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Remarks by
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Good morning, and thank you for asking me to join you in Phoenix at the close of what I'm sure has been another great IBAA convention. Of course, I know it hasn't been all work. I'm sure some of you have had time for some golf in this beautiful weather.

There's a wonderful scene in a recent Kevin Costner movie, where a golf pro shares a bit of advice useful to the weekend duffer and the community banker alike. "When a defining moment comes along," he says, "the moment either defines you or you define the moment."

This is just such a moment for community banks.

As many of you know, I have a special fondness and respect for community bankers. In part, it is because I grew up in a small town where the community banker was one of the pillars of the community. Perhaps I also have an affinity for institutions like yours because I know just how important you are for a great number of American families and businesses -- an important source of strength and stability to local economies.

That's why this morning, I want to talk about some of the opportunities and pitfalls community bankers face as you use this moment to define your industry for the future.

This spring, I testified before Congress on the importance of financial modernization to the banking industry and the country as a whole. I outlined what I believe are the five critical principles that should guide any legislation to modernize the banking system. One of the principles I highlighted -- and one I feel particularly strong about -- is the retention and enhancement of the community banking segment of the financial services industry.

How do we ensure that important goal in a world that is changing so rapidly?

Today, new technologies are revolutionizing not only banking but the entire financial services industry. In this highly competitive environment, financial institutions must be both flexible and efficient in order to meet their customers' needs. So in my testimony, I suggested that regulators and lawmakers can help ensure the goal of a strong community banking sector by guaranteeing that any new legal and regulatory regime we devise gives community banks the flexibility -- consistent with safe and sound operations -- to offer the financial products and services and to choose the organizational structure that will let you do the best possible job of meeting your customers' needs. Government should intrude in your business only when clear public policy concerns make it absolutely necessary.

Obviously, one relevant policy concern is the safety and soundness of our nation's financial institutions. But over the past 15 years, we have learned through hard experience that effective supervision is our most important tool to ensure bank safety and soundness. In fact, many -- including myself -- believe that the banking problems of the past 15 years resulted from outdated legal restrictions on bank activities, which pressured banks to take increasingly greater risks or become excessively concentrated in those lines of business that were available to them.

With that experience in mind, a consensus has developed that banks must be permitted to broaden their activities. But old habits and old ways of thinking die hard. There is no consensus on how banks should be permitted to structure those activities.

It is clear to me that the best way to ensure a healthy banking system is to make sure banks -- and particularly community banks -- have the freedom to structure their operations in a way that best suits their needs and the needs of their customers, as long as we have appropriate supervisory safeguards in place. Allowing banks to engage in new activities on the one hand but imposing an artificial structure on the other will impede rather than promote safety and soundness. And it will impose substantial costs and inefficiencies on banks that will limit your ability to prosper, to serve America's consumers and communities, and to compete in the global marketplace.

This morning, I would like to offer my thoughts on what you as community bankers can do to ensure your place in the banking system of the future by seizing the opportunities before you and addressing new challenges. I will focus on three categories of opportunities:

- opportunities that flow from your smaller size and unique position in your communities;
- opportunities that flow from new technologies and the ways you are uniquely positioned to take advantage of these technologies; and
- opportunities that flow from recent legal and regulatory changes.

Then, I want to look at two potential pitfalls -- for you, the potential to neglect the fundamentals of risk management, and for us as supervisors, failing to make sure our supervision keeps pace with the changes in community banking.

Opportunities for Community Bankers

Perhaps the greatest opportunities for community banks are those that flow from your smaller size and the special relationships you have with your local communities. Our world seems to be becoming more and more homogenized -- with McDonald's and Starbucks at every shopping mall within driving distance. Yet regional and local differences will persist, and these differences offer real opportunities for community banks. Specialized market providers who have grown up in America's small towns, who are familiar with the trials and tribulations of their businesses have a distinct advantage in meeting the needs of their indigenous businesses.

In my home town of York, Pennsylvania, for example, agricultural providers, fruit growers and farmers from the local area have unique banking and financial needs, and they can benefit from a local financial provider familiar with these needs. The community bank can engage in niche banking, tailoring its products and services to respond to the specific needs of the local marketplace.

Another opportunity that flows from the community bank's size and special relationship with its community is almost the flip side of the point I just made -- the ability to be a full-service provider of financial products and services.
Undeniably, even more than in the past, many bank customers will be searching the marketplace or surfing the Net for the lowest price and the best deal in financial services. But I'm convinced that many more customers will want someone they know and trust to manage all their financial affairs. And that's where you have a unique advantage.

The second category of opportunities I see for community banks of the future are opportunities presented by emerging technologies. Many of you may be tempted to view technology as a threat rather than an opportunity, because some technological advances at least initially require sizeable investments that are prohibitive for smaller banks. On balance, however, I see technology as the friend of community banks for several reasons.

The requirements for implementing computer technology in a community bank may be relatively modest because of the small size and geographic scope of the bank. A community bank rarely has to assemble information from far-flung locations or integrate previously separate -- and perhaps incompatible -- systems. That challenge is a big issue for larger, interstate institutions that must combine previously independent operations to gain operating efficiencies. And, in many cases, community banks can employ technology more efficiently because the reduced scale and complexity of your operations allow you to go with "off-the-rack" technologies.

In addition, some new technologies do not require massive initial investments. These technologies can give small institutions the ability to offer their customers a wide array of products and opportunities at relatively low cost -- making it possible for smaller institutions to enjoy economies of scale similar to those available to larger institutions.

For example, the Apollo Trust Company of Apollo, Pennsylvania, is exploiting new technologies through an operating subsidiary that provides home banking services via a direct Internet connection to the bank's home banking system and provides Internet access to bank and non-bank customers in the bank's service area. Many community organizations use the bank's Internet service, including local libraries, schools, local county governments and other public organizations.

Peoples National Bank & Trust of Ottawa, Kansas, recently received OCC approval to establish an operating subsidiary called "Interbank." Interbank provides investment portfolio management services for the bank and computer networking for other financial institutions. Clearly, the creative use of new technologies allow community banks -- not only to serve their localities more efficiently -- but to expand the scope of their operation. In the past, to operate on a broader scale required investments in branches and equipment. Technology makes it possible to have a huge market presence with comparatively low investment.

The third category of opportunities for community banks includes those presented by recent legal and regulatory changes. These changes provide greater flexibility in the products and activities that banks can offer and the forms in which they can organize their activities. Many of you may be aware of OCC's recent revisions to Part 5, the section of our regulations that governs corporate applications. In addition to streamlining our application procedures, Part 5 establishes a process under which banks can apply for permission to conduct, in operating subsidiaries, activities that are part of or incidental to the business of banking but different from those that may be conducted by the bank itself. Many news reports have focused on the importance of this option for bigger banks. But I believe operating subsidiaries offer a particularly useful alternative for smaller banks like you that may find it uneconomical to establish a holding company structure.

At the OCC, we have also recently clarified the ability of banks to make minority investments, primarily through limited liability companies, in activities that may be too expensive for individual banks to undertake. The limited liability company offers the advantages of limited liability and flow-through tax treatment. Community banks may form LLCs together and undertake business ventures while spreading the cost among LLC owners. This option offers them the possibility to offer products and services that might otherwise be profitable only for larger banks.

Some of the opportunities I have just outlined are uniquely available to community banks. Others are available to all banks regardless of size. They offer community banks new arenas to compete with larger institutions on an equal footing. I believe they offer a blueprint for building a successful community bank in the 21st Century.

Community Bank Challenges

But with every market opportunity come new challenges. So let me now turn to two primary challenges I see facing America's community banks and their supervisors: for community banks, the challenge of maintaining strong risk management programs as you seek to grow and take advantage of new opportunities; and for us as your supervisors, making sure we take into account changes in community banking in the way we supervise your institutions.

No one ever argues about the value of strong risk management systems -- at least in theory. Yet history has shown that, all too often, the first casualty of a bank's efforts to increase profitability and to grow has been the bank's program of sound risk management. The same danger will confront banks in the 21st century. The risk management issues faced by America's community banks will continue to include maintaining sound underwriting standards, avoiding asset concentrations, strengthening internal controls, ensuring adequate liquidity, and improving back office management. And you will have to deal with these issues in the face of increasing pressures to cut costs to maximize your earnings.

Let me spend just a moment talking about potential liquidity problems at community banks. For some time, community banks have been losing core deposits to mutual funds. But last year, for the first time ever, the dollar amount of all mutual funds exceeded commercial bank total deposits. At this moment, I can see no reason not to expect this trend to continue, and as a result, community banks may have to increase their reliance on wholesale funding in the future. That means increased liquidity risk that must be carefully managed.

Part of that management should include diversification of funding sources. For example, you will need to monitor the growth of wholesale funds in your bank to make sure you have appropriately limited how much you rely on any large fund providers. Your bank should also make appropriate use of financial markets and instruments for funding purposes, with appropriate maturity structures and balanced fund flows. It should go without saying that wholesale funds providers are generally quite sensitive to bank credit quality and may withdraw funding support if financial performance deteriorates. And, of course, even so-called core deposit customers may withdraw funds under severe conditions.

So it is essential that banks have contingency funding plans in place that could be used during periods when credit-sensitive or non-relationship funding might be unavailable. Given the current trends in bank funding, it is only good sense for all institutions -- including community banks -- to develop contingency plans now, during strong economic times, as a pre-emptive defense against potentially serious liquidity problems in the future.

Another challenge for community banks will be to take a strategic view of the future. None of us can predict the full extent of the changes the future will bring, but a good place to begin is looking back at the immediate past. Ten years ago, I doubt Apollo Trust Company or Peoples National Bank conceived that they would be providing the services I described earlier. Few community banks would have expected to see the decline in core deposits that occurred in the first part of this decade. And who would have imagined the extent to which community banks have increased their fee income from sales of mutual funds and annuities?

Let me emphasize this point once again. It is imperative that community banks retain the flexibility to offer new products and services as the need develops and to utilize the structures that will enable them to offer cost effective products on a smaller scale. Community banks simply cannot afford excess costs that would inevitably result from structural impediments to flexibility.

In your strategic planning -- and in our supervision of your banks -- you and we must recognize that community banks today are different from community banks of the past. Community bankers and their supervisors alike must factor these changes into their strategic planning, including developing effective risk management strategies.

That's what we're doing at the OCC. At the beginning of this year, I sent every community national bank and mid-size national bank a personal letter informing them of changes we are making to do a better job of supervising the risks in your institutions.

For starters, we are changing our district organizational structure to focus on community and mid-size banks. Our new supervisory structure will accomplish two key goals. First, it will allow us to create a cadre of senior examiners to specialize in community banks, recognizing that community banks have special needs. This allows us to add maximum value to the supervision of community banks, because there is a great benefit to you to have examiners who are expert in community banking. Second, more seasoned and specialized examiners will be able to spot problems earlier. This is particularly important today, when there is increased volatility and a premium on being able to respond quickly to emerging concerns.

We are also developing automated systems that will generate more and better information on community bank activities. Through these systems, we will be able to do a better job of identifying trends among community banks. And that means we can provide better information to you about potential problems and risks.

Let me give you an example. As part of our supervision by risk program, we are developing more detailed aggregate information about the risk levels and risk trends in 2,300 community national banks, based on reports from our community bank examiners. We just completed our analysis of the first risk data provided by our examiners for year-end 1996. With your permission, I would like to share some of the results.

Overall, our examiners report high levels of risk in a very small number of community banks. However, they also report that risk is increasing in a significantly larger percentage of community banks.

This pattern is most pronounced in the credit risk area. As of year-end, examiners found high levels of credit risk in 3 percent of community banks. But they also reported credit risk increasing in 18 percent -- almost one-fifth -- of community banks. That's the highest percentage for any of OCC's nine risk categories.

Now, it's true that many of these banks had previously had low or moderate levels of credit risk. It's also true that part of this increase is the result of greater loan demand in an expanding economy. But that's not the whole story. At least some of this growth in credit risk is a result of a weakening in underwriting standards, where banks feel pressured to continue booking loans in an increasingly competitive environment.

Let me say this once again: now is not the time for any bank to cut corners on its underwriting standards or its internal controls. Now is the time, however, to make sure you have the necessary controls in place to recognize credit problems early and to take appropriate action to manage these problems.

Just 10 days ago, the OCC issued an advisory on underwriting standards and portfolio credit risk management. I've asked our examiners to discuss the issue of portfolio credit risk during their next meeting with you. I think you will agree that now, when the economy is strong and credit risk at most community banks is stable, is exactly the right time for us to address this issue together.

In the area of interest rate risk, examiners report high interest rate risk at 2.2 percent of community banks, with the risk increasing at another 2 percent of those banks. However, examiners also reported moderate levels of interest rate risk at 43 percent, or almost half, of community banks.

Year-end reports about the level of transaction risk, or operating risk, at community banks showed a very small minority of banks -- 1.5 percent -- with high levels of operating risk. Less than 7 percent were found to have increasing levels of operating risk.

This was our first attempt at gathering this kind of aggregate information about the risk levels in community banks under the OCC's nine categories of risk. It gives us a snapshot of where our examiners believe community banks stood at year-end -- a benchmark against which we can measure changes in community banks' overall risk levels going forward. We intend to collect and analyze this information from our examiners each quarter so we can identify changes in these banks' overall risk profile. More specifically, we will be able to identify trends that could lead to problems for community banks in the future.

A few of you might wonder why we're making these changes in our community bank supervision now, when the banking industry has just turned in another year of record profits. I think most of you already know the answer. As I stressed earlier, now -- when the economy is healthy and bank earnings are strong -- is precisely the time when we must be on our guard against actions that could sow the seeds of future banking problems -- problems that will only become apparent when the economic cycle turns.

Conclusion

As you return to the small towns and communities that have come to depend on your banks, I urge you to rise to the challenge of this defining moment for the banking industry in general and for community banking in particular.

Your size gives you tremendous advantages, but the current environment presents significant challenges you must address to position your institutions and the communities they serve for continued success. Don't let the pressures of this moment define you. You have the ability -- and the responsibility -- to define this moment for your banks, for your communities and for an important sector of America's financial services industry -- community banking. And the OCC looks forward to continuing to work with you and for you as you successfully compete on your corner.

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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.