Remarks
by
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I'm here to talk about risks that the banking industry — including thrifts — faces. In particular, I will talk about: one, the risks banking faces in the Year 2000 — or Y2K — challenge; two, risks that arise from economic trends; and, three, risks that are the result of the behavior of bank management.

I. First, Y2K. The risks associated with Y2K are the most immediate, and not because the regulators think that banks are going to fail — or have severe problems — because we simply don’t, but because there is an uncertain element in how events will develop between now and

January 1, 2000. That element is the behavior of the public in the next seven months.

Federal Reserve Chairman Alan Greenspan put the concern this way just a few weeks ago, when he said: "I’m increasingly less concerned about whether there will be true systemic problems. What I am concerned about are peoples’ reactions to the fear that something momentous is going to happen on January 1, 2000."

Clearly, we have a job ahead of us: maintaining public confidence in banking as concerns rise that computers will fail. To maintain confidence, both bankers and the FDIC have a responsibility to go beyond our normal scope of communications. Certainly, the FDIC has been vocal in reporting on the progress of the banking industry, and we will continue to be outspoken.

Our three-part story is as follows:

First, bankers have been working aggressively to meet the Y2K challenge, and a number of experts say that banking is the industry best prepared for the date change.

Second, regulators are aggressively supervising the banks' preparations to become Year 2000 ready. Examiners have been in every bank and savings association in the country not only once, but at least twice to make sure that banks are making satisfactory progress. Any problem banks will receive strict supervisory attention. No one can say there won't be glitches, but — if you do all that you can — we have a great deal of confidence that the banking industry will be ready.

And three, money in an FDIC-insured account is safe — no ifs, ands, or buts. **The Year 2000 will not affect our Federal guarantee.**

Communicating on Y2K is one of our highest priorities. The Federal bank regulators have been working together on Y2K communications for many months, but we are prepared to take an unprecedented step. For the first time, the FDIC, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision are formally forging a coordinated approach to communications — communicating to the public the status of the industry's preparedness. In fact, we have formed a communications team: Fed Governor Mike Kelley will speak for the central bank, with Governor Roger Ferguson continuing to speak on international Y2K issues; Comptroller Jerry Hawke, OTS Director Ellen Seidman, and I will speak for our respective agencies. We expect to be busy.

But as important as it is to talk about the industry's progress as a whole, which we regulators have done and will continue to do, there is other information that reassures the public, perhaps even more — information the government cannot provide, but information that only you — the industry — can: information on your Y2K preparations and readiness.

How can I say that? Recent focus group research found that nearly two-thirds of participants said that receiving information from their bank would increase their confidence in the bank’s ability to become Y2K ready. At the same time, another recent Gallup poll found that 78 percent of respondents trusted computer experts as sources of information about Y2K issues, 77 percent trusted bank managers, and 75 percent said they trusted Federal regulatory agencies. In other words, bankers have about the same level of credibility in talking about Y2K as bank regulators — and a solid majority of people say that receiving information from their particular bank would increase their confidence.

Yet, that same Gallup poll reported a troubling statistic: Almost three-out-of-four Americans believe that they haven't received any Y2K information from their banks — almost three-out-of-four. You and I know that this is not true. Perhaps you sent it out — once. But it takes repetition to reach a wider and wider audience.

At the same time, bankers have told the FDIC — again and again — that the regulators should be doing more on Y2K because the public trusts us more than it trusts the industry. Not true. You’re missing a great opportunity. Your customers want to hear from you, and they want to hear facts, not broad assurances.

I want to encourage you — and your colleagues throughout the industry — to talk with your customers — not just as a trade association, not just as an industry — but as individual institutions. You know what you cannot say: You cannot reveal your Y2K assessments, which can change over time. But you also know what you can say: You can describe what you have done — such as meeting Federal Financial Institutions Examination Council milestones. Tell consumers exactly what you're doing.

Your customers need to know that:

• You have tested your systems and they are ready for Y2K.

• You have met all of the Y2K milestones set by Federal regulators.

• You have contingency plans to make sure that customers will have access to their money.

• You are taking steps to ensure that customer financial records will be preserved.

Consumers want to know how you will serve them if there is an unanticipated disruption due toY2K.

The bottom line is that consumers deserve to know — specifically — what you are doing to ensure that they will have access to their money, and — specifically — what you are doing to ensure that your customers continue to receive accurate information on their accounts.

Specific information lends credibility to your story. In your interest, you need to weigh in with your positive story. If you don't tell your story, no one else will. And, if there is a negative story out there and your customers haven't yet heard your story, it will be difficult for you to turn them around. I urge you to use every opportunity to get your story out, to make the facts known.

Most people are not expecting everything to be perfect come January 1. After all, everything is not perfect now. So don't overpromise, but do provide information — complete, accurate, and reliable information. This information will help people keep the Y2K rollover in perspective.

The FDIC can tell our story, but only you can tell yours. Our stories reinforce each other's, and provide reassurance to a public that may have fears. You have a good story to tell as an industry — most experts say that banking is the industry best prepared for Y2K. We certainly will continue to get our story out.

But the most effective story is the one that only your institution can tell individually. The regulators and the trade associations are reporting on your progress as an industry, but you, individually, hold a trump card in your hands. In the interest of maintaining public confidence, I urge you to play it.

II. As a risk to the banking industry, the Y2K challenge is unique. But the industry faces other types of risks, as well. Emerging risks and the reemergence of old familiar ones are a constant concern to bank supervisors in all economic cycles.

Let’s consider the second area of risks I’m here to talk with you about — risks that banks face from the economy. The economy is in its 98th month of expansion. If the economy continues to expand through January of next year, this will be the longest economic expansion — ever. The expansion shows few signs of slowing. By most measures of prosperity, this is the best economy in a generation. Inflation and unemployment are at levels not seen since the 1960s. Consumer spending and business investment are propelling growth even at this late stage of the expansion. But consider this: According to the National Bureau of Economic Research, over the past 17 years, the U.S. economy has been in recession only 4 percent of the time — essentially 8 months.

However, between 1857 and 1957, the U.S. economy was in recession 40 percent of the time.

So while the recent performance of the U.S. economy is a triumph of fiscal and monetary policy, it is also uncharted territory.

In other words, this is no time for complacency. Moreover, our economy has become linked to the health of — and events in — foreign economies. This linkage has increased the incidence of sudden adverse economic and financial events. And — given the medium- and long-term nature of the banking business — banks do not react well when faced with sudden change. That makes our job of watching the horizon all the more important.

Commodity price weaknesses, hot commercial real estate development, and an uncertain outlook for the global economy are areas clouding an otherwise strong economic picture. Bankers in the Northwest know that this region of the country has been affected by problems from widespread commodity price declines and slackened export demand. The Asian crisis had a number of effects in this region, especially reducing exports, particularly in high-tech manufacturing and in agriculture. For example, the rapid expansion of computer and electronics manufacturing jobs crested in 1998, when jobs in California, Oregon and here in the state of Washington fell by 11,200. The year before — 1997 — they rose by 24,000 in these three states.

And agricultural producers in this region and across the United States have felt the impact of weakened demand for farm and ranch products. Just look at what has happened to U.S. wheat farmers. The dollar value of U.S. wheat exports in 1998 was 40 percent less than it was just two years ago.

Commercial real estate is another area where we are monitoring developments closely.

Commercial real estate lending is on the rise, though credit losses to this point in the cycle have been very low. In several major markets around the country, we are seeing rapid development that threatens to produce near-term oversupply. Those markets are Portland, Phoenix, Dallas, Las Vegas, Atlanta, Nashville, Salt Lake City, Charlotte and Orlando. There are signs of possible trouble ahead: rising vacancy rates and slowing employment growth. Let's keep those factors in mind.

III. Let's turn to the third area of risk — the area where bank management behavior plays more of a role. Strong competition in the financial marketplace has placed pressure on banks to look for ways to maintain market share and increase profitability. These pressures may also be forcing institutions to compromise their underwriting standards. Banks become deeply committed to their borrowing customers.

When trouble arises, immediate extrication or unlending your bank's money is not an option.

So keeping a wary eye on developments that affect the success of your borrowing customers —and preserving flexibility — are long-standing banking traditions.

In that regard, we see the "new frontiers" in consumer lending — subprime and high loan-to-value home equity lending — pushing institutions into riskier territory where some institutions are having problems, even though times are good. About one-half of the FDIC institutions are subprime lenders. The bank regulatory agencies have provided guidance on sub-prime lending on a couple of occasions — and the FDIC may issue more. Subprime loans are particularly vulnerable to a down cycle.

The FDIC has always been sensitive to the need for banks to maintain proper capital against the risks being undertaken. As banks become engaged in categories of lending that traditionally have been the province of entities that are willing to accept greater credit risks, it is reasonable to expect that the percentage of capital maintained against those risks will be adjusted proportionately upward. At the FDIC, we are working closely with our counterparts studying this issue and will react as necessary to ensure that capital remains in a proper proportion with the riskiness of assets.

The market currently rewards high-performing banks to an unprecedented degree. This gives some lenders the incentive to push the envelope. While bank income statements have been telling a pleasing story, one also has to consider whether there is more risk on bank balance sheets, especially when you are a bank supervisor.

In this environment, our examiners tell us that the good condition of an institution does not necessarily mean that it is following sound risk management practices. Therefore, we believe that the FDIC ratings we assign to institutions must reflect more than their current financial condition. They should also reflect the practices they embrace.

The thrift and banking crises of the 1980s and early 1990s taught us the importance of a proper level of cash flow as a basis for lending, as well as the importance for proper documentation of loans, for enforcement of covenants, and, in general, for maintaining a prudent degree of control in a lending relationship. It is important for you to observe a sound credit culture in your vigorous competition with each other.

Disregard for proven banking principles may appear benign now, but when the economic cycle turns, those of you who have tended to the fundamentals and the basics will meet the challenges.

In that regard, maintaining a proper allowance for loan and lease losses is a well-founded principle of the lending business. Transparency is important. But the allowance for loan and lease losses serves a safety and soundness purpose as well. Loan loss reserves are estimates —and are often ranges. We at the FDIC believe it is important and very appropriate to be at the high end of those ranges. Thoughtfulness in setting the allowance for loan and lease losses may be particularly important now, given (1) the extraordinary length of the expansion, (2) the fact that banks are passing up few opportunities to lend, and (3) a relaxation in lending standards that has been apparent in periodic surveys of lending practices.

In closing, I want to remind you of Murphy’s Law, not Murphy’s First Law "If something can go wrong, it will," but Murphy’s Eighth Law, which he developed later in life, with the benefit of experience. It reads: "If everything seems to be going well, you have obviously overlooked something." Things certainly seem to be going well for banking.

Last year was the first year — ever — that the commercial banking and the thrift industries both had returns on assets of more than one percent. Last year, commercial bank earnings surpassed $60 billion for the first time. And savings institution earnings surpassed $10 billion for the first time. Last year, only three commercial banks failed. And for the second consecutive year, no savings institution failed. It is high tide for the industry. But we all want to make certain that when that tide begins to ebb, banks stay afloat. So — although it has never been better for banks than it is today — we’re working to make sure that we don’t overlook anything.

Thank you.

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