is going to call them to task for being excessive. At the same time, banks that rely on a purely numeric ratio as the principal methodology for setting the level of their reserves are not necessarily going to be in the best position to defend their decisions if questioned by the accountants.

Also, take a hard look at your loan grading. It is customary for our examiners to rate the loans on a bank's books, but the reliability of management's own internal credit risk ratings is crucial. We not only verify the grades assigned to specific loans, but also look at the timeliness of movement within the credit grades. Management itself should downgrade credits when weaknesses are identified, and not delay that decision based on the hope that conditions will improve, or because of concerns about the short-term earnings impact that might result from a downgrade of a deteriorating credit. Thus, a management that has already downgraded a loan could still be subject to criticism if the examiner concludes that the downgrade was late or too lenient.

Sound risk identification and management require accurate and timely data, and banks need to have the tools in place to properly manage the risk in their portfolios. This is especially critical for banks that have recently gone through a merger or other corporate upheaval, where multiple loan systems, systems conversions, or entirely new systems may disrupt the flow of critical information to bank decision makers. Knowing where the risks are in your portfolio, quantifying and tracking their course, and keeping

the board of directors well informed, are important components of good risk management.

Portfolio risk management deals with how well management understands the macro and micro risks in their various portfolios, and how these risks add up to affect the portfolio as a whole. Obviously, the sophistication of the risk analysis and risk management techniques required by each bank depends upon the nature of that bank's risk profile. While less complexity is expected in community banks, all bankers should have the same solid understanding of the types of risks they are taking and the risks that are already embedded in their portfolios. Systems that can accurately monitor that risk and line managers who can manage it are essential.

Finally, bankers need to maintain vigorous loan workout and asset disposal functions. We know that in capable hands many wounded credits can be nursed back to health. Most of the time, that's a win-win for the banker and the borrower. But sometimes the cost of rescuing a credit is greater than the value of the credit itself. Here again, bankers must understand the limits of their capabilities, and be prepared to pull the plug after a reasonable period of time. And they must manage the workout and liquidation functions carefully, with realizable action plans, measurable targets, and regular performance checks.

An increase in problem loans is never good news. We're at that point in the credit cycle, however, where increases may be unavoidable. The question is, how much pain will that cause -- and what effect might it have on banks' ability to operate? The answer will obviously vary from bank to bank, but the key variables relate to the measures I've just discussed. Bankers who are clearly on top of the situation -- appropriately

identifying, managing, reserving, and resolving problem assets -- will keep the confidence of shareholders and regulators, and protect the institution's long term viability. They will be in a position to continue making good loans to creditworthy borrowers, thus helping to immunize the economy from recession. And they will have a hand in ensuring that all those down-on-California pundits wind up eating their words.

So, what kind of reaction and support can you expect from regulators in this effort? At the OCC, we have quite literally spent the last ten years preparing -- and helping national banks to prepare -- for the same circumstances we face today. Post-mortems on the banking crisis of the late 1980s and early '90s concluded that sectoral and geographic concentrations ranked high among its causes, as did an overreliance on volatile net interest income. With that lesson in mind, we have worked to bring about the regulatory changes necessary for banks to diversify their product lines and their market areas, and to develop more predictable sources of fee income. We have defended the industry's right to charge reasonable fees for these services, and to compete on equal terms with nonbanks in the financial services marketplace. And we have argued forcefully that banks should be free to rely on their judgment and expertise in setting loan loss ratios at levels that they, and we, believe is prudent, given the increased credit risk in the banking system today.

But of all the changes that have taken place in our supervision over the past decade -- and there have been many -- the one that stands out is the one that's the most difficult to put your finger on. Ten years ago, we were widely criticized for inconsistent supervision -- for undue forbearance when problems first appeared, followed by draconian reactions when those problems had matured to the point where they could no

longer be ignored -- or effectively dealt with. When conditions in credit markets had deteriorated as the result of significant deterioration in the condition of the banks themselves, and banks were sometimes reluctant or unable to provide credit even to creditworthy borrowers, supervisors were blamed for creating a "credit crunch." In my view, this was in large part a bad rap: regulators don't create credit crunches; fundamental problems in the economy do. But after all, what better excuse does a banker have when turning down a borrower than "the devil made me do it"?

Nevertheless, we learned a great deal from that experience, and I think we all recognize the importance of a supervisory approach that is modulated and predictable. Since becoming Comptroller, I've emphasized how imperative it is that we fashion a carefully calibrated response to changes we see taking place in the banks we supervise. But that doesn't mean sitting by silently as conditions deteriorate. It means addressing problems as we see them developing -- incrementally -- while we still may be able to do something about them -- and doing so consistently and in a measured way. It means working with professional organizations, as we do with RMA, for example, to promote better understanding of our supervisory expectations.

Both in public and in our private meeting with bankers, we have addressed issues of declining underwriting standards and eroding credit quality. And while some bankers have sniped at us for doing so -- discomfited, perhaps, by the heightened awareness of their own problems that we have stimulated among many bank directors -- we will continue to address these issues, keeping in mind the need to do so in a balanced manner.

Bank supervision is inherently pro-cyclical in nature. That is, when the economy comes under stress, traditional bank supervision, with its emphasis on the maintenance of

high capital and conservative loan loss reserves, can appear to contravene the efforts of economic policy makers to turn the economy around.

In much the same way, accurate disclosure of a bank's condition can carry pro-cyclical penalties in the market place, increasing the bank's cost of deposits and capital as its condition deteriorates, and in so doing possibly adding to its immediate problems. No one would seriously argue today, however, that fair disclosure should be avoided simply because it might be painful. The value of meaningful disclosure is widely recognized -- not only to provide investors with the information they need, but precisely because disclosure brings with it the discipline of the marketplace, helping to encourage managers to run their business in such a way as to avoid the pain that market imposes when deteriorating conditions must be disclosed.

Banks play a critically important role in our economy, as providers of the credit and liquidity so necessary for economic expansion. It is my conviction that bank supervisors must stay focused on their primary responsibility during times of economic stress to assure the health of the banking system -- and if they don't, they run the risk of contributing to even greater problems in the economy. One does not have to look very far back in history to see how the task of economic recovery can be made infinitely more difficult if the health and quality of a country's banking system has been allowed to decay and sound prudential supervision has been subordinated to other objectives. Our own experience with the savings and loan debacle of the 1980s should be an object lesson in this regard. The greatest contribution we as bank supervisors can make to the maintenance of a healthy economy is to work with our banks to help preserve their ability and capacity to extend credit to creditworthy borrowers.

Very keen observers have commented that bad loans are made in good times -- that it is at the height of an economic expansion, when optimism can easily overtake prudence, that bankers make the loans that will later cause problems. That's true enough. But it's important to recognize that bad loans are also made in bad times, as bankers strive to maintain high returns and to preserve market share by going further out on the risk spectrum. This is precisely the time when supervision must be most vigilant. To be sure, we must always be cautious not to overreact, for we have learned how repressive supervision -- or at least the fear of repressive supervision -- runs the risk of causing bankers to retreat even from good credits. But we have also learned that we can pay a high price for forbearance and inaction. Refusing to note that the emperor has no clothes does not make him any better dressed. The balanced approach so strongly recommended by recent experience, which we at the OCC are committed to, requires that examiners do their jobs consistently, objectively, and impartially, without bending their standards to accommodate a shifting economy. Only in that way can we help to assure that our banks will maintain the capacity to make good loans in bad times. I'm confident that our examiners have gotten this message, for they hear it repeatedly and consistently from OCC managers, and from me.

Finally, it takes courage and foresight for bankers to define success in their own way -- not as the analyst crowd does, in terms of market capitalization and other short-term ephemeral measures, but in terms of the long-term value of the institution. If you do, I can assure you that your shareholders will thank you, and your customers will be grateful.