Remarks by
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There's a new realism in our thinking about the global economy. We now have a keener awareness of the special security challenges -- as well as the more familiar political and financial challenges --- that internationally active businesses have to contend with.

This awareness has been forced on us by recent events. The world is a different place today from six months ago. It may stay that way. And that means adjustment -- by all parties -- to the realities of the new international environment.

By arranging this timely conference on the new uncertainties of the global economy, the NABE has materially contributed to this cause. I congratulate you -- and I thank you for the opportunity to be here with you today.

This more balanced, more cautious, perspective on the global economy is an enormously positive development. To the extent that it contributes to a better deployment of our finite stock of human and financial assets, I believe it bodes well for the future of international trade and investment -- and therefore for our collective well being.

Let me go further and suggest that the most commonly cited benefits of globalization -- new markets, access to innovation, comparative advantage and specialization -- are not the <u>only</u> important benefits that globalization has brought us.

I am not by any means discounting the importance of the bottom line -- probably the second most powerful animating force known to mankind. But I do believe that we're profiting from the global convergence of financial practice -- and a similar convergence in financial oversight and supervision -- in other ways that have little to do directly with dollars or deutschmarks. Convergence has given us a wider range of experiences on which to draw -- and from which to learn

As U.S. bank supervisors, we're intensely interested in the experiences of our supervisory colleagues around the world. We work closely with them, both bilaterally and through the Basel Committee on Banking Supervision. It's part of our ongoing effort to raise bank supervisory standards and practice -- and to bring them into greater harmony among both the advanced nations of the world and the world's emerging economies.

In the U.S., our interest in the structure and operations of bank supervision in other nations isn't simply a matter of professional curiosity; it goes deeper than that. For more than a century, the structure of bank supervision in the United States has been a controversial subject. And although U.S. lawmakers have frequently tinkered with that structure, it's resisted fundamental change.

As someone who has spent the better part of a long career working within that structure, I confess to a certain affection for it, in all of its convoluted glory. Moreover, the system works quite well and the various players have learned how to live with it.

But there are some who think that it's not enough that a system works in practice. They believe it should work in theory as well -- and our bank supervisory structure probably fails that test. It's not uncommon for those who have not lived within the present system to view it with chagrin on first exposure. Understandably, it presents an inviting target for rationalization and restructuring.

What the structure of bank supervision in the United States would look like if we were designing it from scratch is an interesting and provocative subject for those of us involved in the supervisory process.

But it's not the subject I'll be addressing today. There's no reason to bog you down in the arcane politics of bank supervision and regulation, or in the details of how our system compares with those in other countries.

Indeed, one of the lessons we have already learned from the Basel Committee's work on a new international capital accord is that it's very difficult to find common institutional arrangements suitable for all countries at all times.

This shouldn't come as a surprise. Institutions spring uniquely from a country's culture and history. Whatever else one might say about the U.S. supervisory structure, which has emerged largely through historical accident, it's come to reflect distinctively American values and habits -- suspicion of authority (especially centralized authority), competition, and egalitarianism.

The structure of our banking system is also uniquely and authentically American. We would not graft our model onto another country and expect it to work, just as we might find that any particular foreign model might fail to gain acceptance here. I think that most Basel Committee members would agree that the range of national practices in financial services and supervision worldwide is <u>too</u> wide to be accommodated within a single uniform framework.

But where the Basel Committee <u>has</u> been quite successful -- in its previous work as well as its current work -- has been in identifying common <u>principles</u> of effective supervision and leaving it to each nation to decide how those principles should be implemented.

One such principle emerges with striking frequency and clarity from the recent history of financial crisis in countries around the world. Nearly every crisis we examine, no matter where it occurred, provides a reminder of the dangers of politicizing the banking system and its supervision.

We see such interference taking various forms. Central governments may compel banks to make loans in defiance of good credit practices in order to promote certain policy goals, such as protecting inefficient industries. Governments may take an ownership interest in the banking system to facilitate such policies. In some cases, government pressure has forced financial institutions to lend to weakened, but politically powerful, companies or industries.

Pressure may be exerted on supervisory authorities to forbear, or "look the other way," when a bank's condition has deteriorated and supervisory action would be warranted. In some cases, court decisions, legislative action, or other informal influences have undermined supervisors. Where supervisors are removed from office without cause

-- and appointed to office without regard to their professional competence -- the quality of bank supervision inevitably suffers.

But though the means may vary, using the banking system to advance a political agenda rarely succeeds in the long run. Where short-term expediency is given primary weight, the safety and soundness of financial institutions is frequently undermined. And when that happens, the banking system's ability to support an economy's growth and well being is surely compromised.

I believe that the evidence of specific national cases bears this out.

In some respects, Argentina stands as a textbook example of the dangers of politicizing the banking system, because the consequences there have been so sudden and dramatic. What had been South America's breadbasket -- and one of its most vibrant economies -- is now an economic basket case, suffering high and rising unemployment and remote prospects for recovery any time soon.

Although a great many factors contributed to the country’s decline, it can be argued that Argentina's downfall was sealed in late 2000 with the launching of a series of official actions that had the effect of crippling the nation's banking system. Banks, as well as pension funds, were pressured into relaxing their limits on holding government debt. A committed safety-and-soundness advocate was ousted from his position as governor of the central bank.

The banking system itself was pushed to the brink of insolvency when the government asymmetrically "pesofied" dollar-denominated bank deposits and assets, a move that decimated bank capital. And the imposition of deposit withdrawal limitations destroyed what little public confidence remained in the system. As a result of the country's liquidity crisis, new loans that might help revive the economy are difficult to come by and Argentina's downslide continues -- regrettably with no end in sight. It will take many years for the banking system to recover.

Japan's economic problems have also been well chronicled, and the role of a weakened banking system in aggravating those problems is well documented. Not as well recognized is the role played by Japanese bank supervisors, then directed by the ministry of finance, in keeping insolvent institutions afloat.

Reluctant to take action against these institutions, Japanese regulators allowed them to bleed slowly, draining resources that might have aided the country's recovery. A new unified Financial Services Agency, responsible to the prime minister's office, was created to correct the problem. But in part because the habits of regulatory paternalism and opaqueness are proving hard to eradicate, stagnation continues to characterize Japan's economy.

South Korea offers another illuminating primer on how even well intentioned government actions can undermine a banking system's safety and soundness. Among the fundamental weaknesses in the Korean banking system as late as the mid-1990s was the truly massive scale of the Seoul government's directed lending program. For years, industries earmarked for support in its export-oriented economy received government-subsidized loans, among many other things. Bank supervisors, through lax supervision, had become instruments of this policy of propping up favored borrowers. Supervisory responsibility was divided between the central bank and the ministry of finance.

But the quality of South Korean supervision, rather than its structure, was the biggest problem. Prudential supervision standards were lax. Banks were not required to undertake in-depth analysis of commercial borrowers. Loans were repeatedly rolled over without meaningful review of the borrowers' abilities to repay. Regulatory limits on concentrations of credit to a single borrower were loose, and they were widely suspended in dealing with favored borrowers. Banks were permitted to grow without adequate risk management safeguards.

When the South Korean economy crashed in 1998, the banking system led the way down. Wisely, the Seoul government recognized the role that inadequate supervision had played in the debacle, and in that year, it undertook a comprehensive restructuring of the country's oversight of financial institutions. Supervision was consolidated into a single agency, independent of the government, and prudential regulations have been brought closer in line with international best practices. At least part of the credit for South Korea's progress toward recovery must go to its effort to reform its supervisory structure -- and to the international donor agencies that encouraged it to act.

South Korea seems to have learned from its experiences. So has Turkey. Supervisory changes have been an essential part of the reform efforts initiated by the Turkish authorities over the last several years, and were among the conditions of the International Monetary Fund's 1999 aid package.

Turkey's financial instability has been the result of a combination of factors, including government interference in the state-owned banks. These banks have incurred huge losses due to directed lending. Fragmented, ineffective supervisory oversight was also a factor. But Turkey is enacting sweeping changes in its national supervision, including the creation of a new, independent, professional regulatory body to do the job previously performed by several government entities. Turkey still faces significant hurdles. But most analysts agree that while the country has a way to go, it's headed in the right direction.

There's a final example I'd like to discuss -- an example considerably closer to home. The independence of bank supervision in the United States itself has often come into question.

It’s a question that has a long and difficult history. During the Great Depression of the 1930s, there was strong sentiment that federal bank supervisors should take marching orders from their superiors in the Treasury Department and from the Federal Reserve. Many people thought that the Comptroller of the Currency should encourage national banks to make loans to good borrowers and bad borrowers alike, and to look the other way as credit quality deteriorated.

Given the gravity of that crisis, with the very survival of the U.S. economy perhaps hanging in the balance, this viewpoint might have been understandable. But had it prevailed, the result could have been disastrous for the banking system, for the federal supervisory agencies, and for the U.S. economy. Fortunately, more sensible heads prevailed, and the statutory firewalls that were designed to protect our independence and shield us from improper influences did their job.

That was not the last of it, however. Over the decades, there have been occasional attempts to draft federal bank examiners into the service of some larger political or economic strategy. For us that's meant contending with pressures that have arisen from time to time to alter our supervision in ways that may be expedient -- but may also be fundamentally unsound.

The late 1980s and early 1990s, for example, were a time of great stress in the U.S. banking system and the U.S. economy. The OCC was encouraged to overlook weaknesses in the balance sheets of some troubled banks in the hope that the economy would improve and the banks in question would turn the corner on their own. Some called this watchful waiting; a better term might have been wishful thinking.

As it turned out, we did no one any favors -- certainly not the affected banks -- by allowing problems to go uncorrected. Losses mounted, forcing us finally to take precipitous action to deal with what were by now deeply troubled, if not insolvent, banks. Loans that passed muster in one examination were severely criticized in the next, as examiners demanded large additions to loan loss reserves previously thought adequate -- with serious consequences for the credibility of supervisors, among other things.

Many banks failed; bank credit became increasingly difficult to come by, generating talk – and it was mostly talk -- of a "credit crunch" ostensibly caused by bank supervisors. But it's certainly true that the banking system's troubles complicated and prolonged the process of economic recovery a decade ago.

This experience is one that we've been determined to learn from -- and never to repeat. It taught us that ignoring or failing to comment on increasing risk or deteriorating conditions -- forbearance, to call it what it is -- is poor supervision. It reminded us that we serve our banks best when we forthrightly convey our concerns to bank managers and encourage them to address changing circumstances.

It caused us to reaffirm our commitment to the proposition that we best serve the public interest by overseeing the safety and soundness of the national banking system consistently, predictably, and independently, in good times and bad. We make our greatest contribution to a sound economy by assuring that our banks have the capacity to extend credit when creditworthy loan opportunities are presented.

I believe the results speak for themselves. While there are pockets of weakness in the banking system today and the possibility of additional problems ahead, those problems are much less widespread – and much more manageable – than they were at a comparable stage of the last business cycle.

Capital is high – twice as high as it was in 1989. As one might expect after two years of business slowdown, nonperforming assets are up, but not alarmingly so. Loan loss provisions are adequate, even if not as conservative as bank examiners might wish. Overall, the industry is still highly profitable -- again, no small accomplishment given the recent condition of the economy.

And here's another quite remarkable development. Although the evidence shows that U.S. banks have gradually been raising their lending standards – a positive development, in our opinion – business credit is still plentiful – much more plentiful than at any similar time since the early 1970s, according to a new FDIC study. So much for credit crunch allegations -- which seem to emerge principally from marginal borrowers whose banks have prudently cut back on their lines.

Perhaps the foremost reason for the improved availability of business credit is that the banking system has generally remained healthy despite what was until recently a down economy. And now that loan demand is poised to pick up again, banks will be in a condition to respond, and the economy will have the capital it needs in order to resume its upward growth.

Before we become too totally intoxicated with our own accomplishments, however, let me offer two quick caveats. First -- and I can't stress this enough – it's important that we not indulge in premature celebration over the news from the front, as it were, because conditions on the battlefield are subject to change. As I said at the outset, the new global economy undoubtedly has many surprises in store for us in the months ahead, and any sense of relief and satisfaction we might feel over the present condition of the banking system must be leavened by a large measure of caution -- and humility.

Second, I am not suggesting that bank supervisors deserve all – or even most – of the credit for the banking system's current health. Many of the changes that have taken place over the last decade, and have helped buffer the industry against hard times, have come from bankers themselves.

Banks are much more diversified in their product lines and less concentrated geographically than they were just ten years ago. That makes them less vulnerable to the kinds of local disturbances that proved so ruinous to financial institutions during the recession of the early 1990s. They have recognized the need for strong capital bases. They have reduced their reliance on volatile interest income, have diversified their revenue streams, and they have invested in advanced risk management techniques that make it possible for them to better measure and manage their risk and thus to limit their exposure to loss.

Bankers too have learned from the last downturn. The historically high levels of capital in the system today are a reflection of the experiences of a decade ago, when adequate capital -- by regulatory standards -- turned out in some cases to be wholly inadequate to cover the actual volume of loan losses. Some bankers vowed that this would never happen again. And tougher capital regulation reinforced that lesson for bankers who might have missed it on their own.

Clearly, we have all learned from experience.

Yet one can't discount the contribution that bank supervisors have made to the industry's health. Bankers certainly don't. Sometimes it's as simple as our taking the blame for a politically awkward decision by a bank, such as declining a longstanding customer's request for a questionable loan. In that spirit, let me say this to the world: we're happy to serve as any banker's scapegoat if it results in a safer and sounder banking system.

And bankers often express their appreciation to us for helping them recognize weaknesses and arrange appropriate corrective action.

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."

The past 24 months -- and the past six months especially -- have been a trying time for the American economy and the American people. Yet, in part because bank supervisors have been resolute in facing the facts and in addressing problems in the banking system as we saw them developing, I believe the American people are better off. Because we have been able to provide not just quality supervision, but independent supervision, the U.S. banking system is strong today. And thankfully, so is our nation.