

Remarks by
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In the opening scenes of famed director Frank Capra's depression-era feature, American Madness, a rebellion is brewing in the boardroom of the Union National Bank. The directors, watching the banking system collapsing around them, have lost confidence in the liberal lending policies of the bank's president, played by Walter Huston, and demand that he agree to a merger with another institution. Huston's character refuses, vowing to continue to make loans based on the borrower's good character. "Faith," he says in a defiant coda, "is the only thing that matters to me" -- and the only thing, he insists, that would lift the country out of depression and return it to prosperity.

There's no question about who's cast as the hero in this encounter. It's Huston's character battling against the tide of ignorance, fear, and self-doubt that gave Capra his title: "American Madness." Yet, although not depicted nearly as sympathetically, the board also had a legitimate point and expressed it unambiguously.

So while the Union National of 1932 is hardly a model of what good management and board relations should be, Capra's film does dramatize a situation we could stand to see more of -- directors taking an active and independent role in overseeing a bank's affairs -- and, when appropriate, challenging management, instead of merely rubber-stamping its decisions.

That's one of the things I'd like to talk to you about today.

Corporate governance in this country has been the target of a fair amount of criticism in recent years -- much of it justified. Too often, outside directorships have gone to people whose major qualification is a nice personality and a willingness not to rock the boat. During the early 1990s, at a U.S. company that was once synonymous with the personal computer, the board was one big happy family, blissfully unfamiliar with the personal computing business. In fact, only a few of the directors had ever used a personal computer. The results for this company were predictably disastrous.

Unfortunately, it's just as common -- and just as wrongheaded -- when companies appoint competent directors -- people who actually know something about the business they're supposed to oversee -- and then leave those people there to languish -- unnoticed, unheeded, and unloved.

I wish I could say that the banking industry has been the shining exception to these practices. But I can't.

Maybe there was a time when banks could afford to forego the benefits of a strong, professional, and independent board of directors. But you'd have to go back to the days when even badly managed institutions raked in big deposits and big profits. I don't have to tell you that those days are long gone.

By comparison, today's banking environment can be summed up in two words: challenge and opportunity.

On the one hand, the market for financial services has never been bigger -- or better. Americans are wealthier than ever before. But "you ain't seen nothin' yet." Economists estimate that the next 20 years will bring the greatest net transfer of collective wealth since time began. We're talking about real money here: some \$8 trillion in assets -- assets that will be passed down from the parents of baby boomers to their children. That works out to roughly \$50,000 per boomer family. For providers of financial services, numbers like that can get your heart racing faster than a ride on the Sooper Dooper Looper over at Hershey Park.

And yet the affluent and soon-to-become affluent may not even be the most lucrative market out there waiting to be tapped. Right now, at the other end of the spectrum, there are communities all across our country where banks are as uncommon as spinach soufflé inside the Hershey chocolate works. And then there are communities with plenty of banks -- yours may be among them -- but still substantial numbers of people who, by choice or necessity, rely on high-cost, nonbank providers for such basic services as bill payment, check cashing, and short-term loans. If these people can be introduced to the financial mainstream, the potential rewards -- for them, for our economy, and for the financial institutions that reach out to them -- can be enormous.

That's what I call opportunity -- and challenge.

It's a challenge because banks can't just sit back and assume that a major share of this wealth will automatically drop into their laps, the way it once did. In fact, they can't even assume that they'll hang on to what they've already got: many banks have seen their late customers' sons and daughters withdraw their inheritance as soon as they were free to do so. Today's financial consumers -- at both ends of the spectrum -- have many other options. Regrettably, Americans at all income levels no longer take for granted that banks are the best places to do the business that banks used to dominate.

The industry analyst who wrote that "banking is essential to the modern economy, but banks are not," spoke a basic truth, although it's one that none of us really want to hear. But admitting you have a problem is the first step toward solving it.

It's not going to be easy for bankers to reclaim their old preeminence, and it won't be easy to capitalize on the opportunities that lie ahead. Experience teaches us that market share lost is often lost forever. Recapturing the banker's traditional market won't be easy, because it involves reversing habits that have themselves been years in the making.

In case you doubt the magnitude of the challenge the industry faces, consider what I'll call Exhibit A. Last I looked, the Dow Jones industrial average had fallen about 8 percent since the beginning of this year. For the NASDAQ, the decline has been roughly 10 percent. Yet the net assets of the nation's mutual funds have increased -- by over \$200 billion -- over that same period. If the current correction on Wall Street hasn't put a damper on Americans' infatuation with the stock market and non-traditional approaches to wealth-building, then I'm afraid that nothing short of a seismic shift in our economy will.

Or consider Exhibit B. The past decade has seen noteworthy efforts by government and nonprofits and a fair number of financial institutions to publicize the advantages of bank accounts and to make them more accessible. Studies have shown that over the course of a lifetime, a person without a bank account could incur fees of more than \$15,000 for cashing checks and paying bills. The many long-term benefits of bank accounts for wealth-building are increasingly understood. Yet, over the last decade, the number of check-cashing outlets nationwide has more than tripled.

Check-cashers, payday lenders, and pawnshop keepers may not operate widely in your community. But the growth of what we sometimes refer to as fringe banking represents a big problem for the whole industry.

For banks generally -- and for community banks particularly -- this shift in the norms of financial behavior -- in our traditional approaches to savings and investment and transactions -- has involved a host of operational challenges. The loss of core deposits has forced banks to increase their reliance on higher-cost, more volatile wholesale funding. It's required banks to pour resources into advanced delivery systems --- ATMs, on-line, and telephone banking -- because today's sophisticated consumers won't settle for anything less. New products and services have had to be introduced on the fly to keep up with the fast-moving competition. And while all this has been going on, the bar of corporate performance has continued to rise. Banks today are expected to post returns on assets that, on first blush, seem wholly incompatible with the goals of safety and soundness.

How many of you worry about meeting expectations to consistently outperform the previous quarter or year -- and, at the same time, make only sound loans?

Obviously, some banks will thrive and others will falter in the face of these challenges. Some will seize the opportunities presented by new markets and others will come up empty-handed. But how can we tell the potential winners from the losers? If you were one of those banking industry analysts whose livelihood depended on handicapping the competition, what would you be looking for in making your picks?

I'd suggest starting with the words of one of our most esteemed living philosophers -- one Joseph Vincent Paterno, who, I'm told, is also loosely associated with a certain college

football program. "The will to win is important," Joe often says. "But the will to prepare is vital." That's as true for banks as it is for the Nittany Lions.

Preparation is the key these days, not only for anticipating and serving the needs of the burgeoning base of financial consumers, but also in getting ready for the challenges the financial environment is almost certain to throw our way in the months and years to come.

To paraphrase the sixteenth president of the United States -- four years and three Comptrollers ago, the OCC started talking about the dangers of slipping underwriting standards and declining credit quality in bank portfolios. Actually, as some of you may know, the OCC has been monitoring risk in the banking system since the days of Lincoln himself. When we see negative trends, we have always taken it upon ourselves to bring those concerns to the attention of the people who are in the best position to do something about it -- you.

In recent years, we've made a special effort to remind bankers -- in a time of great general prosperity -- not to lose sight of the fundamentals of good banking. We urged bankers to look at a potential borrower's overall debt burden, to price loans fairly, to walk away from deals that made no business sense for the bank, and to stress-test early and often, recognizing that even in optimistic scenarios, the economic expansion was not likely to outlast most of the loans then being booked.

And we urged banks to maintain the rigor of internal controls -- an area that too often gets the short end of the stick when banks are under earnings and cost-cutting pressures, as most have been in recent years. Board oversight is perhaps the crucial component of any internal controls regime.

We regulators are sometimes accused of being professional scolds whose greatest joy comes from pulling the punchbowl off the table just as the party is getting started. That's not true. We do, however, go to considerable lengths to hide the vodka bottle, so that the economy doesn't wake up with a giant hangover the next morning.

Incidentally, as Steven Phillips pointed out this morning, the economy has begun to slow, credit quality problems are increasing, loan loss provisions are rising, and bank earnings are starting to suffer as a result. But I won't say we told you so.

Of course, not all banks have been affected equally by these developments. Coach Paterno wouldn't be surprised to learn that those who have prepared for a softening economy are those most likely to be weathering it successfully so far. And what we see, with remarkable consistency, is that the banks that are continuing to thrive in these uncertain economic times -- banks whose portfolios are holding up best -- happen to be the banks that are blessed with strong, professional, and independent boards of directors.

Fortunately, it's not too late for banks that have fallen behind in their preparations to get back on track, so that, come what may, they, too, can find a place in the winners circle.

And we're doing all we can to help.

That's why the OCC has put together what we're calling the National Bank Director's toolkit -- a set of publications that explain the responsibilities of bankers to their directors and the responsibility of directors to their institutions. Every national bank should have already received two of these kits, and additional sets can be ordered.

Here's what the toolkit looks like, and here's what it holds. The centerpiece of the toolkit is the OCC's Director's Book -- a book that no one who serves on a bank board should be without.

It contains general concepts and standards for the safe and sound operation of a bank and summarizes various laws and regulations of which directors should be aware. It explains the board's role in managing risk, in dealing with the OCC and other regulators, and addresses in broad terms the duties of the individual director.

These duties include:

- Keeping informed of the bank's operating environment
- Hiring and retaining competent management
- Maintaining an appropriate board structure
- Ensuring that the bank serves its community's credit needs
- Monitoring operations, and
- Overseeing business performance

Many directors have told us that these last two responsibilities -- monitoring operations and overseeing business performance -- are the most challenging of all. Maybe that wouldn't have been the case a couple of decades ago, when community banking was a pretty simple business. But it isn't any longer.

As Mike Brosnan discussed, risk has grown exponentially in magnitude and complexity, and it's the responsibility of directors who may lack specialized financial skills to understand its impact -- prospectively -- on a community bank's safety and soundness.

We understand that many directors need help in performing that portion of their fiduciary responsibilities, which is why we've included in the toolkit a booklet entitled Red Flags in Board Reports: A Guide for Directors. It tells directors what to look for as they review the reports

provided by management -- and what ratios or trends ought to trigger further investigation. We believe it's so important that directors have these benchmarks at their fingertips that we've summarized the Red Flags in a "Pocket Guide" -- another feature of the toolkit. A copy of the Pocket Guide has been packed into your conference materials.

But I don't want to leave you with the impression that you have to be a technical expert to fulfill your responsibilities as a director. We don't expect directors to be auditors, credit experts, or banking attorneys. Of course, if you are, so much the better! But that would just be icing on the cake.

No -- what the job of director calls for fundamentally are bright generalists -- people with good common sense, solid business instincts, and unflinching integrity. What it calls for are people who know how to ask the right questions, who bring a healthy skepticism to the answers, and who set a tone of accountability up and down the organization. It's not so important that you have technical expertise yourself, as long as you know how to recruit and retain the people who do.

The first responsibility of a director, then, is to establish a control environment conducive to safe and sound business operations. What goes into a positive control environment is discussed in the fourth and final component of the Director's toolkit, a booklet entitled Internal Controls: A Guide for Directors, which you also have in your conference packet. The booklet talks about many of the things I've mentioned already -- a commitment to competence and ethical behavior, clear assignment of authority, effective oversight, and open communications -- as parts of an effective control environment.

Time and again, we've found that this kind of broad, conscientious oversight is what makes the crucial difference between a well-run institution and a weak one. If a strong control environment exists, under a strong board, then much of the rest will fall into place.

That's why the OCC places so much supervisory emphasis on a bank's internal controls.

This afternoon, Bill Morris, from the OCC's core policy development unit, will discuss the subject in greater detail. And in three weeks, the OCC will hold a telephone seminar on audit and internal controls for community banks. Some of our leading experts will examine the components of an effective audit and internal control program, explain OCC policies and practices on the subject, and answer your questions. It should be an informative event, and I encourage you to sign up for it.

What I've tried to do today is to give you a broad overview of the challenges and opportunities that lie ahead for community banks -- and what it's going to take for you, as national bank managers and directors, to succeed in today's dynamic financial environment.

If there's one message I'd like you to take back with you, it's that you're not in it alone. The OCC stands committed to continuing the dialogue with national banks and to providing supervisory guidance that helps you achieve your goals. With today's conference, I believe we've taken another step in that direction.