



Testimony

of

Nicolas Retsinas, Director

Office of Thrift Supervision

concerning

**EXAMINATION AND SUPERVISION SYSTEMS**

before the

Subcommittee on Financial Institutions and Consumer Credit

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Office of Thrift Supervision  
Department of the Treasury

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**TESTIMONY ON EXAMINATION AND SUPERVISION SYSTEMS  
BEFORE THE  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT  
OF THE COMMITTEE ON BANKING AND FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES**

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**I. Introduction**

Good morning, Chairwoman Roukema and members of the Subcommittee. Thank you for your invitation to discuss the OTS's examination and supervisory systems.

Our approach to examination and supervision at OTS is based largely on risk assessment. It is the heart of the statutory mission of the OTS and the other federal banking agencies. Assessing risk, however, can be difficult because the risks facing depository institutions are constantly changing. As a result, supervisors and examiners have to be alert to new risks and to shifts in the environment in which institutions operate.

The thrift industry that we regulate today is not the same industry that was in place when the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") was enacted in 1989. Thrifts are enjoying their best period of sustained health and profitability in 35 years. Ninety-six percent of all thrifts earned a profit in the second quarter of this year, and troubled institutions represent a mere three-tenths of one percent of the industry's assets. Capital levels are at all-time highs, and industry assets are stable.

Many factors contributed to the thrift industry's remarkable recovery over the last eight years. The reforms of 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 that recovery. New supervisory tools and enforcement powers have given us the ability to intercede more quickly and forcefully if problems develop at an institution. But we believe that our upgraded, risk-focused approach to examination and supervision has also contributed to the industry’s comeback.

As with the industry we regulate, the OTS is also a different agency than the Federal Home Loan Bank Board that it replaced in 1989. We maintain a staff of highly-experienced, well-trained financial institutions’ examiners who have, on average, at least ten years experience. Our examiner training programs emphasize new and potential areas of thrift expansion, such as small business and consumer lending and the exercise of fiduciary powers. We are proud of our contribution to the recovery of the thrift industry, and we are prepared for the challenges of the future.

Today, assessing risks at depository institutions is a difficult process. To maintain the integrity of the examination function, we rely on a regulatory process in which OTS examination and supervisory personnel assess an institution’s safety and soundness, objectively evaluate its condition, report their findings, inform boards of directors of institution strengths and weaknesses, and facilitate corrective action where necessary. Our objective during the examination process is not only to identify existing regulatory violations, but to anticipate potential problems, prevent the development or continuation of unsafe operating practices, and effect the timely resolution of existing problems. This type of proactive regulatory supervision that evaluates future needs and potential risks helps to ensure the success of our financial system over the long term.

This approach is particularly appropriate today. Rapid and constant changes in local economies and financial markets, the development of new, hybrid financial

products, and the continual development and spread of new technologies all pose challenges both to institutions and their regulators. To address these new challenges, the tools used by the regulators to monitor risk have evolved over time. The examination process and off-site monitoring activities have become extremely sophisticated. We no longer send examiners into institutions to count cash. Our regulations no longer describe the width of a vault's wall; they grapple with the issues raised by electronic banking. We have developed tools and methods in the examination and supervisory process that are directed at risk assessment.

Today, I will outline our examination process and how we assess various risks in that process. I will then discuss how the OTS is responding to changes occurring in today's financial services industry. Finally, I will discuss the developing supervisory issues that now concern us most.

## **II. Risk Assessment and the Examination Process**

Today, thrift industry capital is at an all-time high; but capital can be a lagging indicator of potential problems that exist at an institution. Thus, it is important that, in addition to monitoring capital adequacy, we have in place a system that is able to identify potential risks that are not directly linked to capital. Since its inception in 1989, the OTS has concentrated its supervisory and regulatory resources to develop such a comprehensive, risk-focused supervision and examination program. This program is designed to evaluate the level of risk exposure at an institution, management's ability to control that risk, and the thrift's ability to absorb losses that could result from those risks. The process utilizes a combination of on-site examination and off-site monitoring.

### **A. On-site Examinations**

The OTS's examination strategy generally requires annual on-site examinations at every institution, regardless of an institution's composite "CAMELS" rating—the regulators' common examination rating system. The rating system, which was adopted by the OTS in 1993 and modified by the banking agencies in 1996, evaluates an institution's capital, asset quality, management, earnings, liquidity, and sensitivity to risk. For healthy, well-managed, well-capitalized thrifts with less than \$250 million in assets, an 18-month examination rule applies. More frequent examinations or supplemental examinations may be scheduled as necessary.

To meet our commitment to examine each institution every 12 or 18 months, our examiners utilize risk analysis and prioritization. In preparation for an examination, examiners custom design (or scope) each examination to focus on the most significant risks associated with each thrift's business strategies, financial condition, and unique history and circumstances. This focus enables examinations to be efficient without compromising accuracy. For instance, where an institution is engaged in significant credit card lending, commercial lending or derivatives activity, examiners will flag these activities for special attention during an examination.

The OTS places the responsibility of managing institutions' risks squarely on the shoulders of management and the board of directors of the institution. Consistent with this policy—and because OTS examiners cannot possibly review every transaction processed by an institution—OTS examinations focus substantially on the effectiveness of management in controlling the levels of risk.

Because risks are primarily managed through effective internal safeguards, our examinations evaluate an institution's internal controls, including the extent to which controls are maintained and followed. By "internal controls," I am referring to the policies and procedures regularly employed by management in making decisions,

safeguarding the assets of the institution, and maintaining reliable financial records. If internal controls are inadequate or not being faithfully implemented, the scope of an examination will be expanded to determine whether deficiencies have resulted in material problems such as increased delinquencies or inconsistent earnings.

On-site, examiners employ a “top-down” approach that provides for graduated depths of review—determined by potential risks—of key operational areas. Examination procedures are divided into three groups, each representing a different level or depth of review.

Level I procedures focus on the review of examination scoping materials and institution documents, including its operating policies and procedures and internal controls. The Level I review is followed by interviews with institution personnel to determine if practices conform to written guidelines and to confirm any preliminary findings. If significant items of concern are uncovered during the Level I analysis, or if significant problems were identified during the off-site pre-examination monitoring and scoping of the institution, the examiners may employ Level II procedures.

Level II procedures focus on the analysis of institution documents such as loan files, management reports, and supporting financial records. Examiners may develop an independent analysis of asset values at this level as well as independent verification of other items. If examiners determine that they cannot rely on the data contained in institution records, Level III procedures will be triggered. Level III procedures involve a more detailed, audit-type review of an institution’s information systems, procedures and financial records.

Upon completion of an examination, an examiner’s overall assessment of an institution is determined according to the uniform CAMELS system that I described

earlier. The examiners communicate the results of the examination to the institution's management and board of directors and, if required, direct corrective measures.

We assess the effectiveness of our examinations in a number of ways. For instance, each region has at least one employee specifically assigned to provide internal quality control for the examination process. There are currently 28 areas of the examination process that are subject to internal quality assurance reviews. Evaluations consist of a written review of a particular aspect of the examination process. That written review is then submitted to the Regional Director and forwarded to supervisory staff in Washington. The entire program is closely monitored for consistency and overall performance by Washington staff experienced in the various disciplines involved in the examination process.

To gather feedback on our examinations, we also developed an Examination Outreach Program ("EOP"). Under the EOP, each region details one or more experienced examiners or supervisory staff to review recently completed examination reports prior to their issuance to ensure clarity, content, and consistency. The EOP managers also visit from 5 to 10 thrifts a month and interview management about the conduct of the most recent examination. We seek input on how to improve our examination process and attempt to identify concerns management has about the conduct of examinations, their institution, the industry, or the OTS. The EOP managers prepare a monthly written summary of each interview, which is shared within the region and Washington staff.

Another example of our efforts to gauge and improve the effectiveness of our examinations is a survey we send out after every examination asking thrift management whether we have lived up to the examination standards we set forth in published guidance on the conduct of examinations. In 1996, 98% of the thrifts that we regulate said they

liked the way our preliminary examination inquiries were delivered; 99% liked how quickly our material concerns were revealed; and 99% said our examination teams communicated their findings clearly. We hope to maintain these very positive results.

These are but a few examples of our continuing efforts to maintain the quality and efficacy of our examinations. We also have processes in place for when an institution disagrees with the results of an examination. The available alternatives—appealing examination findings or seeking mediation through our Ombudsman—provide institutions additional recourse to address issues they maintain have not been adequately reviewed during an examination. Input from the industry on how to improve our examination functions is always important, but we must bear in mind our primary responsibility to maintain the safety and soundness of individual institutions and the thrift industry.

## **B. Off-site Monitoring**

The OTS utilizes detailed off-site evaluation procedures to monitor changes in the risk profiles of institutions between regular examinations. The goal of off-site monitoring is early identification of significant changes in an institution's financial condition or business activities. Off-site monitoring tracks changes in key financial ratios and indicators; the levels and composition of capital, as well as trends in capital formation and accumulation; excessive rates of growth; and negative earnings, unfavorable earnings trends, or dependence on nonoperating income.

Off-site monitoring of these items involves review and analysis of current Thrift Financial Reports, industry and regional trends, and other detailed information. To assist in this analysis, OTS staff utilize various tools, including:



- The Uniform Thrift Performance Report (“UTPR”), which is an in-depth comparative financial performance report based upon the quarterly Thrift Financial Reports;
- The Thrift Monitoring System, which uses UTPR data to generate reports for individual thrifts and groups of thrifts; and
- The Risk Assessment Model (“RAM”), which tracks key performance ratios, ranks thrifts by relative risk of failure and provides a cross-check for CAMELS ratings.

Special attention is paid to institutions that have a composite CAMELS rating of 3, 4 or 5; low capital levels; a high RAM score; heavy exposure to high risk loans or investments; high loan delinquencies, nonaccrual loans or real estate owned; or high levels of interest rate risk.

### **C. Assessing Various Risks**

As I noted at the outset, risk assessment is at the heart of the examination function. Risk assessment strategies should be tailored to the particular mix of risks faced by each institution. As a result, risk assessment strategies must take account of industry trends as well as trends at individual institutions. That being said, there are common risk elements that we monitor within each thrift institution.

#### **1. Interest Rate Risk**

Thrifts tend to specialize in long-term residential mortgage lending. The volume of mortgage lending, as well as the value of the underlying assets (mortgage loans,

mortgage servicing, and securitized mortgage loans) are very sensitive to the level of, and changes in, interest rates. Thus, we are continually attempting to refine our approach in managing and monitoring the interest rate risk exposure of our regulated institutions.

Interest rate risk is the risk that an institution's earnings and capital will be adversely affected by changes in interest rates. Because mortgage lending typically involves the origination of longer-term loans that must be funded with shorter-term liabilities, interest rate risk is inherent in the basic business of the thrift industry. The mismatch between the duration of long-term assets and short-term liabilities gives rise to interest rate risk.

To address this inherent risk, the OTS has developed a comprehensive interest rate risk program. Our goal is to prepare and educate thrift management in order to protect their institutions against unexpected adverse movements in interest rates. Over the years, the OTS interest rate risk program has evolved and improved, as the market and the OTS have become more sophisticated about the problem of interest rate risk and as more products designed to deal with that risk have become available.

We first issued guidance in 1989 to directors and officers on setting appropriate interest rate risk exposure limits, the need for certain thrifts to have interest rate risk models, and the importance of adopting effective interest rate risk policies and procedures. We have issued additional guidance since then, and are currently revising our guidance in this area to update and simplify existing OTS risk management guidance.

The revisions will include a general set of best practices for interest rate risk management, consistent with similar policies being adopted by the other regulators. In addition, the revisions will provide guidelines for OTS supervisory staff to use in assessing the quality of an institution's risk management practices and the level of its

current exposure to interest rate risk. The revisions will also assure that the OTS's risk management policies explicitly address the new Sensitivity to Market Risk ("S") component of the CAMELS rating system.

In an effort to quantify interest rate risk, the OTS has also built a complex interest rate risk model, known as the OTS Net Portfolio Value Model ("Model"). We use the Model to conduct a type of scenario analysis known as "stress testing" to measure the vulnerability of thrift institutions to different interest rate environments. The Model has proven to be a valuable supervisory tool with numerous benefits. It provides the OTS with a means of identifying institutions with high levels of interest rate risk exposure, improves our ability to distinguish between the speculative and non-speculative use of derivatives products, and facilitates constructive dialogue between examiners and thrift managers.

The Model has also benefited thrift managers. Currently, about 450 thrifts are required to file supplementary interest rate risk data, and over 87% of the remaining exempted thrifts voluntarily submit this data to the OTS. In doing so, these institutions gain access to the OTS Model for evaluating the interest rate risk sensitivity of their existing loan portfolio. Among other things, this information can be used by OTS examiners and thrift management to assess the specific sources of an institution's interest rate risk exposure over a range of interest rate scenarios. Moreover, OTS analysts and examiners can compare the individual institutions' results with other institutions in the industry. Comparable aggregate industry data are provided quarterly to allow individual thrifts to assess their performance relative to other members of the industry.

The industry has made great strides in understanding, managing, and controlling its exposure to interest rate risk. Financial markets have responded to thrifts' demand for better and more varied tools for controlling interest rate risk with a host of new financial

instruments, including interest rate swaps and interest rate options (caps, floors, and collars). In addition, most thrifts now offer adjustable-rate mortgages, which reduce the mismatch between the duration of assets and liabilities, and thus interest rate risk.

## 2. Other Risks

Although perhaps the most important, interest rate risk is by no means the only form of risk thrifts face. Thrifts are also subject to a variety of risks that are common to most retail-oriented insured depository institutions.

**Credit Risk.** Credit risk is the risk that borrowers, counter parties, or issuers of securities will not repay their obligations as contractually agreed. OTS procedures require examiners to evaluate the quality of a thrift's lending policies, including standards for credit underwriting, loan documentation and management reporting systems. Examiners review management's independent loan review and classification system. Examiners also review management's strategy for ensuring that an institution's assets are diversified by borrower, location, and to the extent a thrift makes commercial loans, industry.

**Operational Risk.** Operational risk is the risk of loss flowing from inadequate system information, breaches in internal controls, inconsistent application of an institution's policies and procedures, or operational problems. Operational risk is managed by the maintenance of sound policies and procedures, strong internal controls and security, adequate information systems, and staff training. Examiners review all of these areas when analyzing operational risk. Weakness in this area is often an indication of a broader problem in the management of the institution. Assessment of operating risk may be supplemented by the audit and related reports prepared by independent auditors and by the internal auditing program established by the institution.

**Market Risk.** Market risk is the risk to the economic value of an institution's balance sheet resulting from changes in interest rates, exchange rates, or commodity prices. For thrift institutions, market risk is virtually synonymous with interest rate risk.

**Liquidity Risk.** Liquidity risk is the risk that arises when a thrift does not maintain adequate liquid assets or sufficient, ready access to funds to meet its obligations in a timely manner. Such a thrift may find itself in a position where it is forced to cash in some of its less liquid assets over a short interval of time (i.e., less than the normal marketing period for such assets). Assets sold in these circumstances usually sell at a discount below market, thus impairing the institution's profitability. OTS examiners review each institution's asset/liability management policies and evaluate the internal systems and controls for monitoring cash flows. Such systems must provide assurance that the thrift can maintain adequate liquidity reserves and meet its funding requirements on an ongoing basis.

**Legal and Compliance Risk.** Legal risk refers to the possibility that contracts, lawsuits or adverse judgments may negatively affect an institution's operations, capital, or profitability. OTS examinations include a review of significant contracts, contingent liabilities, and potential losses from foreseeable litigation. Moreover, the OTS conducts regular compliance examinations to determine whether management has adequate procedures in place to ensure conformity with consumer laws and regulations, including applicable nondiscrimination laws, the Community Reinvestment Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Bank Secrecy Act. To mitigate losses from legal risks, the OTS requires thrifts to maintain adequate fidelity bond coverage, liability insurance, and director and officer insurance.

**Strategic Risk.** Strategic risk addresses the risk of loss from business decisions or investments that the board of directors and management do not adequately evaluate or control. Examiners evaluate management's business plans for adequacy and reasonableness, paying special attention to new business and new activities initiated by thrifts since their last examination. The examiners will scrutinize whether the institution performed a thorough due diligence review and evaluation of risks before commencing a new activity. Examiners will also evaluate the training and level of expertise of institution staff conducting the new activity. Finally, an analysis of strategic risk must also focus on how management addresses external factors that impact the future prospects of the institution.

### **III. Responding to Change**

While the procedures and policies I have outlined have served us well in maintaining the safety and soundness of the thrift industry, we cannot be complacent. In today's dynamic financial services industry, we must constantly review and update our supervisory systems and regulatory approach. Three key aspects to our constantly evolving approach to supervision and oversight are technology, training, and interagency coordination.

## **A. Technology**

Perhaps the single most significant development for the financial services industry in the past several decades is the impact of technology on the delivery of financial services. We are currently in the midst of a technological makeover that is virtually reshaping the financial services industry. We have seen rapid advances in technology that have changed not only how fast institutions are able to perform certain service functions, but that have fundamentally altered relationships within various sectors of the financial services industry, and between those sectors and consumers.

We are currently adopting new technologies in our examination and oversight process. Our objective is to use computer programs that enable examiners to better evaluate risks to institutions. This has the added benefit of reducing the examination burden on institutions because it allows more examination functions to be performed off-site. We recently unveiled our revised preliminary examination response kit (“PERK”) that will allow institutions to submit loan data electronically, thereby reducing the amount of time our examiners visit an institution. Technology is bringing us to the point where, in the not too distant future, examination data can be relayed electronically in real time.

In addition, our automated examination procedures initiative, which was activated in August, is expected to further improve our analytical skills and reduce examination burdens on institutions by providing examiners with software to analyze loan portfolios. We also, recently, implemented another technological innovation by arranging to provide thrifts with sophisticated new software that facilitates their electronic filing of all regulatory reports with the agency. Although this program will require a sizable capital investment by the agency—costing about \$1 million over the next two years—it furthers our ultimate objective of increasing institution and agency efficiencies by reducing the burden of paper filings imposed on our regulated institutions.

Our commitment to upgrading our technological capabilities is also apparent in the changes we have made in our own systems. We have spent almost \$7.5 million this year alone on new equipment and computer training for our employees. We have created a website to foster better communication between the OTS and the industry and public. Most of our Washington headquarters employees now have Internet access, and our regions should have full Internet access soon.

Technology is also affecting how we approach our examination and supervision function. Institutions' technology systems are becoming increasingly complex and highly interconnected. Many thrifts are already highly technology dependent. We have seen an increased use of data warehousing and data mining techniques to integrate customer information with the credit decision-making process, and a proliferation of so-called "decision technology," such as credit scoring, automated underwriting and risk management software.

Reliance on such new technologies poses new risks to depository institutions. Thrifts must understand these systems. Poor implementation of new technologies, such as credit scoring and risk management software, could result in immediate and sustained losses. The OTS must ensure that thrifts have proper infrastructures in place for using these systems, including adequate controls, safeguards, and contingency plans. With greater emphasis on technology-driven efficiencies, there will be less room for error in making decisions. Technology can be a great liberator, but it can be misused and is no substitute for good judgment.

Examiners will require a greater understanding of technology and its attendant issues going forward. In the future, examiners will spend less time poring over credit files and more time looking at larger, homogenous pools of loans to determine whether



proper underwriting procedures were followed up front. They will have to be capable of reviewing asset pools, judging inherent risks and assessing the adequacy of reserves. When setting reserves, examiners will have to focus not only on the quantity of the reserves but on the methodology used to establish them.

Technology continues to revolutionize our industry. Keeping up with technology is critical to fulfilling our responsibility to ensure the safety and soundness of thrift institutions and the underlying financial markets.

## **B. Training**

Part of our efforts to remain abreast of new technologies must necessarily focus on training. Due in significant part to the new regulatory challenges presented by changes in the financial services marketplace, we have increased our emphasis on training. In fact, our current year's training budget was double what we spent last year, and will rise again in 1998. Our training program presumes a continuous rapid expansion of the business practices of thrifts, particularly in the electronic forum.

Accordingly, we are committed to extensive, comprehensive training for examiners. Toward this end, all OTS examiners must successfully complete a full regimen of classroom and on-the-job training, as well as pass various required tests to become accredited examiners.

Moreover, we are continually upgrading our training opportunities to augment both our examination and supervisory function, and our other areas of operation. For example, recent legislative changes in the Qualified Thrift Lender test have enabled thrifts to increase their commercial and consumer lending activities. Over the last three years, commercial loans to small businesses, while still a small portion of the industry's

aggregate loan portfolio, were the fastest growing loan type, increasing at an annualized rate of 22 percent. Consumer loans experienced the second highest growth rate over that time period, increasing by more than 4 percent annually. As thrifts gain expertise in this area of their operations, it is likely that such lending will occupy an increasingly larger portion of institutions' portfolios.

As a result of increased commercial and consumer loan activity, the OTS has developed new and/or advanced training courses that focus on these areas. The OTS is also coordinating training plans with the other federal banking agencies, and utilizing new technologies to facilitate the training process for our examiners.

We now offer a variety of commercial and consumer lending classes, including classes dealing with small business and SBA lending, commercial and consumer leasing, direct and indirect lending, and credit card lending. We have also revised our courses on mortgage banking, capital markets, and advanced compliance issues. Many of these specialized training programs have been developed as video, CD-ROM or teleconference presentations.

In addition, we are continuing to coordinate training activities with the other banking agencies. The interagency Federal Financial Institutions Examination Council ("FFIEC") conducts many interagency training programs and seminars for the four banking agencies and the National Credit Union Administration. In 1998, FFIEC will offer courses covering a wide variety of subjects, including capital markets, the regulatory implications of cyberbanking, emerging issues for community financial institution supervisors, emerging issues for multinational financial institution supervisors, information systems and technology, international banking, risk management planning, fiduciary activities and white collar crime.

During the last several years, the OTS has invested heavily in training as a primary means of preparing its staff to perform effectively in the rapidly changing financial services environment. We budget over three times as much as the average private sector company on training, and our training funds compare very favorably with the other banking regulators. For 1998, we have set a target training budget of three percent of our projected total budget of roughly \$140 million. We remain firmly committed to upgrading our employees' professional development to ensure top performance by a well-qualified staff.

### **C. Interagency Cooperation**

Another key element to maintaining an effective examination and supervisory presence is interagency cooperation. Your invitation letter specifically asked about efforts to coordinate examination functions with the other banking regulators. All the federal banking regulators recognize that reducing the inherent disadvantages of multiple regulators is good for the institutions we regulate.

To strengthen coordination and cooperation in examining and supervising insured depository institutions, the bank regulatory agencies, together with the states, have developed many cooperative arrangements, both formal and informal. Congress created FFIEC for the express purpose of facilitating interagency coordination and the exchange of ideas. FFIEC has fostered such coordination among both the federal and state agencies in most aspects of supervision and regulation.

Consistent with the concept of comparable safety and soundness regulation, the OTS and the other banking agencies have been steadily moving toward greater uniformity in all aspects of examination and supervision. A good example of such uniformity is OTS's adoption in 1993 of the CAMELS rating system.

This movement toward greater coordination and uniformity is reflected in the Interagency Statement on Examination Coordination. The Interagency Statement sets forth the procedures that the agencies will follow in: (1) planning the examination of banking organizations; (2) conducting joint interagency examinations; (3) holding joint agency meetings with the management of depository institutions and their parent holding companies; (4) sharing information among the agencies; and (5) coordinating enforcement actions. In the examination of larger, more complex companies, the agencies coordinate extensively to reduce duplication of effort and minimize regulatory burden.

Federal and state banking agencies conduct examinations in areas of common interest, such as mutual funds, interest rate risk, liquidity, and mergers and acquisitions. When joint examinations are not conducted, the agencies leverage off the work performed by the primary regulator or the institution's internal and external auditors to avoid duplication of effort and burden to the institutions. In addition, the agencies routinely share with one another reports of examination, inspection reports, and other communications to their institutions. The agencies also provide each other with access to their organizations' financial and supervisory information data bases.

In addition, the federal banking agencies continue to work cooperatively in a number of other important areas. In 1997, the agencies: (1) adopted GAAP as a common basis for all call reports; (2) adopted common forms for filing of certain corporate applications; (3) issued joint guidance on the sales of 100% loan participations; (4) jointly extended an 18-month examination cycle to healthy, well-managed banks and thrifts with up to \$250 million in assets; and (5) issued joint interim guidance on the treatment of servicing assets for regulatory reporting and capital purposes, which was followed by a joint Notice of Proposed Rulemaking.

A good example of the agencies' cooperation is our common approach to addressing the multi-faceted challenges presented by the Year 2000 challenge. This effort has included developing a uniform policy statement, examination procedures, and an assessment questionnaire. The agencies are sharing information and coordinating priorities in dealing with the critical issues involved in the conversion to the new millennium.

In addition to banking agency coordination activities, the OTS and the other federal banking agencies routinely coordinate on information gathering with the National Association of Securities Dealers ("NASD"), a self-regulatory organization under oversight of the Securities and Exchange Commission ("SEC"). The agreement, which was entered into in 1995, permits the banking agencies and the NASD to share certain information to avoid duplication of regulatory efforts and promote consistency regarding broker-dealer activities. Because thrifts, their subsidiaries and SLHCs must all conduct any brokerage activities through NASD registered broker-dealers, this arrangement reduces duplicative burdens imposed on these entities. The OTS, consistent with its functional regulation approach, is committed to cooperation and communication with the NASD to facilitate this process.

Aside from information sharing with the NASD, the OTS is also routinely asked by the SEC to comment on pending regulatory issues that exist when a thrift reorganizes into a SLHC structure, or a SLHC is formed in connection with the acquisition of a savings association.

The OTS, along with the other federal banking agencies, is committed to continuing to explore ways that we can work together with each other and with other

federal and state regulators, to better leverage off the work that we do individually, and to ease regulatory burden on the entities we supervise.

#### **IV. Current Supervisory Issues**

In addition to the general examination and supervisory approaches that I have touched upon today, we are currently reviewing a number of specific issues that are either affecting thrift operations now, or that we believe will affect thrift operations going forward.

##### **A. Increased Thrift Charter Applications**

Perhaps the major supervisory issue currently facing OTS is the recent interest by various financial companies in the thrift charter. Since the beginning of this year, we have received applications for new thrifts from major insurance companies, investment banks, credit unions and other commercial enterprises. Although the number of applications for thrift charters has markedly increased -- there have been 38 applications filed for thrift charters in 1997 -- the applications do not raise novel issues of review for the agency; nor do the proposed operations of the thrift institutions that would result involve supervisory challenges with which we are unfamiliar.

For decades, thrifts have maintained affiliations with various financial services providers, as well as with commercial firms. Such broad affiliations are familiar to the OTS via our regulatory experience with savings and loan holding companies ("SLHCs"). Although SLHCs are not generally subject to activity restrictions, nor capital requirements, the interaction and relationships between the subsidiary thrift institution, the SLHC and its affiliates are monitored closely. In this manner, we attempt to ensure that a holding company (and its affiliates) will not adversely impact a subsidiary thrift.

This is accomplished in a number of ways. First, based on the capitalization and earnings of a savings association, we impose restrictions on the extent to which the association may make capital distributions (e.g., via dividends and other capital payments) to its holding company. Second, we impose stringent affiliate transaction restrictions on a thrift's dealings with its holding company and affiliates. In addition, if a SLHC (or affiliate) is engaged in non-permissible BHC activities, the restrictions on an affiliate savings association are even more stringent—it may not make *any* loans or extensions of credit to the SLHC (or affiliate).

Besides these specific restrictions on the relationship between a thrift and its affiliates within a particular holding company structure, we have taken an umbrella supervisory approach to the SLHC as a whole. This approach allows us to assess accurately how risks to an insured institution may be affected by risks in the other components of the holding company structure.

The SLHC also is subject to examination and intervention in the event that its (or an affiliate's) operations appear to threaten a thrift's safety and soundness. Otherwise, the SLHC generally is free of government intrusion into its operations.

In reviewing recent applications for new thrift charters by various financial companies, we rely on the tools provided to the OTS by FIRREA and FDICIA, and our experience in dealing with interlocking financial services companies that exist in SLHC structures. New activities and institutions are vigorously scrutinized, both during the application process and, if approved, after the initiation of their operations. Our applications staff reviews in detail the business plans submitted by applicants in support of their proposed activities. Areas of concern or uncertainty must be adequately addressed before an application is approved.

After an institution is operational, we remain vigilant in overseeing and examining new activities. In this regard, we have upgraded our training programs to respond to increased interest in certain thrift powers. For example, many of the currently pending thrift charter applications are for institutions that will operate as nationwide, full-service trust companies. Consequently, we have increased our training efforts in fiduciary activities and have increased the number of examiners who focus on that area. The FFIEC has also included courses in the exercise of fiduciary powers in its 1998 training offerings.

We are well prepared for new entrants to our business. Our examiners have the expertise and training to monitor new institutions and their affiliations to ensure the safety and soundness of the thrifts. We look forward to the challenges presented by these new companies and the hybrid of financial services they will be able to provide through the thrift charter.

## **B. Year 2000**

Another large challenge currently facing the thrift industry and its data processing service providers is the Year 2000 computer compliance problem. The potential impact of this issue on thrifts and their customers is substantial. To ensure that the computer operations of thrifts roll over smoothly at the turn of the century, the OTS is aggressively pursuing a plan intended to ensure Year 2000 compliance by all industry participants.

Pursuant to this plan, we have adopted a four-part supervisory strategy. First, we have been enhancing industry awareness of the Year 2000 computer issue. Second, we are currently expanding our examination process to include Year 2000 review procedures. Third, we are providing active supervision to ensure that necessary system changes occur



by year-end 1998, which will allow for sufficient time to test new systems. Finally, on an interagency basis, we are developing a contingency planning program.

In addition, we are actively addressing Year 2000 issues related to our own internal systems and infrastructure. To date, we have completed approximately 55 percent of the computer code modifications necessary for Year 2000 compliance, and another 33 percent of the revisions are currently underway. The final 12 percent of the modifications will begin soon.

The combination of industry education, examiner oversight, and internal system modifications should ensure that effective and timely actions are taken to avoid potential computer problems with the Year 2000 rollover.

### **C. Electronic Banking**

We are also looking at the recent introduction and future potential of various forms of electronic banking. We have been closely monitoring and, in some instances, facilitating the evolution of so-called "on-line" banking. The range of financial services that may be delivered via electronic banking is limited only by the ability of institutions to incorporate new technologies that include adequate security measures. Possible financial products encompass the performance of any authorized financial institution function.

In May 1995, the OTS approved an application to create the nation's first Internet bank. We have recently approved our second Internet bank. These institutions are looking to develop a new market niche and appear to have a promising future. Our goal is to facilitate the development of innovative approaches to the delivery of financial

services by institutions consistent with prevailing market forces and the maintenance of adequate safety and soundness standards.

Recognizing that retail on-line personal computer banking offers new business opportunities for financial institutions, we have also issued a statement of guidance on the subject to our examiners and the institutions we supervise. The eight-page statement focuses on the strategic, legal and regulatory, and operational risks involved in offering on-line personal computer banking to customers. In this guidance we encourage institutions to evaluate the risks associated with personal computer banking and implement appropriate controls commensurate with the risks.

Issuance of the guidance was one of several steps in a series of initiatives that we are currently pursuing to increase awareness of issues associated with technological and electronic activities. We are also updating our safety and soundness examination procedures and enhancing training programs to help examiners better evaluate if an institution's planning, policies and procedures, and audit processes are adequate to ensure a safe, sound, and secure infrastructure for deployment and use of information technology. In addition, we are considering how Community Reinvestment Act guidelines will be adapted to virtual banks whose only boundaries are electronic.

In furtherance of our objective to be proactive in the development of new approaches to "on-line" banking, just this past week we issued a proposed rule on electronic banking. The goal of the new rule is to allow federal thrifts to take full advantage of this emerging technology. The proposed rule clarifies that a federal thrift may engage in any activity through electronic means that it may conduct through more traditional delivery mechanisms.

The proposed rule would remove regulatory roadblocks to the full use of automated teller machines, automated loan machines, personal computers, the Internet, the World Wide Web, telephones, stored value cards and other electronic devices used to deliver financial services to customers. This approach allows thrifts creativity in providing access to financial services (subject, of course, to adequate safety and soundness safeguards and security measures). The proposal specifies that new electronic technologies must develop within the framework of interagency Community Reinvestment Act regulations and interpretations.

The goal of the proposed rule is to allow thrifts to be able to compete better by offering enhanced services to their customers. This effort is consistent with our objective to ensure that institutions stay abreast of changes in the marketplace and adapt their policies and practices consistent with the development of new technologies.

#### **D. Financial Crimes**

New technologies have also given rise to concerns about a new advent of financial crimes. Technology can facilitate a broad range of financial crimes, including fraud, tax evasion, counterfeiting, theft, and money laundering. If left unchecked, stored value devices and encryption security could make large, anonymous, and potentially illicit financial transactions easier to conduct and more difficult to detect, particularly across international borders.

Partly in response to these possibilities, the OTS and the other federal banking agencies have been reevaluating their approach to uncovering and investigating money laundering activities affecting our regulated institutions. The Riegle Community Development and Regulatory Improvement Act of 1994 required that we review and

enhance our training and examination procedures to improve the identification of money laundering activities involving depository institutions.

In response, we have adopted a two-pronged regulatory approach to detecting and ferreting out money laundering activities. First, we are currently revising our examination procedures, in part, to focus on identifying money laundering activities in financial institutions. We expect to issue these revised procedures in the near future. Second, we are enhancing the training of our compliance examiners to improve the identification of money laundering activities. During the training sessions of our new Advanced Compliance Examiner School held in 1997, a significant portion of each session was devoted to the Bank Secrecy Act—with a major emphasis on money laundering activities. That segment of the course was taught by a representative from Treasury's Financial Crimes Enforcement Network ("FinCEN").

In these and other endeavors, we have attempted to cooperate with other bureaus of the Treasury Department, including FinCEN, the other federal bank agencies, and the Justice Department to improve the federal government's detection and elimination of money laundering activities. We are also an active participant in the newly-formed Money Laundering Working Group, which is composed of representatives of federal and state law enforcement and regulatory agencies. The group was formed to ensure coordination and cooperation among federal and state participants to enhance anti-money laundering efforts.

#### **E. Expanding Lending Activities**

Recent legislation expanding the permissible lending activities for savings associations has sharpened our regulatory focus in several areas. Although none of these lending areas presently represents a significant portion of aggregate thrift lending

activities, some institutions have pursued lending opportunities in these areas. Our objective is to stay abreast of this gradually increasing lending activity and work with thrifts exploring these lending areas.

**Commercial Lending.** Perhaps the most significant of the expanded lending authorities available to thrifts is the increase in commercial lending allowed by the Economic Growth and Regulatory Paperwork Reduction Act (“EGRPRA”). Pursuant to the EGRPRA, the basket for permissible loans made for commercial, corporate, business or agricultural purposes was increased from 10 percent of assets to 20 percent of assets, provided amounts in excess of 10 percent of assets are for small business lending.

Although the amount of commercial lending by thrift institutions has increased at a substantial rate in recent quarters, the amount of commercial loans still represents a very small portion of most thrift institutions’ aggregate lending portfolio. From June 1996 to June 1997, aggregate thrift commercial lending increased from \$8.35 billion to \$9.98 billion, which represents just under a 20 percent increase. However, as of June 1997, aggregate commercial lending stands at slightly less than 1.3 percent of aggregate thrift assets and represents slightly more than 1.6 percent of aggregate mortgage lending and investment activities at thrift institutions. Clearly, despite the increase in commercial lending that has occurred over the last year, such activity comprises a very small portion of aggregate thrift lending.

**Consumer Lending.** For one segment of consumer lending—credit card lending—the EGRPRA clarified that thrifts are not subject to any percentage of assets limitations. With respect to increased consumer and credit card lending activities by thrift institutions, we do not break out in our aggregate industry financial data the amount of credit card lending that is included within the line item for consumer lending by thrift institutions. From June 1996 to June 1997, aggregate consumer lending by thrift

institutions increased from \$38.27 billion to \$40.29 billion—an increase of slightly more than 5.25 percent. Anecdotal evidence suggests that a significant portion of this increase is attributable to increased credit card lending activities of thrift institutions. As with commercial lending, we are attempting to keep abreast of the steady increase in consumer and credit card lending activity at thrift institutions. Our efforts include increased training for our examiners and updating of agency guidance available to institutions to monitor the risks that arise with increased lending in these areas.

**Small Business Lending.** Small business lending requires specialized lending expertise that thrifts historically have not gained because the volume of their small business lending activities did not justify the expense. Thus, most thrifts have had minimal experience in this area. With the increase in their small business lending authority provided by EGRPRA, however, the marginal costs for entry into this lending market become less prohibitive. We anticipate that within the next several years more thrifts will explore this lending activity.

As a result, we have focused on revising our programs and policies to take account of the particular nuances of examining and overseeing small business lending activities conducted by thrift institutions. In particular, this involves training our examiners and revising our guidance to educate both our staff and the industry on the risks associated with small business lending activities.

**Sub-prime Lending.** One of the most publicized issues in the financial services industry recently has been the proliferation of sub-prime lending. For thrifts, this increased activity does not arise from a new or expanded authority, nor does it involve a new lending category. Instead, it involves offering traditional lending products to traditionally underserved segments of the lending business. Generally, sub-prime lending activities include consumer, mortgage and home improvement loans to borrowers that

have weak credit ratings, as well as the purchase of sub-prime loans from other lenders. High profit margins, and some well-publicized failures, have focused attention on this aspect of insured institutions' lending activities.

Because of their historical focus on longer-term, higher-credit quality mortgage lending, many thrifts have avoided sub-prime lending. In some markets, however, traditional retail lending has become extremely competitive and less profitable. As a result, many thrifts have explored limited (and in certain instances, more wide-scale) sub-prime lending as a way to improve their overall performance and profitability. In addition, as markets become more competitive, the distinction between prime and sub-prime loans continues to blur. Increasingly, credit is granted across a continuum of risk-based pricing, and competition across the credit continuum is likely to remain intense with margins squeezed tighter. Thus, it is imperative that thrifts understand and safely navigate these lending markets.

In response to these new and more risky lending activities, the OTS will rely on the examination process to monitor increased risks. We are also developing more detailed guidance for thrifts entering this new field. The guidance will detail the additional risks posed by sub-prime lending and describe the appropriate steps for thrifts and their management to take to minimize these risks. In addition, the guidance will clarify that unless risks are controlled, OTS will consider sub-prime lending a high risk activity that is unsafe and unsound. Our intent is not, however, to discourage sub-prime lending. Clearly, there are bona fide lending needs within the sub-prime lending market. Instead, institutions will be permitted to engage in sub-prime lending, provided it is done in a safe and sound manner and can be done profitably.

## **V. Conclusion**

We believe our risk-focused approach to examination and supervision has worked. The thrift industry is currently in the midst of one of its most profitable periods in decades. Industry capital is at an all-time high and, perhaps most importantly from a supervisory standpoint, troubled institutions and assets are at their lowest point since FIRREA. The thrift industry has fully recovered from its virtual demise in the late 1980's.

That being said, however, I trust my testimony today has demonstrated our vigilance in preparing for a changing future. We have upgraded our training and technology programs and increased interagency cooperation, and we are monitoring the effect that new technologies, products, and markets are having on the thrift industry. In addition, we are currently focused on several issues that we believe will be of great importance to our industry in the very near future. Now is an exciting and challenging time to be in the financial services industry. Recognizing the constraints of an uncertain future, we are optimistic about tomorrow.

Risk assessment is a dynamic process that requires continuous innovation. The OTS will continue to seek out ways to enhance supervision of the thrift industry, working in partnership with our regulated institutions, the other federal banking agencies, the Administration, and the Congress.