**Remarks by**
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Recently, I had the pleasure of announcing that the commercial banking industry in the second quarter of 1999 reported the second best quarterly profit you have ever enjoyed -- $17 billion. This second quarter was the 26th consecutive quarter that return on assets for the industry - as a whole - exceeded one percent. For the first six months of this year, industry earnings totaled almost $35 billion - more than nine percent higher than the first half of last year. Indeed, the financial performance of the industry during most of the 1990s consists of an almost unbroken string of record-shattering earnings performances. These results reflect your efforts to reduce costs, increase efficiencies and meet the evolving needs of your customers. I want to commend you for all your hard work.

The economy -- and the banking industry -- have performed remarkably well over this decade. We are experiencing the longest peacetime expansion in U.S. history.

It is no time to be complacent, however. The economic data -- and financials of the industry -- are scorecards that show us where we have been -- and the scenery in the rear-view mirror is great - no doubt about that.

But to get a better idea of what may lie ahead, we need to look at other indicators. Today I would like to talk with you about several trends the FDIC is particularly concerned about and that we believe deserve everyone's attention. Certainly, earnings are strong, balance sheets look solid, and the potential for problems seems abstract and distant, but as the deposit insurer - and a bank supervisor - the FDIC must continually ask two basic questions: One, if the economic cycle turns, how might developments affect banks? And, two, what should bankers and regulators be doing now to guard against adversity?

As bankers, you know the importance of maintaining prudential standards. Because you are in the business of managing risk, you know how important it is to make decisions in good economic times that will serve you well when conditions become less favorable.

The FDIC is also in the business of managing risk, both as deposit insurer and a supervisor, and we are focusing on areas where making changes today could reduce the potential for problems in the future.

One of those areas is assessing the appropriate level of capital for institutions with concentrations in subprime lending.

Not too long ago, hearing the FDIC Chairman talk about capital would not have been surprising, but coming on the heels of my reporting near record earnings and the generally good health of the industry, I suspect you are all wondering why we are thinking at all about capital, particularly in the context of loan portfolios that are contributing greatly to the earnings the industry is enjoying.

Let me explain.

The consumer lending landscape has changed quite a bit over the last few years. One major change has been banks pursuing higher-rate loans to less creditworthy borrowers - a line of business known as "subprime" lending.

The extent of bank and thrift involvement is difficult to quantify because the degree of subprime lending is not transparent in their financial reports. Nevertheless, we have identified 150 insured institutions engaged in some form of subprime lending as of June 1999.

Subprime lending definitions vary, but the programs I am talking about today are aimed at consumers with significantly higher probability of default - and risk of loss -- than prime borrowers have.

We are convinced that a well-managed, appropriately capitalized consumer lending program can meet the credit needs of a broad spectrum of borrowers - including those with subprime credit histories - and do so in a safe-and-sound manner. But consumer lending programs that employ predatory pricing and other questionable practices - that do not adequately account and price for risk - that focus on short-term results without regard to long-term consequences -- and that are led by inexperienced management teams through rapid growth -- are not geared toward safe and sound operations.

Such programs transfer risk to the FDIC.

When not expertly managed, subprime lending has shown itself to be a high-risk activity that poses increased risk to the deposit insurance funds.

Why?

Some lenders fail to understand the risks and underestimate the costs inherent in this activity.

What are those risks and what are those costs?

First, credit losses for subprime lenders are more than double those of traditional consumer specialists in recent years. Second, the variability of credit losses - as measured by the range of net loan loss ratios -- among subprime institutions is also significantly higher-almost twice that of traditional consumer specialists. Third, servicing and collection costs for subprime mortgages are sometimes more than triple that of regular mortgage portfolios. Fourth, the additional fixed cost outlay of servicing a subprime portfolio places pressure on a subprime lender to generate more volume, which increases the concentration of high-risk assets in the institution's portfolio. Fifth, traditional credit scoring models can have limited predictive power for subprime loans, further increasing underwriting costs. Moreover, the effectiveness of credit scoring models for subprime loans has not been tested in an economic downturn.

So what does this trend in subprime lending mean for you?

A great deal.

Turmoil in the global capital markets last fall resulted in a liquidity crisis for many subprime specialty finance companies. Some subprime specialists went out of business, and some have been looking for merger partners - with banking organizations. And industry analysts have predicted that more subprime lenders will seek partnerships with insured institutions in order to take advantage of cheaper funding and access to greater leverage than that available to non-bank subprime specialists. To the extent the insurance funds become repositories for poorly managed risks that are shunned by investors in the private marketplace, the risks are transferred to the FDIC and the costs will be borne by those who ultimately pay for operating the deposit insurance system-and that means you. These risks and costs are not simply of academic concern. There is a disproportionate representation on the FDIC's problem list of insured institutions that have a sizable investment in subprime programs. Nearly 20 percent of all insured institutions rated CAMELS 4 or 5 have subprime lending portfolios that exceed their equity capital. And we are concerned about the potential for an even greater number of problems associated with subprime lending in the event of an economic downturn.

The FDIC is focusing special attention on the appropriate capital level to support subprime lending programs. The risk-reward relationship in lending is well established, and so is the expectation that higher risk will be compensated for through higher capital.

It should come as no surprise, therefore, that we think concentrations of subprime loans generally warrant higher capital levels than traditional consumer lending. The FDIC has already requested higher levels of several banks for this very reason, and we think this approach should be considered for industry-wide implementation. We are therefore developing a framework to require additional capital for subprime portfolios, and we expect to present that proposal to our fellow regulators in the near future for consideration. We believe that this is an important initiative, and we believe that this initiative is well grounded in the traditional relationships between risk and capital.

The risks in subprime lending leads me to another trend I want to talk with you about today - a trend in bank failures. Five of the nine banks that failed in 1998 or 1999 had significant subprime portfolios. While the subprime portfolios themselves were not the direct cause of failure, management weaknesses -- and apparent fraud associated with these portfolios -- contributed to their closing.

One recent event underscores why all of us cannot afford to be complacent. As you know, in late August, the First National Bank of Keystone, West Virginia failed. We do not know at this time what the ultimate cost of the Keystone resolution will be, although it promises to be one of the more costly failures in the history of the FDIC. Why the uncertainty? Approximately one-half of the assets on the books of the bank cannot be accounted for.

Nevertheless, today we estimate that the cost will be approximately $750 million. Keystone's assets at the time of failure were $1.1 billion. Thus, the cost as a percent of assets could approach 75 percent, which is enormously high. The immediate cause of this failure appears to have been fraud. All this calls to mind another failure - the failure of Best Bank in 1998. In that case, too, the loss rate was extremely high - and fraud was present.

While it has been true historically that even in good times there have been a handful of fraud-related failures, the magnitude of recent losses and the presence of other risky indicators in these failures are cause for concern. These failures have highlighted issues that bank supervisors must address on an interagency basis.

Now you might be asking: How is the FDIC improving its preparedness for situations such as these?

First, we are requiring all our Regional Offices to identify institutions that have securitizable loans held off premises by third parties. We intend to target those institutions for review - especially those that have identified management and internal control weaknesses. Controls are of ultimate importance, and the supervisory practice of establishing that the bank actually owns what it claims to own - a task that has in many respects been delegated to auditors -- has reemerged as a priority. So we are also reviewing the regulatory reliance on internal and external audits, and we will be talking with auditing firms about the lessons of Best Bank and Keystone. We plan to revisit current rules that place no limit on the amount of residual assets from securitizations that can be counted for regulatory capital purposes. These assets have been prominent in more than one recent problem bank, as well as one failure. The asset values are extremely volatile and generally not marketable. Where applicable, the industry should also be examining the implications of concentrations of residual assets on your balance sheets.

The FDIC also has another initiative underway that is targeted at risky banking practices. This initiative involves the risk-based premium system.

We have worked for some time with other regulators to develop screens to identify institutions with atypically high risk profiles in the best-rated category of the risk-based premium matrix - those that are not currently paying deposit insurance premiums. The screens would identify characteristics such as rapid growth, high lending concentrations, high yielding assets, and changes in the business mix. Under the initiative, if concerns are not addressed, a bank would be reclassified and pay premiums.

Back-testing of the screens we are considering indicates that a significant number of failures and near failures in recent years - including Keystone -- would have been identified while these banks were still in the best-rated category. We need to push forward on this front.

If the recent failure of Keystone comes in at what we are estimating it will be, the reserve ratio of the Bank Insurance Fund will be reduced by four basis points. This may not seem like much when compared to 140 basis points, the level at which the reserve stood at midyear. But the picture changes when you think of it in terms of the reserve ratio being only 15 basis points above the Designated Reserve Ratio. More than one quarter of that 15 basis points may be depleted as we resolve the Keystone failure.

If we encounter one or two more failures of this magnitude, banks could once again be faced with the prospect of paying deposit insurance premiums in order to maintain the 1.25 Designated Reserve Ratio mandated by law.

I am not predicting that will happen, but I'm here today to remind you that the line between a comfortable feeling of security and the feeling of being rudely awakened can sometimes be crossed quickly and unexpectedly.

In addition to the trends I have already discussed with you - consumer lending and fraud - trends in credit quality and in the agricultural sector could pose problems if the economic environment suddenly became less favorable. These are trends you have already heard about from others - economists, industry analysts and from my colleagues at the other regulatory agencies. These cautionary messages, however, are worth repeating.

Not only do these trends have implications for the safety and soundness of your banks, they ultimately have implications for the deposit insurance funds.

We already see signs that credit quality is declining. First, the FDIC has noted an increase in CAMELS rating downgrades. A total of 734 institutions were downgraded during the four quarters ending June 1999. While just over two-thirds of these downgrades were within the "satisfactory" band -- from a composite 1 to a composite 2 -- roughly 20 percent of the downgrades were from a composite 2 to a composite 3. These downgrades have been attributed primarily to criticisms of management policies and practices and deterioration in asset quality.

The second sign is that evidence from examinations and reported financial information point to a greater volume of problem assets. We have noted an increase in adversely classified assets. In fact, according to an interagency review of commercial loans in the Shared National Credit Review, the dollar volume of adversely classified and especially-mentioned credits increased significantly. Also, rating agency bond downgrades for industrial companies are exceeding upgrades. And we are starting to see modest increases in both corporate bond defaults and losses on the business loans of commercial banks.

A third sign is that for the first time since the late 1980s, more than half of all syndicated commercial loans originated in the first half of 1999 were leveraged loans.

On the positive side, the most recent regulatory surveys show that banks are tightening their business lending practices. However, this tightening follows several years of loosening underwriting standards.

In addition, conditions in the agricultural sector today have the potential to affect a large number of FDIC-insured banks in the upper Midwest and parts of the South. U.S. producers of grains, cotton and hogs are experiencing significant financial distress because of historically low prices for these agricultural commodities. As of the midyear, financial distress in agriculture was only beginning to find its way to the bottom line of agricultural banks. However, there are clear signs that - unless conditions change for these borrowers - losses for their lenders will rise.

Take, for example, the increasing carryover debt on the books of agricultural lenders. Results from our soon-to-be released semiannual Report on Underwriting Practices - a summary of responses from FDIC examiners after each bank examination - indicate a growing volume of carryover debt in banks active in agricultural lending. Specifically, the proportion of banks with both a "moderate" and "sharp" increase in such debt rose from the previous reporting period. Reports out of the Federal Reserve Bank of Kansas City also show greater use of carryover debt. These recent increases in the use of carryover debt mean that agricultural loan losses could rise significantly in the future, unless we see substantial recovery in global prices for some key agricultural commodities.

These credit quality trends have not created serious problems to date.

They do not point unambiguously to future problems. But they do signal the potential for more serious credit quality concerns should economic conditions change for the worse.

All of us - bankers, bank supervisors and the FDIC as deposit insurer - should keep in mind that we are enjoying an economic tide that has risen for almost a decade, and we need to be mindful that - even in this extraordinary era of prosperity - we must continue to be on guard.

Looking back over the 1990s, banks have much to be proud of - rebuilding the Bank Insurance Fund from a negative balance to a position of strength, serving as a driver of U.S. economic growth, posting an almost unbroken string of record earnings performances, and working to meet the Y2K challenge, which you have done so well and that I hope you will continue to do in your public outreach effort.

Looking ahead, there is much to accomplish - navigating the ups and downs of the business cycle, and meeting the challenges of a changing global, financial and technological landscape. My colleagues and I at the FDIC look forward to working with all of you to meet these challenges.

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