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Remarks by
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I am honored to have the opportunity to meet with you and learn from your collective experience. For almost the entire history of our republic, New York has been an important American center of banking and finance. In this century, that has meant not just a national center but a world center of banking and finance.

I always like to tell the story that when Abraham Lincoln and Salmon P. Chase looked for a model for the national bank charter, they looked to the New York state banking statute. They did this because the New York courts had interpreted the grant of bank powers in that statute to be broad and designed to evolve over time. In short, both your legislators and courts, as far back as the last century, understood that finance would not and could not stand still and remain relevant. Banks had to evolve with the changing times.

In today's high-tech environment, changes in finance are coming at a faster pace than ever before. The rapid pace of change places a premium on the need for our financial institutions to evolve in order to stay healthy and to contribute to our economy. Within the last decade, we have seen changes in risk control and modeling techniques used by banks that would have staggered the imagination of earlier generations. Every day, domestic and international markets present new challenges for all of us. Here again, an earlier generation of bankers would have been staggered by the rapidity with which we all must address new challenges.

These rapid changes have also placed a considerable premium on exchanges such as the one we are having today, between the regulated and the regulators. It has always been important, but it is even more important today, that we communicate openly and often, sharing our concerns and our ideas about how to make the banking system safer and sounder, more competitive, and better able to serve the needs of America's consumers and communities. Since becoming Comptroller, I've come to appreciate that an important part of the job is communication -- both listening and speaking out. It is absolutely essential for us to stay directly in touch, and for you to feel that when you have a question, comment or problem, you can talk about that issue with me and others at the OCC. Of course, we may not always agree, and at times we haven't. But it is important that we are able to share

our perspectives in a direct and candid fashion.

A Comptroller simply can't do this job any other way. That's why I speak at events such as these, and why I make personal visits to the largest 25 banks we supervise every year. It's also why OCC's entire senior management team has established strong and continuing outreach programs to bankers and bank customers, and has actively sought your input on proposed policies. I'm proud of the open lines of communication we've cultivated with the entire banking industry through a series of Meet the Comptroller meetings, and I'm equally proud of the direct lines of communication we've built with representatives of the customers and communities our national banks serve. Regulators who are not accessible to the industry they regulate and to the diverse constituencies served by that industry simply cannot be successful in carrying out their primary responsibility: ensuring the long-term safety and soundness of the banking industry to support the economic well-being our nation.

From where I sit, ensuring the industry's long-term safety and soundness means several things. It means sounding a note of caution when events warrant supervisory concern and industry prudence. It means enhancing the ability of the industry to evolve with a changing market and changing consumer needs. It means ensuring that the industry strives ever harder to offer broad and fair access to the services it provides.

In fact, as I look back at my previous speeches to the New York State Bankers Association, they demonstrate the varying nature of the regulator's responsibility. You may remember that in 1994, as your new regulator, I made the case of why financial modernization was needed for an industry and an economy that had undergone significant change in recent decades. When I came back a year later, interest rates had begun to roller coaster, and I felt compelled to discuss the need for banks to take a hard look at their interest rate risk profiles. Last year, in Lake George, the theme was financial modernization once again. Congress had agreed with the need for modernization but the method for achieving that goal was subject to intense debate. So I shared my views of what I believe broad financial modernization must entail.

That brings me to 1997. Circumstances dictate that I use this opportunity to shine the spotlight on important safety and soundness issues. I want to discuss safety and soundness with you today for several reasons. First, I am certain that the banking industry, which so importantly needs the ability to compete and to enter new product areas to remain healthy over the long-term, will be allowed to do so only if it can prove to the Congress and the public that it is able to manage risk more effectively than in the past decade. Second, as the long expansion that we have seen in the economy continues to roll forward, it creates a dynamic that is decidedly unhealthy. Like the Siren song that almost shipwrecked Odysseus, the continuing expansion causes us to forget that cycles are an inherent part of a free market economy and to forget that this expansion, like all others, will not go on forever, but will without question end

with a down cycle. And, third, I want to focus on safety and soundness today because we are continuing to see signs of slippage in some areas that you and we must address now.

In talking about safety and soundness today, I want to discuss three areas: internal controls, consumer credit, and financial modernization.

Internal Controls

First, let me turn to internal controls. Last fall, I spoke out on what I believed was a very troubling dynamic. As some banks were looking hard at increased efficiencies to help fuel profitability, they were considering cuts in internal controls. Certainly, increased efficiency is a desirable goal, and internal controls are not immune from review for their efficiency. But every financial entity should be very cautious about slimming down internal controls lest it weaken a function critical to its long-term health. I noted last fall that we had seen some evidence of banks that were focusing too much attention on savings in the internal control area and paying too little heed to the potential damage that such savings could cause.

Over the last several months, our examiners have focused their attention on banks' internal control systems to determine if critical activities are being sacrificed in the drive for enhanced earnings. And, unfortunately, we continue to see actions at some banks that give us cause for concern. Accordingly, today I urge each of you and each of your colleagues in national banks to review this area and give careful scrutiny to proposals to save money at the expense of weakening these controls in any way. Indeed, I would urge you to go further and work on ways to strengthen your bank's internal control area. Failures in internal controls have been at the heart of a very high percentage of banking industry troubles for generations. For our part, we are asking OCC examiners to highlight their concerns in this area during their regular discussions with bank management and to work with management to ensure that weakening in this area does not occur.

Consumer Credit

I also want to say a few words about consumer credit -- particularly as it relates to credit cards. In the last three years, median outstanding credit card balances have increased by 36 percent, and the median total credit limit has nearly doubled. In the past, consumers had somewhat predictable repayment patterns. Today, these repayment patterns are increasingly difficult to predict. With greater frequency, consumers who have no pattern of delinquency are building up large credit card balances and then filing for bankruptcy without warning. These changes in consumer behavior are affecting retail credit portfolios in all banks, both large and small. It is worrisome to consider that there was a 44 percent growth in credit card losses, and a 50 percent increase in credit card delinquencies during the past year. Further, according to the Standard & Poor's Credit Card Quality Index, credit card chargeoffs

increased significantly in the first month of 1997. The monthly loss rate for the \$220 billion bank-issued credit card securities market hit 6.5 percent in this January, compared to 4.7 percent a year earlier. These statistics are particularly troubling given the current health of the economy.

On the positive side, we have seen and we continue to see banks tightening underwriting standards in this area. Current losses likely represent weaker credits making their way through the pipeline -- business activity undertaken before the industry began to respond to regulatory warnings and tightened their credit card underwriting standards. However, we can expect some continued losses before we begin to see the beneficial effects of more cautious underwriting decisions.

As I indicated earlier, the role of the regulator is to take action before potential problems become real problems that trigger in response the type of credit crunch we saw in the late 1980s. Let me be clear that what we're seeing today does not necessitate a retreat from the lending market. Markets remain strong, and banks should pursue profitable opportunities. But in doing so, banks cannot ignore the fundamentals.

Portfolio Credit Risk Management

To ensure that fundamentals are in place and adhered to, the OCC is, today, issuing an advisory on credit underwriting standards and portfolio credit risk management. Our goal is to remind national banks how changes in underwriting standards affect overall portfolio credit risk and to highlight the key components of an effective portfolio credit risk management process.

This advisory will help banks develop and strengthen their own processes to identify, measure, monitor and control loan portfolio credit risk. It does not establish any new requirements that banks must adopt to manage their overall portfolio credit risk. Instead, it highlights concepts

that all bank managements should review to see how they can be applied to an effective risk management program in their own institutions. The extent to which each bank formalizes these processes will depend upon the size and complexity of the institution as well as its business strategy.

Let me briefly highlight a few of the central components of risk management.

First, it's important for banks to assess periodically whether their employees -- from loan origination to marketing -- understand their institution's credit culture, and to gauge if employees are conforming with desired standards and values. Further, banks should review their compensation systems to ensure that they reward employee performance that meets long-term objectives for credit quality. In other words, if your bank has a relatively low tolerance for portfolio credit risk, your compensation system should reward employees based on the quality of loans booked -- not the quantity of loans originated or the volume of fees generated by those loans.

Second, risk management depends on adequate management information systems. We encourage all institutions to assess periodically the quality of their technology in light of loan growth, acquisitions and changes in their business strategies. Maintaining an adequate credit management information system heightens your ability to segment loan portfolios and isolate key risk characteristics.

Third, each bank must be able to assess the effect of loans originated and underwritten at other financial institutions on its credit risk profile. We remain concerned that banks may be purchasing loans based on underwriting standards inconsistent with their own established risk acceptance criteria. Banks must perform proper due diligence before deciding whether to acquire such credits. Before engaging in a syndication or a participation, a bank should evaluate the risk of the proposed credit to determine if the loan meets its strategy and risk tolerance. While time is often a factor in deals of this nature, a tight deadline should not be an excuse to bypass established portfolio management processes.

Finally, the advisory letter emphasizes the value of stress testing. In addition to stress testing significant individual credits, bank management should consider weighing key portfolio segments against hypothetical scenarios to identify flash points that could push risk beyond acceptable levels. It may be valuable to assess how the portfolio would respond to events such as rapid interest rate change, technological changes, commodity or other price shocks, and a downturn in the business cycle. A good method is to determine best, worst and most likely scenarios for each segment of your portfolio, and to have contingency plans in place that would increase monitoring, limit portfolio growth, and provide hedging or exit strategies if circumstances warrant. In short, this advisory letter will help focus the industry's attention on the importance of comprehensive risk management processes.

Financial Modernization

Finally, let me turn to financial modernization. Financial modernization is first and foremost a safety and soundness issue. Strategic risk -- in this case the risk of not being able to offer the products and services that the market demands -- is, in the long term, the most important risk facing the banking industry today. In our dynamic economy, if banks are not able to offer new products, to evolve as the markets evolve, they will not survive as healthy entities. Accordingly, I am pleased to see that the Congress has recognized the importance of this issue and has given financial modernization priority on its agenda for this session. I am similarly pleased that the Federal Reserve has taken action in this area. The OCC, too, will continue, as we have for the last several years, to allow the system to evolve.

Today, I want to focus particular attention on one aspect of financial modernization -- the importance of giving financial services firms the flexibility to conduct their businesses efficiently. It is not enough for a statute or regulation to allow banks to evolve if the law or regulation permits evolution only in such an inefficient way that banks cannot actually compete with other entities. For banks of all sizes, needless inefficiencies -- whether in corporate structure or otherwise -- exact a high cost for consumers, for America's economy, and for the safety of the banking industry. If banks are saddled with inefficient structures or requirements, they will either shrink or take on greater risks to maintain earnings. Markets for financial services will be less competitive, and fewer resources will be available to meet community development needs. Customers will face higher fees, reduced service, and fewer options. Further, the ability of U.S. institutions to compete in the global marketplace will be impaired, and American businesses and consumers may ultimately be the losers. As we go forward to modernize our financial system, it is essential that we pay careful attention that we truly modernize in a meaningful way -- in a way that allows the marketplace to work for all providers and consumers of financial services.

CONCLUSION

As I said at the outset, one of the most important lessons I've learned as Comptroller is the importance of timely, two-way communication -- both listening to the concerns of banks and the communities they serve, and speaking out when necessary to ensure the safety and soundness of the banking industry. Today, the circumstances warrant that I assume the role the regulator must take from time to time -- giving voice to supervisory concern about immediate safety and soundness issues. I urge you -- as some of the nation's leading bankers -- to remain focused, both on the importance of financial modernization and on the importance of

fundamental risk management. I'm confident that, working together, the nation's banks and the OCC can continue to provide this country the modern, strong and vibrant banking system it needs today and tomorrow.

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The OCC charters, regulates and supervises approximately 2,800 national banks and 66 federal branches and agencies of foreign banks in the U.S., accounting for more than half the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.