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Comptroller of the Currency

Before the

Committee on Banking, Housing and Urban Affairs

of the

U.S. Senate

Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate this opportunity to discuss the condition of the banking system.

If one were to take a snapshot of our banks today, it would show a system that evidences great strength. Capital and earnings are at very high levels by historical measure. Yet if one were to look at a moving picture of the system spanning the past few years, it would disclose trends that raise cause for concern.

Let me elaborate.

The last decade has been a period of economic prosperity and strong growth in the banking sector. Commercial bank credit grew by over 5 percent per annum during the 1990s. During this period of prosperity, most banks strengthened their financial positions and improved their risk management practices.

As a result, the national banking system is in a solid position to bear the stresses of any economic slowdown. National banks are reporting strong earnings with a return on equity for the first quarter of this year of 15.2 percent--a level considerably higher than the ROE of 11.5 percent prior to the last economic slowdown in 1990-1991. Fifty five percent of banks reported earnings gains from a year ago. Asset quality for the national banking system is better than it was 10 years ago. The ratio of noncurrent loans (*i.e.*, 90+ days past due and nonaccrual) to total loans is 1.3 percent, compared to 3.3 percent in the first quarter of 1990, the year marking the start of the last slowdown. And capital levels are at historical highs. As of the first quarter of 2001, the ratio of equity capital to assets was 8.9 percent, compared to 6.0 percent in the first quarter of 1990.

Greater diversification of income sources improved the quality of bank earnings during the 1990s. This diversification trend should improve the capacity of banks to weather difficult economic times and better manage the risks embedded in their operations. The trend away from reliance on traditional interest income is in part an active effort by banks to better manage risk. As a supervisor, we strongly support the efforts of national banks to diversify their revenue streams through financially related activities.

Banks have also made gains during these years in diversifying risks. Loan securitization has become a significant funding tool, and banks have broadened the geographic scope of their operations and increased the range of financial services they offer, providing them with a greater capacity to weather adverse economic developments. Advances in information technology along with more sophisticated risk measurement tools now provide bank managers with advanced risk management tools that were unavailable a decade ago.

There are, however, trends that concern us, and banks cannot afford to be complacent about the risks that will continue to surface in the current economic environment, particularly in the areas of credit and liquidity. While the level of loan losses is still relatively low, since 1997 the OCC has been concerned about a lowering of underwriting standards at many banks. This relaxation of standards stems from the competitive pressure to maintain earnings in the face of greater competition for high-quality credits, particularly from nonbank lenders. In some cases, banks' credit risk management practices did not keep pace with changes in standards. We now are beginning to see the consequences of those market and operational strategies in a rising number of problem loans. One area where this is most noticeable is in our annual review of Shared National Credits. In 1999 and 2000 adversely rated Shared National Credits increased 53% and 44% respectively. In addition, the severity of classifications increased in both years. While this year's Shared National Credit Review is not yet complete, we expect problem credits will rise further reflecting the effects of prior lending excesses, a slowing economy, and improved risk recognition by bankers.

And this emerging deterioration of credit quality is not just an issue for large banks. As corporate earnings have weakened, the spillover effects on credit portfolios are beginning to show up in the smaller institutions.

Funding risk at banks is also increasing as households and small businesses reduce their holdings of commercial bank deposits. Banks have traditionally relied on consumers and small businesses in their communities as a major source of funding. With the rapid run up in the stock market in the 1990s, however, and the widespread popularity of money market mutual funds, households and small businesses have increasingly shifted their savings and transaction accounts into pension funds, equities, and mutual funds.

Our job as bank supervisors is to maintain a sound banking system by encouraging banks to address problems early so that they can better weather economic downturns and remain able to contribute effectively to economic recovery. By acting early, in a measured and calibrated way, bank supervisors can moderate the severity of problems in the banking system that will inevitably arise when the economy weakens. By responding when we first detect weak banking practices, supervisors can avoid the need to take more stringent actions during times of economic weakness. We make our greatest contribution to a sound economy by working to preserve the ability of our banks to make creditworthy loans when the demand exists.

Since 1997 the OCC has implemented a series of increasingly firm regulatory responses to rising credit risk and weak lending and risk management practices. These efforts, which are highlighted in my written statement, have focussed on maintaining an open and candid dialogue with the banking industry and our examiners about rising risk in the system and the need for improved risk management by bankers.

National banks have responded positively to these initiatives. Bankers are adjusting both their risk selection and underwriting practices. Credit spreads are wider, recent credit transactions are better underwritten than they were as little as twelve months ago, and speculative grade and highly leveraged financing activity has slowed in both the bank and public credit markets.

The OCC has also taken a number of steps, particularly examiner training and banker education, to address our concerns about increasing liquidity and funding risk.

We recognize that we need to ensure a balanced approach as economic conditions weaken. We have implemented, and will continue to follow, a careful but firm approach to addressing weak practices and increasing risks. In this regard, we are constantly mindful that the alternative approach of silent forbearance can allow problems to fester and deepen to the point where sound remedial action is no longer possible--a lesson that all bank supervisors learned painfully in the late 1980s and early 1990s.

If we have learned anything from past economic crises both in the U.S. and overseas, we know that a sound banking system is essential to continued economic growth. I can assure you that the OCC will remain vigilant in our efforts to continually improve the risk management of national banks and thereby maintain a viable, healthy industry to support our economy.