TESTIMONY ON RECENT BANK FAILURES
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

February 8, 2000

Ellen Seidman, Director
Office of Thrift Supervision

I. Introduction

Good morning, Chairman Leach and members of the Committee. Thank you for your invitation to discuss recent depository institution failures and the supervisory systems and initiatives we have in place to safeguard institutions and protect the federal deposit insurance funds.

OTS's approach to examination and supervision is grounded in risk assessment. Accurately assessing risk in a timely manner, however, is becoming more difficult as the risks facing depository institutions change at an ever faster pace. As a result, supervisors and examiners have to be alert to new risks and to shifts in the environment in which institutions operate. We have to understand how to supervise in a manner that both mitigates risk and is respectful of the fact that the institutions we regulate are privately-owned profit-making entities. And we must do this in the context of the responsibilities of both thrifts and OTS to consumers and communities. All this requires well-developed and well-executed policies and experience, coupled with training and a mind-set that encourages constant learning.

OTS has a staff of highly-experienced, well-trained financial institution examiners who have, on average, at least ten years experience. Our examiner training programs for both new and experienced examiners emphasize new and potential areas of thrift expansion, such as small business and consumer lending and the more broad-based exercise of fiduciary powers. Moreover, we encourage our examiners, as well as the rest of the staff, to learn constantly from their experience, from each other, and from the experience of other bank regulators, including in particular from recent failures and near failures. We are proud of our contribution to the current health and stability of the thrift industry, and we are prepared for the challenges of the future.

II. State of the Thrift Industry

Thrifts are currently enjoying their best period of sustained health and profitability in over 35 years. As of September 30, 1999, there were 1,111 OTS-regulated thrifts, holding assets of $863 billion, with an industry equity capital ratio of 8.0 percent. This is down from the industry equity capital ratio of 8.32 percent at the end of 1997, but substantially exceeds any other period in the last 50 years. Problem institutions stand at less than one percent of the industry, and troubled assets equal 0.65 percent of industry assets—the lowest level on record.

Many factors are responsible for the current health of the thrift industry. Obviously, a strong national economy and the quality of modern thrift management are two critical factors. We must also give substantial credit to the supervisory, regulatory and statutory reforms initiated over the last ten years to address past problems. The reforms of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") and the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), including higher capital mandates, uniform regulatory requirements and prompt corrective action, played a large role in promoting a safe and sound banking system. New supervisory tools and enforcement powers, such as the Examination Parity and Year 2000 Readiness for Financial Institutions Act, whose quick passage this Committee spearheaded, have given us the ability to intercede more quickly and forcefully if problems develop at an institution. In addition, our upgraded, risk-focused approach to examination and supervision has contributed to the industry's health.

We are ever mindful, however, that conditions can and will change. Tomorrow's problems are being created today. Good times can easily mask structural weaknesses, ranging from lax underwriting and pricing insufficient to support risks to serious fraud. The rigor with which we approach our mission, despite prosperous economic and industry conditions, will yield direct benefits in future periods as conditions become more stressed.

One OTS-regulated thrift, Oceanmark Bank, FSB, failed in 1999. The $69 million SAIF-insured institution, located in North Miami, Florida, was the first thrift failure since 1996. The institution was placed in receivership primarily because of a failed subprime lending strategy. Fortunately, our early intervention in the institution prior to its failure resulted in the sell-off of a significant portion of the institution's subprime lending portfolio. This avoided the much higher losses that would have resulted had the FDIC been forced to sell these loans at fire-sale prices out of a receivership. Based on current estimates, the resolution is projected to cost the SAIF $1.3 million, representing a recovery rate of 98 percent of assets, much better than the FDIC's 88 percent historic average recovery rate. The Oceanmark projected loss represents less than one-half of one percent of SAIF earnings for the first half of 1999.

Regarding our expectations for thrift failures for this year, of course I cannot predict the future. Failure is always a possibility, but we take great pains to ensure that our oversight of problem thrifts is tight. As of September 30, 1999, there were ten thrifts on our problem institution list. To put this in context, we had 15 problem thrifts at the beginning of 1999, 18 at the beginning at 1998, and 29 at the beginning at 1997. During the entirety of that time, only one of these institutions failed—Oceanmark last year. The ten problem thrifts represented just 0.4 percent of total thrift assets, compared to problem thrift assets totaling 0.7 percent at the start of 1999, 0.2 percent at the beginning of 1998, and 0.7 percent in January 1997.

III. How OTS Regulates Thrifts

A. Examination Activities

OTS's examination strategy involves on-site institution examinations; examinations of affiliates and third parties that provide services to an institution; and off-site monitoring of institutions, their service providers, and the industry and economy as a whole.

Thrifts with more than $250 million in assets receive annual on-site safety and soundness examinations.[1] Institutions or service providers raising special supervisory concerns (such as those engaging heavily in asset securitizations or pursuing non-traditional higher-risk activities) may also receive supplemental on-site field visits. With some of our largest institutions, and those with unusual business strategies, we meet quarterly with management and are in touch more frequently.

All thrifts and holding companies are monitored off-site, primarily through quarterly Thrift Financial Reports (which are similar to Call Reports), monitoring of external sources such as news reports and analysts' reports, and discussions with thrift management. The goal of off-site monitoring is early identification of significant changes in an institution's financial condition or business activities. We track changes in key financial ratios and indicators; the levels and composition of capital, as well as trends in capital formation and accumulation; changes in business strategy; excessive rates of growth; and negative earnings, unfavorable earnings trends, or dependence on non-operating income.

Because of the substantial portion of thrift assets held in mortgages,[2] we emphasize quarterly monitoring and supervision of interest rate risk in addition to the more traditional credit, capital, earnings, operations and management risks. This process, detailed below in the discussion on interest rate risk, helps us and the institutions understand the interest rate risk they are taking, and how it compares to the rest of the industry and their own institution over time. It also enables both us and them to address a potential interest rate problem proactively before it becomes difficult to overcome.

The outsourcing of portions of a business traditionally performed in an institution requires that the regulator—and our examiners—follow the activity to the entity performing the service for the institution. When an institution outsources its back office, the investment management of its trust portfolio, or other parts of its operations, examiners need to understand what is being done, be able to pursue an effective examination strategy, and have the authority to intervene when there are problems. This is

[1] As provided in section 10(d) of the Federal Deposit Insurance Act, as amended by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, small, well-capitalized and well-managed thrifts are examined for safety and soundness on an 18-month cycle.

[2] As of September 30, 1999, OTS-regulated thrifts held 48.8% of their assets in whole one-to-four family residential mortgages. In contrast, only 14.3% of commercial bank assets were whole one-to-four family residential mortgages.

most often accomplished by requiring the relevant books and records of the outsourced activity to be made available to us. When we need to go on-site to a service provider, we do so.

In performing their duties, OTS examiners supervise, as well as examine. Our examiners do not just take a look and find out what is happening, they analyze and evaluate an institution, utilizing not only their training, experience, and monitoring information but also what they have learned about best practices at other institutions. When new or unusual lines of business are involved, they are able to call on experts from within their region and nationally and, on occasion, from other federal agencies—to whom we also provide occasional examination assistance.

If risks are excessive, we follow an escalating program of supervisory strategies to address the problem. This starts—and most often ends—with conversations with thrift management and sometimes directors during an examination (or if a concern arises between exams through off-site monitoring or a field visit). The Report of Examination sets forth requests for corrective action that must be responded to by management and the institution's directors; we hold meetings with directors of institutions receiving a CAMELS rating of 3 or below (such meetings are offered to all institutions); and, where appropriate, we downgrade component or composite ratings. Institutions that continue to fail to implement corrective actions may be subject to an escalating set of formal investigations and enforcement actions.

B. Supervisory Structure

OTS maintains a small, flat regulatory structure that promotes a high degree of coordination between front line supervisors and senior management. This structure also permits the early identification of emerging industry trends and problems, as well as the efficient and effective implementation of agency policies to address issues that arise. Small relative to our sister bank agencies, our size allows for a significant degree of nimbleness in adapting our regulatory strategies to an evolving industry.

OTS's fluid internal and external communications structure facilitates frequent agency oversight meetings and review of troubled institutions. For example, our five regional directors meet ten times per year with me and our Washington senior management team to discuss recent industry and agency developments and concerns. In addition, each regional director and his senior regional supervisory staff meet by video-conference or in person with me and Washington senior staff three times per year to discuss higher risk or high profile institutions in the region. Our topics: each institution's current condition, what has happened since we last met, and our supervisory strategy going forward.

Outreach to the industry also enhances safety and soundness. In addition to regular written communications and presentations at trade association meetings, we host frequent "town meetings" with senior thrift executives, attended by Washington and regional staff, in towns and cities throughout our regions, to discuss particular issues of concern and so both they and we can remain on top of new developments. We also hold regular working sessions with thrift CFOs and external auditors, and we have recently instituted a series of all-day seminars for directors of thrift institutions. More than 250 directors attended our first session in Dallas last November; over 100 are signed up for the next session, in San Francisco next week.

C. Information Technology Oversight

For many years, OTS has had a small, highly-trained and specialized group of Information Technology ("IT") examiners who were responsible for assessing technology risk, particularly at institutions with in-house processing systems. During the preparation for Y2K, we—like other regulators—found we needed to broaden our technology expertise substantially, and over 170 safety and soundness examiners were trained to do Y2K examinations. For both the agency and many of these examiners, this was a major turning point in how we assess and supervise both safety and soundness and technology risk—going forward, they must be integrated. Not only is the effective use of technology a major portion of any thrift's risk management program, but the impact of technology on an institution's long-term profitability—and thus its safety and soundness—is great.

We have therefore begun the process of further integrating these two functions.[3] This effort includes educating non-IT examiners about IT issues and risks, as well as getting IT examiners up to speed on more traditional examination and supervisory issues. The objective of this program is to develop multi-skilled teams of examiners that can play off of each others' abilities as well as learn from each other as issues develop during an examination. Ultimately, of course, we would like to have all OTS examiners well versed both in traditional supervisory and IT issues.

D. Training

Another aspect of our regulatory oversight is OTS's focus on dynamic, needs-based employee training. We have inventoried the skill sets possessed by all of our examiners and, utilizing that data, are able to identify areas of deficiency that require training. This typically involves a periodic assessment by regional supervisors of upcoming and emerging issues at institutions in the region, an assessment of the strength of regional examiners in the skills required to address these needs, and training targeted to address areas of need.

OTS examiners typically receive training several times annually. Our training is designed for maximum impact with minimum disruption to the day-to-day operations of the agency. Training is delivered in various forms, including computer-based programs, video-conferencing, outside programs, and by pooling specialized examiner resources so

[3] Technology plays an increasingly important role in many areas that traditionally have come under the rubric of "compliance," privacy being the current most obvious case. We are therefore similarly working to integrate compliance and IT considerations.

individuals can share their expertise nationally within the agency. For example, both our trust and IT examiners, although regionally based, work across the country, and the agency's credit card specialists are always on call to deal with this specialized set of risks. We pay close attention to periodic training activities focused on evolving issues and areas requiring greater regulatory scrutiny.

All OTS examiners have had comprehensive training in fraud detection and the identification of white collar crime activities. Our IT staff and field examiners have also recently received specialized training on the use of new technologies by financial institutions. This is critical as institutions have become more involved in the use of Internet delivery channels and PC banking, automated underwriting systems, credit scoring, account acquisition, and portfolio modeling and risk mitigation techniques.

In addition to our internal training activities, we work closely with the other Federal Financial Institutions Examination Council ("FFIEC") agencies to identify areas that warrant more extensive and coordinated training initiatives. For example, OTS has taken the lead on interagency subprime lending training activities. This training, on a compact disk that includes a wealth of background materials, will soon be available to examiners at all agencies. Another product of this effort is a FFIEC-sponsored anti-money laundering program that will be introduced on a pilot basis this summer. This program is expected to be fully implemented and offered by the end of 2000 and through 2001. The agencies, through the FFIEC, are also developing an advanced fraud detection course.

E. Prompt Corrective Action ("PCA")

The PCA provisions of FDICIA, a valuable supervisory tool, provide an effective mechanism for early intervention at a troubled institution. PCA has helped focus OTS and other Federal Banking Agencies ("FBAs") on monitoring and quickly resolving problem institutions. OTS actively utilizes the PCA tools in overseeing troubled and problem institutions, but PCA is not a panacea. Factors such as increasing securitization and other off-balance sheet activities, declining capital quality, capital arbitrage, and out-sourcing of major thrift operations, make GAAP capital less of a leading indicator of trouble than it was ten years ago. Today, risk management by institutions and regulatory oversight of institution risk management policies and procedures must be the first line of defense to ensuring the stability of the federal deposit insurance system. I am pleased to say that more institutions seem to be focusing on risk management; and supervisory efforts, such as our interest rate risk monitoring and supervisory practices, discussed below, help institutions effectively manage their risk.

F. Functional Regulation

OTS has made a considerable effort in the last several years to reach out to other state and federal functional regulators and those involved in oversight of other insured institutions to coordinate and streamline potential overlapping regulatory interests. These activities involve meetings, regular communications, and joint activities and programs, often through various supervisory coordinating entities such as the National Association of Insurance Commissioners ("NAIC"), the Conference of State Bank Supervisors ("CSBS"), the National Association of Securities Dealers ("NASD"), and the North American Securities Administrators Association ("NASAA").

For example, we have worked extensively over the last several years with the NAIC to coordinate the regulatory overlap that has developed with increased insurance company acquisitions of thrift institutions. These efforts have included frequent appearances by OTS and NAIC officials at programs sponsored by OTS and by the NAIC or by individual NAIC state members. We have sponsored several joint programs. OTS senior managers have attended NAIC training sessions on the state insurance regulatory system and the state Insurance Commissioners, their staff and NAIC staff attended an OTS-sponsored training program about the thrift regulatory system.

OTS regional staff also coordinate closely with their regional counterparts at the NASD on issues of common interest involving securities activities by thrift service corporations engaged in securities brokerage activities. Similarly, we have developed a good working relationship with staff of the NASAA that enables us to coordinate and leverage our resources to achieve success in areas of mutual interest. We continue to work with the SEC on policy matters (such as the privacy regulations required under the Gramm-Leach-Bliley Act) and, occasionally, on matters involving specific institutions.

G. Coordination with other FBAs and State Banking Regulators

OTS also works closely with other FBAs and state bank regulators, both through the FFIEC and individually, where appropriate, to identify emerging issues in the financial institutions industry and to coordinate supervisory activities. We maintain a constant dialog with the top supervisory officials at all the other FBAs, and also talk to our counterparts at state agencies with some frequency.[4] Topics of mutual interest include emerging risks, adverse trends and other supervisory matters. This is a mutually beneficial relationship that keeps all parties apprised of potential problems, emerging issues and possible overlaps of regulatory authority that may pose potential regulatory burdens or gaps in regulatory coverage.

An area of particular interest raised in the Chairman's letter is our relationship with the FDIC. OTS has a very productive and effective relationship with the FDIC. I am an active FDIC Board member and I also serve as the sole outside member of the FDIC audit

[4] OTS supervises 179 state-chartered savings associations and 29 thrift holding company structures whose thrift subsidiaries are all state-chartered. This role, which is similar to that of the FDIC and the Federal Reserve with respect to state-chartered commercial banks and savings banks, requires significant coordination with state bank regulators on a day-to-day basis in our regions.

committee. This relationship has greatly assisted me in overseeing OTS and, I believe, has been beneficial to the FDIC.

With respect to our policies regarding FDIC participation in OTS examinations and FDIC requests to examine OTS-supervised thrifts, we have one policy–the door is always open. We have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored. If there are concerns—for example when the FDIC is involved in ongoing litigation against the institution—these are to be brought to the immediate attention of senior Washington staff so they can be quickly evaluated and resolved on a consistent basis. A second set of eyes is a benefit when an institution is showing signs of stress, and in numerous instances we have sought out FDIC participation in examining a problem institution.

Our supervisory staff maintain regular contact at the regional and field levels with their FDIC counterparts. The FDIC's experience and its role in our supervisory and examination process are extremely important in evaluating and dealing with troubled institutions. We also value their insight and perspective with respect to institutions that are basically sound but that are showing signs of potential serious trouble, such as rapid growth of a program involving a new high-risk product.

With respect to the Chairman's request for comment on H.R. 3374, the Federal Deposit Insurance Corporation Examination Enhancement and Insurance Fund Protection Act, I believe this legislation is not necessary. Notwithstanding suggestions that this legislation is necessary to ensure the FDIC has access to a troubled institution when the need arises, I suggest this may directly run counter to productive interagency coordination. In my over-two-year tenure on the Board of the FDIC, no OTS backup supervision case has ever been brought to the Board, yet there has been effective OTS/FDIC coordination. In addition, the bill fails to take account of the fact that the OTS Director has a fiduciary obligation, in serving as a member of the FDIC Board, to ensure that the best interests of the FDIC and the federal deposit insurance funds are served.

The existing system of interagency coordination has worked well. Given the productive relationship we have with the FDIC as well as the mutual benefits arising out of FDIC's involvement in our supervision of thrift institutions, I believe this legislation is not needed.

IV. Overview of Evolving and Emerging Risks to Thrift Institutions

Like our sister bank agencies, OTS expects each institution's management and directors to stay on top of institution risk exposure. We do not micro manage the institutions we regulate. Rather we focus on institution risk assessment and risk management systems and policies. Institutions are required to implement risk management systems and are encouraged to conduct internal modeling and stress testing for internal risk management.

A. Interest Rate Risk Management

Because thrifts are still overwhelmingly invested in relatively long-term assets, in particular residential mortgages, an area of particular concern to OTS is interest rate risk management. Since 1989, OTS has had an active interest rate risk monitoring and supervision program. Initially designed to assist examiners, this program over the years has also increasingly become a tool to help thrift managers and directors actively manager their institution's interest rate risk. The centerpiece of the program is OTS's Net Portfolio Value ("NPV") model.

The NPV model estimates the economic value of an individual thrift's total portfolio—its assets, liabilities, and any off-balance sheet positions—using a common set of economic assumptions. Critically, the model also estimates the changes in a thrift's baseline economic value under different interest rate scenarios; in other words, it stress-tests each institution's portfolio. Currently, the model develops alternative estimates for increases and decreases in interest rates of 100, 200 and 300 basis points. The resulting changes in the baseline economic value for an individual thrift's portfolio show the institution's sensitivity to particular interest rate changes. The estimated economic value after the assumed interest rate change—the "post shock" economic value—provides an important measure of how much additional interest rate risk an institution can absorb before running into trouble. Both measures—the sensitivity to interest rate changes and the resulting "post-shock" economic value—are used by OTS examiners and thrift industry executives to monitor and manage an institution's exposure to interest rate risk.

The utility of our program is demonstrated by the fact that many OTS-regulated institutions incorporate the model into their own interest rate risk assessment and management strategies. Although thrifts with assets of less than $300 million are generally not required to file the data required for the model, each quarter over 91 percent of OTS-regulated institutions supply the additional data required to run the model in order to receive the OTS quarterly exposure reports for their institution, even though only 37 percent of all OTS-regulated institutions are required to file. These reports provide the thrifts with the same information that OTS examiners use to assess whether the institution's exposure to interest rate risk is prudent or excessive. In addition, each thrift receives a two-page graphic summary report, which thrift executives and directors find particularly useful.

By applying similar economic assumptions and the same interest rate stress tests to all thrifts, OTS can compare results among individual thrifts. Thus, we can identify those institutions that have the greatest exposure to interest rate risk and work with them to take appropriate corrective action. Where we identify excessive interest rate risk exposure at an institution, we move aggressively to prompt management into mitigating that risk, and take more formal action if corrective actions—which may involve a variety of strategies—are not forthcoming.

B. Credit Risk

Credit risk is the most fundamental risk characteristic of lending. This is the risk that an obligation will not be paid and a loss will result. Controlling the risk is as much a function of portfolio strategy as making sound lending judgments. Both depend on the ability of management to implement and execute a well-conceived lending strategy.

Two emerging lending strategies that raise significant credit risk issues are high loan-to-value ("HLTV") and subprime lending. HLTV lending occurs when an institution makes a loan that either approaches or exceeds the actual value of the collateral securing the loan. This type of lending raises issues for an industry, such as thrifts, in which the vast majority of lending is collateralized with real property.

With this in mind, in early 1998, OTS began to make its concerns known to individual institutions engaged in HLTV lending. In August 1998, OTS took the lead in issuing guidance (TB-72) on supervisory concerns with the HLTV lending practices of some lenders. We took this action even though only a handful of thrifts were then offering this product as a significant part of their business. Our aim was to encourage these institutions to reduce their concentration in HLTV loans and to educate other institutions about the risks involved with this lending activity. Two months after the issuance of our guidance, the market that HLTV lenders relied on for the sale of these loans collapsed. Perhaps because of our early intervention and the guidance, no thrift institution was seriously impacted. The guidance, which was reissued in October 1999 (TB-72A) on an interagency basis, reiterates the risks associated with high LTV lending, emphasizes the importance of effective risk management programs, and clarifies how the 1992 interagency guidelines on real estate lending apply to HLTV loans.

Subprime lending, which involves lending to borrowers who have a significantly higher risk of default based on their credit repayment history, has been the subject of intensive OTS scrutiny by our policy and supervisory staff for several years. We started sounding warnings about risks arising from this lending activity as early as June 1998. In March 1999, the FBAs issued joint supervisory guidance on subprime lending, and we are currently working to clarify and enhance the manner in which subprime lending programs should be capitalized.

It is too easy when discussing subprime lending to suggest that this may be an area in which insured depository institutions should not be involved at all. On the contrary, there are legitimate needs for this type of lending, and it can be done by depository institutions in a safe and sound manner that is helpful, not harmful or abusive, to borrowers. From the regulatory side, initiatives with respect to subprime lending must strike the appropriate balance between protecting the insurance funds and not inappropriately discouraging banks and thrifts from responsibly meeting the credit needs of a large segment of the population.

To execute HLTV or subprime lending strategies successfully, an institution must have risk management programs in place to identify, measure, monitor and control the additional credit and other risks arising from the activity. These higher risk lending programs require experienced lending and account administration staff possessing specialized knowledge and special skills in areas ranging from marketing and account origination to servicing strategies and techniques.

C. Capital Risk

Capital risk is the risk that an institution will not have sufficient capital on hand to absorb losses arising from unexpected events. Capital risk is really an extension of other banking risks. For example, an institution that runs into credit, interest rate, technology or operational risk problems will rely on its capital cushion to absorb any losses. Obviously, the goal—particularly for publicly-held companies—is to hold sufficient capital to safely cover these risks, but not so much in relation to earnings that the firm's return on equity is non-competitive.

The risk-based capital system used by the FBAs was designed in the late 1980s to require institutions to hold sufficient capital to cover the credit risk posed by their operations. As depository institution lending and operating strategies have become more sophisticated, however, the risk-based capital rules must evolve. Currently, there are several ongoing interagency initiatives aimed at refining the risk-based capital system to better reflect credit risk.[5]

First, the FBAs are analyzing a proposal developed by the FDIC to require a higher level of risk-based capital on subprime portfolios on a standardized basis. Incorporating any such framework will require the FBAs to address issues such as how to define subprime lending and subprime lending programs in a meaningful and objective way that truly reflects risk and that does not have unintended consequences for broad access to financial services.

Second, the FBAs are working on a proposal to significantly change how we treat certain recourse obligations, direct credit substitutes, and securitized transactions that expose banking organizations to credit risk. Although subprime and other new lines of lending activities provide a good example of the concerns with credit risk that exist with residuals, this risk is by no means limited to nontraditional lending activities. Any traditional lending program that involves substantial securitization activities may create a problem that our existing risk-based capital rules do not adequately address.

Third, and also related to risks posed by asset securitization, the FBAs are exploring potential risk-based capital responses to the increase in retained interests held by

[5] As discussed above, OTS has in place a supervisory system that incents institutions to hold capital commensurate with interest rate risk. The capital discussion currently underway internationally includes consideration of the addition of an interest rate risk component (as well as components dealing with other risks) to the Basle standards. We believe that if this is done, it will be critically important to home mortgage lending in the United States to better align the credit risk assigned to such lending with its true—and very low—risk relative to other types of bank lending.

insured institutions in those securitizations. These retained interests, or residuals, usually provide credit support for those interests that are sold, thereby leaving the riskiest and potentially the most volatile position in a securitization on the books of banking organizations. In December, the FBAs published interagency guidelines on managing these risks and attributing accurate values to these interests. At that time, we said we would be studying capital responses, and we are.

The fourth ongoing interagency capital initiative is the FBAs' consideration of broad-based structural revisions to regulatory capital, consistent with our existing law, specifically aimed at small, less complex , and non-internationally active banking organizations. Under most working definitions, this includes the vast majority of all depository institutions in the United States. We are looking at ways to reduce burden for these institutions if they pose little risk, and simultaneously to streamline whatever risk-based capital burdens would remain so as to more closely reflect the risk of smaller institutions. While we may be some time from a broad set of proposals, I am encouraged by the "outside the box" thinking related to this effort.

In addition to these domestic efforts, internationally we have relied for 12 years on the principles of the Basle Accord. Although OTS is not a signatory, we have joined the other FBAs in fashioning our risk-based capital rules along the lines prescribed by the Accord, and in accord with statutory mandates consistent with the Accord. Currently, a comment period is scheduled to run through the end of March on a broad-based 1999 Consultative Paper that represents the first public exposure to the effort at revising the Accord. While final changes may be years away, all FBAs are either active participants in this process directly or, in our case, indirectly.

D. Liquidity Risks

I have noted some of the credit risk concerns that arise from the practice of heavy reliance on the sale or securitization of both traditional and nontraditional lending products. These practices also raise concerns with respect to the ability of an institution to fund a lending strategy that requires the continued sale of loans. An institution that suddenly finds that it cannot liquidate a large block of loans it was planning to sell or securitize may soon face a liquidity crisis arising from depleted reserves to make loans that it is ill-equipped to fund. On a systemic basis, institutions are most vulnerable to liquidity risks during period of market dislocation, as occurred in the fall of 1998. OTS is careful to ensure that individual thrifts not only maintain an appropriate level of liquid assets, but that they establish alternative sources to diversify funding of their operations.

E. Management Risks

Perhaps the one item that gets the least attention, but that undoubtedly has the greatest impact on an institution's operations, is the effectiveness of its management. The willingness of management and directors to understand and manage risk is one of the primary underpinnings of a safe and sound operation.

To help us fulfill our mission, we must continue to ensure that Boards of today's thrifts include well-informed directors from diverse backgrounds who understand their fiduciary responsibilities to retain qualified management, develop a realistic and sound operating strategy, and remain actively involved in risk management. This includes frequent reevaluation of both strategies and management in light of changing economic and competitive conditions. Inactive, self-serving and unqualified directors must be rooted out of the system.

During hard times, it is relatively easy to identify weak management. The challenge we face as regulators is to spot ineffective, incompetent or dishonest management during prosperous times such as these.

F. New Activity and Affiliation Risks

A primary function of management in this new economy is, of course, to understand and effectively implement new lending programs or other strategies, such as expanded trust services, that build on an institution's strengths and enhance long-term profitability. Managing the risks associated with these new products and programs requires knowledge, foresight, good systems, and involved employees.

A particularly vexing aspect of this risk is that many activities may only be feasible if conducted on a large enough scale to cover the costs that must be incurred to ensure the new program is implemented and executed properly. For example, the economies of scale related to a new lending activity, such as small business lending, do not permit an institution to "dabble" to any significant degree in order to familiarize itself with the risks of the activity. Instead, an institution must generally import qualified expertise to manage the new activity, and then support the expense of the program with sufficient lending volume to justify the costs.

Similarly, new affiliations can pose new risks for a depository institution. Although diversified financial institutions have owned thrifts for many years, only over the last several years have institution and affiliate operations and activities been so closely linked. Among the issues: how consolidated firm-wide risk management strategies affect the depository institution on a stand-alone basis, and the independence of depository institution directors and management. When affiliates perform major operations for the depository institution going beyond traditionally outsourced back office functions, we may become concerned not only with the arms' length nature of the transaction, but also with the quality of services provided to the institution's customers. We must understand the structure of the relationship and the internal controls being implemented to monitor the activities or services, and we must have the ability to step in from a supervisory perspective if issues or problems arise that have the potential for a material impact on the thrift or raise issues of thrift compliance with laws.

OTS has significant experience in overseeing the types of complex, diversified financial structures that represent the next wave of our modernizing financial system. We have spent considerable time and energy thinking about and addressing the challenges raised by these types of corporate families. We have reviewed business plans that propose extensive cross-marketing activities and the contracting out of traditional thrift operations and back office functions to affiliates. Issues that concern us include conflicts of interest, usurpation of corporate opportunity, other types of inter-affiliate conflicts, maintaining adequate supervisory controls and oversight, protecting the interests of depository institution customers and protecting the federal deposit insurance funds. During the last two years, we have done the first formal examinations of several relatively new thrifts that are part of such complex institutions. We have generally been satisfied with the results, but each examination makes us more aware of the risks and complexities the institutions and the deposit insurance system face.

The breadth and length of our review of new issues and unusual structures and business operating strategies have not always pleased applicants for new thrift charters. The goal of this review is to ensure that new applicants, affiliations and structures do not raise unexpected or unmanageable concerns for depository institution customers or the federal deposit insurance funds. To move without caution is to lay the foundation for potential future problems.

G. Technological Risks

The financial industry's Year 2000 efforts brought technology from the back room to the board room. More institutions than ever before understand the critical strategic importance of technology. They are also increasingly aware of the downside of their greater dependence on technology, as well as the potential pitfalls of not keeping up with emerging technological innovations that can improve the efficiency and effectiveness of an institution's operations.

We talk frequently about the security risks associated with technology. But from an institution's perspective, technological risk can also arise from failure to implement technological changes in a timely manner, as well as from not understanding the implications of technological changes that are made. The risks can include spending too much for an improvement that produces marginal benefits, or relying too heavily on a technology-based operating strategy, such as Internet banking, without fully understanding the costs and pricing structure associated with the activity.

The issues associated with Internet banking provide a good example of the broad array of risks that must be considered with a new technology. Internet-only institutions generally attract customers by paying higher deposit rates, devote a larger portion of their budget to advertising, have higher operating costs (particularly at the outset), typically must pursue lower yielding investment strategies, and will undoubtedly face stiff competition as traditional financial services providers enter the market. Despite these drawbacks, Internet institutions, like other e-commerce ventures, have enjoyed tremendous success in raising capital. This, of course, raises the stakes even higher for these firms.

In addition to all these issues unique to Internet institutions, they must also secure capable management that are technologically savvy, knowledgeable about financial institution operations, and able to operate successfully in a highly regulated environment. Finally, and perhaps most important to their customers, they must ensure the integrity of their security and encryption systems. Failing to do this will almost certainly jeopardize the continued existence of the institution.[6]

H. Operational Risks and Fraud Detection

Fraud appears to have played a prominent role in several recent bank failures and has caused other institutions to suffer significant financial losses. While we believe fraud is relatively rare, in the course of examinations we have encountered fraudulent activities, including unauthorized and unsupervised overdrafts of customers' checking accounts; unauthorized loans and falsified loan records; employee embezzlements involving check kiting schemes; unauthorized withdrawals from a correspondent account; and unreported shortages from teller windows. When we suspect fraud, we direct the institution’s management and, if necessary, its Board of Directors, to not only take action to ensure the activity stops and the institution or its customers or other innocent parties are—if possible—made whole. We also ensure that appropriate criminal referrals are made.

A highly competitive financial services market, and insistent shareholder demands for competitive returns, unfortunately increase the temptations of fraud. Although regulators and external auditors cannot eliminate fraud and insider abuse, there are steps management and regulators can take to improve fraud detection and reduce potential losses to the federal deposit insurance funds.

The most effective way to combat fraud and insider abuse is for management to develop strong internal controls that are consistent with the size of the association and the nature and scope of its activities. A sound internal control program detects and minimizes errors or irregularities. The objective is to provide reasonable assurance that assets are safeguarded and that financial and other information is timely and reliable. Sound controls promote operational efficiency and encourage adherence to managerial policies, laws, regulations and sound fiduciary principles. The effectiveness of internal controls depends heavily on management’s attention to instilling a strong sense of corporate responsibility.

[6] Traditional institutions adding an Internet “channel” face some (although not all) of these same risks. In addition, they must effectively integrate the Internet strategy into an institution that probably is used to moving more slowly than e-commerce demands and avoid excessive and costly cannibalization of existing channels, at least until the Internet channel becomes more profitable.

OTS considers the effectiveness of an association’s internal control system when it determines the scope and depth of examinations. OTS examiners are particularly alert to situations in which an association:

- discontinues an independent accountant's audit;
- does not have proper controls in high risk lending areas;
- engages in new lending activities with inadequate or unqualified staff;
- deviates from board approved policies without exception documentation;
- fails to effectively segregate duties and responsibilities among employees; or
- fails to provide adequate reports to the board of directors.

We encourage all savings associations to carefully review and, where appropriate, strengthen their internal control systems.

For our part, we will continue to maintain a staff of highly trained and experienced examiners who are capable of recognizing behavior and tactics that may be indicative of problems involving fraud and insider abuse. In addition to the training in fraud detection and identifying white collar crime our examiners receive, several new classes are being developed by OTS and the FFIEC that will incorporate the lessons we learned from some of the most recent failures.

Finally, we will continue to rigorously scrutinize the background of individuals seeking to enter the system. By granting charters only to groups and individuals who display a high level of integrity and sound qualifications, we can minimize opportunities for fraud and insider abuse and lessen potential losses to the insurance fund.

I. Reputation Risk

A bank or thrift’s reputation for safety, competence and trustworthiness is one of its most important assets. The risk of loss of that reputation must concern every institution. While this problem has been with banking since the first healthy institution experienced a run (well before the United States was founded), the fast pace and increasing breadth and competitiveness of the modern banking industry only enhance the risk. When an institution must raise funds from the capital markets or uninsured creditors, the institution’s reputation can be almost as important as its actual health. And when consumers can move their business with the click of a mouse, a bank’s solid reputation may be more important than its pricing. Institutions need to be mindful that their decisions, and how they present decisions to customers and the market, can have broad implications for the health of the institution.

V. Conclusion

As I observed at the outset of my testimony, thrifts, like commercial banks, are enjoying a time of sustained health and record profitability. A thriving economy, experienced and well-trained examiners, capable and qualified officers and directors, sound regulatory and supervisory systems and tools, the benefits of technology, and various other benefits have bestowed on us a financial services system that is unparalleled.

The current health and stability of our financial services system creates opportunities that we have never had before to serve the underserved. Unfortunately, it also breeds overconfidence. Risks can appear to shrink when the upside is obvious and the downside can be dismissed as a trap for the other guy. Not only must we make certain that both we and the institutions we regulate are prepared for any economic downturn, we must also be wary of being too lenient with managers and directors whose inadequacies or missteps are masked by exceptional economic conditions. OTS is up to the challenge.