Remarks by
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Judging by the most recent economic indicators -- unemployment claims, productivity, consumer confidence, and the like -- we may well be in the process of emerging from the nation's yearlong slowdown. But there's also the possibility that today's encouraging numbers may prove to be transient or misleading, and that the economy may be stuck in low gear for some time to come. We just don't know.

In this regard, we should respect the wisdom of the Greek philosopher Plato, who defended the act of prophecy as a moral imperative that allows us -- symbolically, at least -- to assert control over our fate.

At the same time, Plato conceded that trying to predict the future was a losing proposition.

That hasn't changed. A few weeks ago, Federal enforcement authorities brought fraud charges against a well-known infomercial psychic, putting her out of business. One wonders why she didn't see it coming.

Today bank supervisors have dazzling analytical tools that can be of great value in predicting how the institutions we supervise are likely to fare in the future. The OCC's Project Canary, for example, developed an early warning system that helps us identify banks that have the greatest likelihood of developing problems. Of course, we can't be certain about the future any more than Plato could. Circumstances change, and behavioral responses that may radically affect results can't easily be modeled. We are fortunate if our predictive tools do no more than point us in the right direction. But while the future will always be with us, our primary job is to focus on the here and now -- to understand the current condition of the banking system and the ability of our banks to cope successfully with the variety of contingencies that may present themselves. And that's what I'd like to talk to you about today.

Last June I testified before the Senate Banking Committee on the condition of -- and the outlook for -- the banking system. I told the panel that while there were some negative trends in the industry, banks were far better prepared to deal with a slowing economy than they were at a comparable stage of the last economic downturn, in the late 1980s and early 1990s -- a period that we consistently use as a frame of reference not only for assessing the health of the system, but for shaping appropriate supervisory responses as well. I pointed out that with the economic slowdown, the lowered loan underwriting standards that the OCC had been warning about for more than four years were having the effects one might have foreseen, and that problem loans, on both the wholesale and retail sides, were on the upswing as a result. I said that we had concerns about the levels of consumer and corporate leverage, and about signs of trouble in such areas as commercial real estate and subprime consumer loans.

But I also told the panel that the industry's fundamentals were still strong. Despite the build-up in loan loss reserves, banks were still reporting strong earnings, aided by the favorable interest rate environment and robust noninterest income. Even with the rise in troubled loans, overall asset quality remained high, reflecting the industry's progress in minimizing portfolio concentrations and its embrace of advanced risk management techniques. Perhaps most important of all, capital was strong -- 50 percent higher, system-wide, than it was in the first quarter of 1990. On the whole, I said, the picture offered no great cause for concern -- and reasonable cause for optimism about the industry's ability to achieve a soft landing after nearly a decade in the clouds.

Now, nine months later, it is a good time to examine the changes that have taken place in the economy and the banking system since my Senate testimony. Obviously we have passed through an extraordinarily eventful period -- nowhere more eventful than in New York City.

September 11 was a watershed for the economy. It will be a while longer before the fourth quarter 2001 statistics on bank lending are available, but the third quarter numbers, covering the period through September 30, reflect a key indicator of a slowing economy: a significant drop in loan activity. Overall, the 3d quarter decline amounted to just under 1 percent, with the largest decline, 2.2 percent, occurring in commercial and industrial loans. Consumer lending declined at a slower rate, a little over 1 percent. Only commercial real estate defied this trend, growing by 3.6 percent.

When we break out these numbers geographically, the effects of 9/11 are even more dramatic. Predictably, the northeast was hardest hit of all, lagging behind every other region of the country in nearly every loan category. In consumer loans, for example, negative growth in the northeast -- and among national banks in our large bank program -- more than offset small gains in every other part of the country.

Beginning in late September, there was a marked upsurge in consumer borrowing nationwide. However, sharp gains proved short lived, because they were largely the result of cut-rate financing deals offered by the automakers. Once those offers ended, consumers pulled back, taking advantage of low mortgage rates to cash out some of the equity in their homes, which they used to retire higher-cost credit card debt. This was reflected in a December drop in consumer borrowing -- the biggest one-month drop on record. Yet American consumers were no less leveraged -- and thus no better situated to meet their debt obligations -- than they were months earlier.

2001 thus came to an end amid what seemed a steady stream of bad economic news. Americans were confronted by a convergence of negatives: bleak corporate earnings reports, successive rounds of layoffs, the threat of new terrorist attacks, financial turmoil overseas in places such as Argentina, and high-profile bankruptcies that dominated the business news in the weeks following September 11.

The highest profile bankruptcy, that of the Enron Corporation, not only involved losses to its lenders, but it also had a chilling effect on investor psychology, which has adversely affected all publicly traded corporations. Perhaps more significant, it has had a galvanizing effect on public policy makers. So today we are seeing an acute case of "Enronitis" -- nagging doubts about the transparency and fundamental trustworthiness of corporate financial statements, accompanied by severe criticism of corporate governance and deep-seated concerns about the security of private sector pension plans.

Meanwhile, deterioration of loans already on the books has continued and, in some cases, accelerated. This was especially true of credits to industries that felt the effects of 9/11 most acutely: travel and tourism, insurance, retailing, media and entertainment, and their suppliers. Large-scale layoffs in these industries led to rising defaults; consumer bankruptcy filings shot up by 19 percent in 2001.

Troubled times for the economy always mean challenges for the banking system, and even if the economy has turned the corner, as some indicators suggest, we may still be six to nine months away from the point at which we can expect problem loans to peak. That means more additions to loan loss reserves, with the attendant impact on earnings for the affected banks.

We also have to keep in mind that the most serious credit quality problems so far have been largely confined to large banks or to banks that specialize in lending to high-risk borrowers. That is likely to change, however. Historically, credit quality problems tend to trickle downward, gradually spreading to mid-size and community banks. We can now see that process beginning. So while things may not get much worse for banks that are suffering already, the ranks of the sufferers are likely to swell.

Yet what is striking is how little has actually changed for the banking system since September 11. For all of the turmoil of these last months, evidence shows that the banking system is not in appreciably worse shape than it was when I testified before Congress last June -- and still is in far, far better shape than it was at a comparable stage of the last business cycle.

In June, the return on assets for all commercial banks was 1.21 percent, more than twice what it was in 1989. As of September 30 -- the most recent date for which numbers are available -- it was 1.17 percent.

In June, nonperforming assets for all commercial banks stood .82 percent of total assets, compared to more than two and quarter percent in 1989. As of September 30, it was .85 percent.

In June, the ratio of bank equity to assets equaled 8.76 percent, compared to 6.21 percent in 1989. Today it stands it 8.93 percent -- even higher than it was in June.

In light of all that the economy has been through, I think you'll agree that these numbers are remarkable.

The statistics say a great deal about the resilience and underlying health of the banking system. They also suggest that we are unlikely to see a repeat of the early 1990s, when the banking system's troubles complicated and prolonged the process of economic recovery. Back then, bank supervisors were accused -- wrongfully, I believe -- of creating a "credit crunch" by taking too tough a hand with their banks. Whatever the merits of that charge, I am committed to assuring that our supervision of national banks doesn't get in the way of economic recovery. This does not by any means mean encouraging bad loans, or closing our eyes to them. It does not mean that we should break out in a sweat every time some entrepreneur who is turned down for a loan sees a "credit crunch" in the offing, like Henny Penny fearing that the sky is falling. Our job is neither to encourage nor dissuade banks from making loans. Our job is to address problems as we see them arise, and to do so in a measured and forthright way. Our job is to do what we can to assure that when creditworthy loans are there to be made, our banks are in sufficiently good condition to make those loans. If we are successful in doing this, we will have made the best contribution we can to a healthy economy. One need only look at Japan to see how a failure to attend to the fundamental health of the banking system can have a devastating effect on economic recovery.

The significance of the recent past is often as difficult to fathom as the future. But there's evidence that the economic pain of recent months may point the way to a more robust and sustainable recovery. For example, the Enron affair may lead to beneficial reforms of some corporate practices. As I have been saying for many years, when corporate managers place undue emphasis on short-term performance and the approval of the analyst community of their quarterly results, they do a disservice to their customers, employees, and shareholders. In the current climate, bankers who move to restore the proper emphasis on fundamentals and long-term shareholder value may find greater support for their efforts than has been the case for a long time.

We are likely to see other companies take steps to better align their accounting practices with the economic substance of their activities, strengthen their internal controls, and improve the quality of the oversight provided by boards of directors. When all is said and done, we could well have a more transparent, more efficient and more fundamentally sound financial marketplace -- a marketplace that will lend strength to the gathering recovery.

We also see compelling evidence that banks are not only strengthening their risk management and loan workout capabilities to deal with credits already on the books, but are exercising a higher level of prudence and responsibility in underwriting new loans.

Recently, the Federal Reserve's survey of senior loan officers showed, in general, continued tightening of credit standards by U.S. banks, with tightening most pronounced in commercial and industrial and commercial real estate loans. But the same survey provided evidence that banks are still willing and able to lend to creditworthy customers. Given the level of liquidity in the banking system, this is not surprising. The percentage of domestic banks that reported having tightened loan terms to large and middle-market firms actually declined from previous surveys, with particularly striking declines in the percentage of banks that increased loan spreads to these borrowers. On the other hand, an increasing percentage of banks did raise premiums on the riskiest loans, suggesting better assessments of the risk-adjusted returns for these products

Such policies may indeed help bankers avoid the problems of the future. But it is not too late to deal effectively with many of the problems that bankers face <u>today</u>. Most bankers are approaching these problems from a position of strength. That gives you options -- and opportunities to take control of your fate. It has never been more important than it is today to keep your eyes on the future rather than the end of the next quarter.

This means:

- building and maintaining strong credit analysis, portfolio monitoring, and loan review capabilities;
- recognizing and dealing with deteriorating credits forthrightly, rather than trying to pretend that no deterioration has occurred, or that it will correct itself if left alone;
- building and maintaining sound workout and collection operations capable of dealing effectively with troubled borrowers;
- building and maintaining a strong capital base and conservative loan loss reserves, even at a time when profits are being squeezed;
- continuing to invest in enterprise-wide risk management and portfolio MIS. As an added benefit, bankers that upgrade their internal risk ratings capabilities will be one step ahead of the proposed Basel accord, which is

likely to encourage and reward bankers to adopt more robust and accurate credit risk management processes.

Many banks are doing these things. Risk recognition and rating accuracy have clearly improved since the last time the industry faced comparable challenges. And many bankers came out of the last recession as true believers in the need for a strong capital base. One leading banker, whose institution had been under severe capital pressure in the 1980s, said at an OCC conference two years ago that never again would he let capital fall even to the level the regulators defined as the minimum needed to be considered "well-capitalized." It's in large part because the industry -- and its regulators -- have put such strong emphasis on capital that banks are holding up so strongly. Clearly, we have all learned from experience.

And let me say finally that bank regulators in particular have learned lessons. In the recession of a decade ago, we were criticized for adopting policies that appeared erratic and inconsistent. In some cases, we swung from forbearance to harsh supervisory action against banks whose condition had deteriorated -- but too late to avert many failures. We have learned from these experiences -- and are determined never to repeat them.

We have learned that ignoring or failing to comment on increasing risk or deteriorating conditions is poor supervision. We serve our banks best -- and best serve the public -- when we forthrightly convey our concerns to bank managers, and encourage them to address changing circumstances. For example, two years ago we became very concerned about the volume of "enterprise value" lending we were seeing -- that is, credits whose repayment depended on the borrower's success in realizing projected cash flows, frequently from start-up ventures. We viewed this as no more than a very chancy kind of unsecured lending -- or, perhaps more accurately, as a kind of equity investment, without any upside. We knew we were on to something when we heard loan officers refer to these credits as "airball" loans. We heard some carping about our repeated comments on this subject, but I believe our focus on this practice served banks well. Just recently, one of the country's leading bankers said to me, somewhat apologetically, "you guys were absolutely right about that enterprise value stuff."

September 11 cost us much. But it also taught us much -- about our strengths and our vulnerabilities, about our friends and our enemies. It taught people around the country and around the world things they never knew about the character of the American people -- and especially the character of New Yorkers. Its suddenness reminded us of what Plato tried to teach us two thousand years ago -- that try as we might to divine the future, it is -- and always will be -- essentially unknowable.

We cannot predict the future. But we can certainly influence it with the work we do. And no group has greater power to influence the general prosperity -- and its own present and future well being -- more than the banking community. On behalf of the OCC, I would like to congratulate the New York Bankers Association for the fine work that you have done through these enormously challenging times to uphold the promise of better times ahead -- for all Americans.