Remarks by

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I recently learned of a poll being sponsored by a leading media conglomerate to identify the best popular song -- not of the year, the decade, or the century, but of the millennium. Those of you who know about my love affair with Italy will not be surprised to learn that my nomination is any song by Francesco Landini, the musical sensation of 14th century Florence -- although admittedly his recordings are not easy to come by.

But the poll organizers have the right idea. Significant calendar changes -- and I can hardly think of a more significant one than the Year 2000 -- are natural watersheds: the time for sizing up the triumphs -- and mistakes -- of the past. We've had plenty of both in banking during this century, and both -- the successes <u>and</u> the failures -- have something to teach us about the challenges we face today. What history has to offer as guidance for the future is the subject I'd like to discuss with you this evening.

The 20th century has seen three major banking crises, along with a host of minor ones. Each had its own peculiar characteristics. The crisis of 1907 to 1909 -- they were then called "panics" back then -- was the result of seasonal currency flows from the cities to the countryside that left too little cash in vault to sustain public confidence in the money center banks. The crisis of 1930 to 1933 stemmed from a variety of factors: overchartering in the 1920s, lax credit underwriting standards, and low (or nonexistent) capital requirements. The crisis of the late 1980s and early '90s was related to, among other things, excessive portfolio concentrations, cutthroat competition in the financial sector, and macroeconomic instability.

Yet, while they differed in significant respects, these three crises had some significant commonalties. In each case, bankers made business decisions that were valid under one set of circumstances, but that unraveled when those circumstances changed, as they inevitably did. There was a mismatch in time horizons -- between the bankers' planning and vision, on the one hand, and the length of the commitments they undertook, on the other. They weren't adequately prepared for future contingencies. Their own optimism -- or external pressures from competitors or shareholders -- overtook good business sense.

In all three crises, although the events were different, the sequence they followed was much the same. In each case, the decisions that determined the industry's fate were those made in the flush of prosperity, when competition was vigorous, when even marginal borrowers had positive cash flows, and when every deal turned a profit -- at least at first. Then as now, to paraphrase Thomas Paine, the good times are the times that try the banker's character -- times when the pressures to ease loan underwriting standards, to cut back on internal controls, to reduce reserves, and generally to get caught up with a fast crowd, are hardest to resist.

And in each case, the bankers who yielded to these temptations almost invariably came to regret it. They learned from unhappy experience what they presumably already knew in theory:

that sacrificing long-term strategic goals for the sake of a short-term earnings boost is a mistake. They learned that maintaining a cool head and a clear vision in feverish times is often what separates the corporate survivors from the victims.

Each crisis that I've mentioned has something to teach us; together, they're even more meaningful. But we probably have the most to learn from the most recent of these crises, if only because the circumstances that preceded it most closely resemble those we see today. Moreover, the participants and the principals are still with us to lend us their own recollections and unique insights. In a recent FDIC-sponsored symposium on the lessons of the '80s, John Medlin, the highly regarded former CEO of Wachovia, declared that the root cause of the last wave of bank failures was not the kind of loans that bankers made -- energy, real estate, Third World, or what have you -- but the terms on which they were made. In the late 1980s, he said, "the dumbest and weakest competitors in the marketplace set the basic standard of pricing and credit terms." It was a race to the bottom, and, in his informed judgment, the primary responsibility for the disasters that followed rested with those who knew better but lacked the will -- the courage -- to take a stand for sanity in the financial marketplace.

That observation should have special meaning for us today. For several years, OCC examiners have been reporting a troubling incidence of loans with structural weaknesses. We're seeing loans based on dubious business assumptions about the future income and cash-generating capabilities of the borrower. We're seeing loans with equity-like features and risk characteristics. Some of these loans are based on so-called enterprise value, where loan amounts exceed the value of the borrower's underlying assets. And even though many of these loans are currently performing, we're beginning to see rising levels of missed payments, defaults and bankruptcies among corporate borrowers.

What induces bankers to sign on to such deals is no mystery. In a sense, some banks are the victims of their own success. Repeated years of unprecedented earnings have raised the bar of success, and bankers feel compelled to jump ever higher if they are to meet investor expectations. With a limited number of good loans to be made, even in an expanding economy, and an increasing number of lenders eager to make them, the maintenance of market share must inevitably come at the expense of loan quality.

I appreciate that at a time of record profits, it may be unrealistic to expect bankers to trim back their profitability and growth targets, and to turn their attention to the structural weaknesses of loans booked months or years ago. Shareholders -- especially those fixated on short-term performance -- may react unfavorably to the diversion of earnings into loan loss reserves or to adding new staff to loan administration, audit, and workout departments. In fact, such additions run the risk of adverse reactions from the market, which can also be personally costly for the banker whose compensation is geared to the performance of the company's stock.

But banking is not simply a shareholder venture. It's also a business affected with a public interest. That's why banks are subject to government supervision. And, considering how far the industry has come in rehabilitating both its balance sheet and its reputation since the early 1990s, it would truly be a tragedy if it were again to fall victim to the temptations of imprudence that accompany a highly competitive market environment. Fortunately, it's not too late to take the steps necessary to avoid the mistakes of the past and to ensure that the industry begins the next decade in better shape than it began the last.

In the speech I quoted earlier, John Medlin rejected the view that regulatory failures were a significant contributor to the banking crisis of a decade ago. Indeed, he argued that, in the end, regulatory behavior doesn't matter much one way or the other -- that it ranks relatively low on the list of factors that influence the health of the banking system.

As you might imagine, I disagree on this point -- perhaps the only disagreement I have ever had with John's consistently wise observations -- and so do many scholars of recent banking history. In fact, academic analyses of the banking crisis of the '80s has generally concluded that changes in regulatory practice might have made a real difference in limiting the scope and the cost of the bank failures that occurred. Scholars point to a variety of obstacles that prevented regulators from moving swiftly and efficiently to identify and resolve troubled institutions: the inadequacy of the deposit insurance funds; difficulties in coordination among the regulatory agencies; statutory limits on the regulators' ability to close weakened banks; and reductions in the numbers and experience levels of examiners, brought about by pressures to reduce agency budgets.

A number of important steps have been taken in recent years to address the supervisory shortcomings of a decade ago. The FDIC Improvement Act, with its focus on prompt corrective action, should significantly reduce the prospect that institutions will be permitted to continue to operate in a condition of insolvency, racking up greater and greater losses before they are closed. The bank insurance fund today is fully capitalized and fully prepared to meet virtually any contingency. The regulatory agencies are constantly improving their supervisory capabilities -- hiring examiners, enhancing the quality of examinations, and beefing up training to help examiners understand the evolving nature of financial risk. At the OCC, for example, we employ nearly as many examiners today as we did in 1990, when there were almost twice as many national banks for them to examine. And we've improved the mechanisms for interagency consultation, so that, as near as possible, we speak with a single voice, and are able to act in concert if and when circumstances require it. The agencies' joint response to the Y2K challenge, our ongoing study of capital standards, and the development of uniform examination guidance exemplify the progress we've made in this important area.

Yet some pieces of the puzzle are still missing. Students of the last banking crisis have made a persuasive case that with better analytical tools, supervisors might have been better able to predict the impact of economic changes on banks' balance sheets and prevent deterioration in some banks' overall condition from passing the point of no return. While no one suggests that predictive tools can change the course of the economy or prevent all troubled banks from failing, such tools can be of significant assistance in mitigating the extent of loss that banks might suffer when the economy turns against them. If they can do nothing else, they can add credibility to the cautionary notes that our examiners are sounding. We have experienced some real difficulties in getting bankers and bank directors to take seriously our criticisms of structurally weak loans when those loans are currently performing well. Yet we know that when the economy turns, these loans will experience deeper losses than they might otherwise have.

That's why earlier this year the OCC launched Project Canary -- an initiative designed to use the predictive tools we have on hand more effectively and to develop new, cutting-edge early warning systems that will enable us to spot emerging trends in industry risk and project future events with a higher degree of accuracy than is possible today. The allusion is to the canary in the mineshaft that gives its life to warn miners of deadly gasses that would otherwise go undetected. The objective is to alert us to specific environmental changes that signal future trouble for national banks and the national banking system, so that we can respond in a carefully modulated way.

I emphasize "modulated" because it's important that examiners have choices between the extremes of velvet glove forbearance, on the one hand, and drastic enforcement actions, on the other. Incremental changes in condition need to be accompanied by incremental supervisory responses. Even as the work goes forward on Project Canary, I've asked OCC staff to focus on refining and elaborating the range of supervisory responses that we have available to apply to the diverse conditions that exist in the national banking system. Our goal is a well-calibrated range of supervisory options proportionate to the degree of change in a given bank's condition.

I've often joked over the past nine months that my predecessor did me no favors by leaving the national banking system in the best condition in its history. Nobody's likely to remember my tenure if things stay pretty much the same -- even though in this climate, it will be challenge enough merely to preserve the status quo. But if the economy should falter, and we begin to experience serious losses in the system, I'm likely to be viewed as the relief pitcher that put the winning run on base. That's something I'm determined to avoid. Succeeding in that regard will require not only the development of better supervisory tools and better modulated responses to change, but a recognition by bankers that the long term health of the system may require some belt tightening during good times. The philosopher George Santayana said that "those who cannot remember the past are condemned to repeat it." I hope that's a mistake we can avoid.