Testimony

of

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concerning

Condition of the Thrift Industry

before the

Subcommittee on Financial Institutions and Regulatory Relief

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I. Introduction.

Good morning, Mr. Chairman and Members of the Subcommittee. Thank you for your invitation to appear before you today to discuss the current status of the thrift industry.

This past August marked the eighth anniversary of the enactment of the Financial Institutions' Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). FIRREA was widely viewed as the most significant piece of legislation affecting the thrift industry since the creation of the Federal deposit insurance system in 1933. Its impact on reforming and reviving the industry cannot be overstated. Simply put, the thrift industry today is very different than the industry in place when FIRREA was enacted.

Instead of substantial troubled assets and thin capitalization, the thrift industry today enjoys steady and healthy profits, historically high levels of capital, and has the number of problem institutions and assets at all-time lows. Although the number of thrift institutions continues to decline, overall assets are stable and interest in the thrift charter has been renewed. Financially, the thrift industry is in its best condition in decades.

Notwithstanding the existing profitability of the industry, we must not be complacent. We must resist the temptations of resting on the recent past, lest we be caught unprepared for the wave of change that continues to drive the financial services marketplace.

In addition to highlighting the current state of the thrift industry in my testimony today, I will discuss some of the emerging issues that confront the industry, now and going forward into the future, as market forces shape and reconfigure systems for the delivery of financial services to consumers.

II. The Current Economic Health of the Thrift Industry.

As Members of the Subcommittee no doubt recall, the thrift industry in 1989 was in the midst of what some have called America's worst economic crisis since the Great Depression. In 1988, shortly before FIRREA was enacted, there were nearly 3000 thrift institutions holding approximately $1.4 trillion in assets that were regulated by the Federal Home Loan Bank Board ("FHLBB"), the OTS's predecessor. While many institutions were in sound financial condition and remained profitable throughout this period, there was a sizable segment of the industry with severe and rapidly increasing losses.

In 1988, the industry as a whole operated at a net loss of over $13 billion. The industry's return on assets ("ROA"), a key measure of thrift performance, was negative 96 basis points and the industry as a whole held less than 2% tangible equity capital. Most of the problems, however, were concentrated only in a segment of the industry. For example, over 2000 thrifts, representing almost 70% of the FHLBB-regulated industry, were profitable. The $5.9 billion in profits earned by the larger, healthy segment of the industry, however, were simply overwhelmed by the $19.1 billion in losses incurred by the other 30% of the industry.

The industry that the OTS regulates today is starkly different. There are now approximately 1270 thrifts holding $770 billion in assets. The industry is characterized by consistent, strong income and profits, high capital levels and continually improving asset quality.

A. Income and Profits are Consistently Strong.

In the first half of this year, the thrift industry posted earnings of $3.4 billion. That performance, if it continues, will far outstrip the industry's previous earnings record of $5.4 billion set in 1995. It is also consistent with the industry's performance in 1996 when, after adjustments for the one-time special premium levied in the third quarter of last year to recapitalize the Savings Association Insurance Fund ("SAIF"), thrift earnings would have totaled $6.9 billion. When the SAIF payment and one-time restructuring charges are factored out, thrift earnings have been steadily high for the last six quarters.

The average ROA for the first six months of this year was 90 basis points. With adjustment for the SAIF special payment, thrifts' average ROA in 1996 was 89 basis points. An aggregate industry ROA of 90 basis points is very strong by historical standards. Indeed, the thrift industry's aggregate ROA has not exceeded 85 basis points since 1962—thirty-five years ago.

Significantly, the industry's strong performance during 1997 is both fundamentally sound and broad-based. Current thrift profits reflect improvements in thrift core income, rather than temporary gains from one-time or transitory transactions. Core income as a percentage of assets has averaged over 88 basis points for 1997, and thus is the predominant source of the industry's aggregate ROA so far this year. In the second quarter of 1997, 95.5% of thrifts were profitable. That was the highest percentage of profitable thrifts since OTS began collecting quarterly data in 1984. In fact, since 1991, 90% of individual thrifts have been profitable (with the exception for the third quarter of 1996 with the huge SAIF payment).

B. Capital is at Record High Levels.

Another indicator of the thrift industry's recovery over the last eight years is its record high capital levels. Equity capital for the industry (that is, capital calculated using Generally Accepted Accounting Principles) increased to a record 8.11% in the second quarter of 1997. The previous capital record, of 8.08%, was set in the first quarter of last year. By comparison, the industry's aggregate equity capital ratio in 1988 was only 3.5%—less than adequate under the capital adequacy standards set out in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").

The industry's regulatory capital measures have also increased steadily over time, with a Tier 1 leverage capital ratio of 7.45% and industry risk-based capital at 14.54% as of the second quarter of 1997. These ratios are substantially higher than the levels needed for "well capitalized" status under the FDICIA standards. In fact, almost all thrifts (99.8%) met or exceeded regulatory minimum capital levels in the second quarter of 1997. Only three thrifts were undercapitalized.

The capital position of today's industry stands in stark contrast to that of the 1980's. In the mid-1980's, as few as 30% of thrifts were well capitalized. Clearly, the industry has made great strides in shoring up its capital and the result is a safer, sounder thrift industry.

C. Troubled Thrifts and Assets Remain at Very Low Levels.

In addition to having fewer problem institutions, the industry has improved its asset quality. This is demonstrated by the continued decline in the amount of troubled assets, defined as the sum of noncurrent loans and repossessed assets, net of specified valuation allowances. As of June 1997, thrift industry troubled assets were at $8.1 billion (1.06%), as compared to $24.7 billion (3.07%) just five years ago. In addition, noncurrent loan rates for thrifts' major loan categories (e.g., single family mortgages, consumer loans, commercial loans and nonresidential mortgages) are lower in 1996 and 1997 than they were in 1992 and 1993, when the current economic expansion began.

The thrift industry today is strong, profitable and safe. Many factors have contributed to the existing health of the industry, including the general prosperity in the underlying economy, strict Congressionally mandated improvements in capital levels and business practices, and increased regulatory oversight. It is this last factor that is, perhaps, the most critical not only to the industry's recovery, but to its future health. With this in mind, I will discuss the systems that OTS has implemented over the years to monitor industry risks and current and future thrift operations.

III. Risk Assessment and the Regulatory Process.

Although thrift industry capital is at an all-time high, as we all know, 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 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.

A. Assessing Various Risks.

The heart of the examination function is risk assessment. Risk assessment strategies should be tailored to the particular mix of risks faced by each institution, taking 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 traditional niche has been 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 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.

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"). The Model has proven to be a valuable supervisory tool with numerous benefits. 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 these data to the OTS. In doing so, these institutions receive customized reports based on the OTS Model that assess the interest rate risk sensitivity of their existing loan portfolio. Both OTS examiners and thrift managers are able to evaluate these individual results and compare them with results for the rest 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. Credit Risk.

The other major risk that the examination process seeks to monitor and control is 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.

3. Other Risks.

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

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.

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 a variety of consumer laws and regulations. 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.

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, the predominant market risk is interest rate risk.

IV. Current Supervisory Issues.

As I noted at the outset of my testimony today, although thrifts are currently enjoying their best financial health in decades, we must not be complacent. In today's dynamic financial services marketplace, we must constantly review and update our regulatory approach. As part of this continuing process, 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.

The most pressing issue currently facing thrifts is financial modernization and the potential impact that financial modernization legislation could have on various segments of the financial services marketplace. The failure to press forward on financial modernization and, alternatively, the failure to implement financial modernization legislation that is grounded in sound public policy could have serious repercussions for the future of various segments of the financial services industry. Financial modernization is a laudable goal, but it must be done carefully to avoid the imposition of rules that impede, rather than advance, the ongoing evolution of the financial services marketplace.

With financial modernization as the backdrop, I will briefly discuss several existing supervisory issues that we are monitoring.

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 will be relayed electronically in real time.

In addition, an automated examination procedures initiative activated by the OTS 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 also created a website to foster better communication between the OTS and the industry and public. Most of our Washington headquarters employees now enjoy full Internet access, and our regions should have Internet access within a matter of months.

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. We as regulators will require a greater understanding of technology and its attendant issues going forward.

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. Renewed Interest in the Federal Thrift Charter and the Unitary Thrift Holding Company.

Another major supervisory issue currently facing the 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. We have already received 35 applications for thrift charters in 1997, compared with 66 total new institutions over the prior three years. The number and nature of the recent increase in applications for new thrifts presents challenges for our staff.

The increase in charter applications must be kept in context. Over the last several years the number of institutions leaving the industry has consistently exceeded the number of new entrants. From 1993 through 1996, over 500 thrifts left the industry, while only 66 new ones were formed. Even with those 35 applications for new thrifts this year, 62 institutions left the industry in the first six months of 1997. Consolidation continues to shrink the number of thrifts.

As indicated in the OTS April 1997 background paper on holding companies in the thrift industry, the number of holding companies owning thrifts, the number of thrifts owned, and the business activities of those holding companies can change frequently and significantly. This is particularly true for unitary savings and loan holding companies ("SLHCs"), those companies owning a single thrift that can engage in commercial and other activities not authorized for banks or their holding companies.

During the first six months of 1997, the number of unitary SLHCs, the number of thrifts in such holding companies, and the proportion of total thrift assets in unitary SLHCs has increased even as the number of thrifts continued to shrink. The most dramatic increase has been in the amount of thrift assets in unitary SLHCs. At the end of June 1997, over two-thirds of the thrift industry's assets were in unitary SLHCs, up from 60.7% at the end of 1996. This growth far outstripped the growth in both the number and percentage of thrifts owned by unitary SLHCs, indicating an increase in the size of the thrifts owned by these holding companies. The total number of thrifts in unitary SLHCs increased from 515 to 519 as of June 1997.

During this time period, we have observed declines in the number of SLHCs with non-banking activities; the number of thrifts in such holding companies; and the amount of thrift assets in SLHCs with non-banking activities. However, eventually this trend may be reversed by recent renewed interest in the federal thrift charter by holding companies, especially insurance companies, that engage in non-banking activity. Of the 35 applications for new thrifts this year, 18 applications involved holding companies and 50% of these were holding companies with non-banking activities.

For decades, thrifts have maintained affiliations with various financial services providers, as well as with commercial firms, through the vehicle of the SLHC. Although SLHCs are not generally subject to activity restrictions or capital requirements, the interaction and relationships between the subsidiary thrift institution and its SLHC and 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 activities that are not permitted for bank holding companies ("BHCs"), 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 by FIRREA and FDICIA, and our experience in dealing with interlocking financial services companies that exist in SLHC structures. Each new activity by an institution is 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 charter applicants in support of their proposed activities. Areas of concern or uncertainty must be adequately addressed and resolved before an application is approved.

After an institution is operational, we will 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.

Our confidence in our ability to integrate these new institutions into the industry, however, does not obscure the fact that some of the new applications present challenging issues with which we are currently grappling. A good example is how the Community Reinvestment Act ("CRA"), and general ideas about community-based banking, affect the operations of the new thrifts. For instance, how does the Community Reinvestment Act apply to an Internet thrift whose only boundaries are electronic?

We support implementation of the CRA and the goals it was enacted to serve. In the two decades since its passage, the CRA has strengthened local economies and has had both a direct benefit to individual lenders as well as the community as a whole. As has become clear, if communities have access to capital and are part of the financial mainstream, economic development follows, as do jobs and profits. The CRA is both good public policy and good business. We are committed to maintaining the benefits of community-focused lending in approving and monitoring the activities of new thrifts.

C. 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 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, including data processing and other service providers to the industry.

Pursuant to this plan, we have adopted a four-part supervisory strategy. First, we have been working to enhance industry awareness of the Year 2000 computer issue. Second, we are expanding our examination process to include Year 2000 review procedures. Third, we are requiring that necessary system changes occur by year-end 1998, to allow for sufficient time to test the 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 61 percent of the computer code modifications necessary for Year 2000 compliance, and another 27 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 are intended to ensure that effective and timely actions are taken to avoid potential computer problems with the Year 2000 rollover. One issue of concern in achieving this objective, however, is our ability to oversee third party service providers to determine if they are taking the necessary steps for Year 2000 compliance. In this regard, the OTS lacks the same statutory examination authority as the other federal banking agencies to examine service providers. We are currently exploring ways to address this statutory gap in coverage.

D. 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. 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 furtherance of our objective to be proactive in the development of new approaches to “on-line” banking, earlier this month 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.

New technologies such as electronic banking 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 concerns, 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.

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. We are also 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.

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.

Perhaps the most significant of the expanded lending authorities available to thrifts is the increase in small business 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 approximately 20 percent in recent quarters, commercial loans still represent a very small portion of most thrift institutions' aggregate lending portfolio. In fact, commercial lending still only represents less than 1.3 percent of aggregate thrift assets.

Small business lending requires specialized lending expertise. Thrifts historically have not engaged in this line of business because the permitted volume of small business lending was too small to warrant the expense of hiring the expertise. Thus, most thrifts have had minimal experience in this area. With the increase in the small business lending authority provided by EGRPRA, however, the potential returns for entry into this lending market may have become more attractive. We anticipate that within the next several years more thrifts will explore this lending activity.

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 examiner training and revising our guidance to educate both our staff and the industry on the risks associated with small business lending activities.

The EGRPRA also included provisions affecting thrifts' consumer lending activities. For one segment of consumer lending—credit card lending—the EGRPRA clarified that thrifts are not subject to any percentage of assets limitations.

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 small business 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.

Finally, 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, most 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 closely monitoring developments in this new field to keep abreast of the additional risks posed by sub-prime lending. Unless those risks are controlled, sub-prime lending is a high risk activity that is unsafe and unsound. At this point, 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.

F. The OTS's Strategic Plan.

Finally, the Chairman's invitation letter asked that I discuss the OTS's strategic plan. As you know, the Government Performance and Results Act of 1993 requires the OTS, as well as all other government agencies, to submit a five year Strategic Plan. The OTS submitted its Strategic Plan on September 30, 1997.

Our Strategic Plan first identifies the OTS's mission statement. With the overriding purpose of the agency being to preserve and maintain a safe and sound financial system, the OTS' mission statement has evolved to embrace the following two concepts:

- Effectively and efficiently supervise thrift institutions to maintain the safety and soundness and viability of the industry; and

- Support the industry's efforts to address housing and other community credit and financial services needs.

These two simple statements of intent are the foundation for five major goals for the 1998-2002 period. As detailed in the Strategic Plan, the goals translate into 14 specific objectives, with 16 separate performance measures of our efforts to achieve those objectives.

Our first major goal is to "maintain and enhance our risk-focused, differential and proactive supervision of thrift institutions." In other words, we will focus our examination and supervisory resources in the areas where they are most needed, and of most value to our regulated institutions.

Our second major goal is to "improve credit availability by encouraging safe and sound lending in areas of greatest need." That is, we intend to promote community lending that safely, efficiently and effectively allocates loan resources based on market needs.

Our third major goal is to "enhance the competitiveness of the thrift industry to ensure its safety and soundness." Through our regulatory oversight, we hope to anticipate and avoid safety and soundness problems that may arise due to competitive pressures from other financial services providers.

Our fourth major goal is to "conduct operations as efficiently as possible to keep regulatory burdens on the thrift system at the minimum necessary level." To achieve this goal, we will continue to look for areas in which we can reduce the costs of regulation imposed on thrift institutions.

Finally, our fifth major goal is "to provide exceptional customer service." The goal is to maintain government accountability to the industry we regulate, while remaining responsive to the unique needs and requirements of individual institutions.

The OTS, along with the other federal banking regulators, participates in the Government Performance and Results Act Banking Regulatory Agencies Working Group. We have all agreed to share information, reconcile inconsistencies in our plans, and have all affirmed that the plans will emphasize the common interest in maintaining safe and sound depository institutions.

The OTS' planning efforts have taken place, and will continue to take place, in an era of uncertainty and change. Notwithstanding the thrift industry's current strong financial position, it is at a crossroads. Uncertainty exists on several fronts. Pressure from a wide array of financial competitors continues to mount; the very existence of the federal thrift charter is being debated; and perhaps most significantly, advances in technology, driven by the biennial doubling of microprocessor productivity, are changing both how thrifts conduct their existing business operations, and how they plan for new business opportunities.

Of course, underlying any planning scenario is the state of the nation's economy. The robust economic growth of recent years has brought an unusually long series of profitable quarterly returns to thrift institutions, but we must be ready to assess accurately the health of the industry under whatever economic scenarios unfold.

The OTS must be ready to adjust its operations and procedures to respond to each of these sources of uncertainty. If Congress determines that the agency should be consolidated with another regulator, the OTS must be prepared to do so. On the other hand, if financial modernization legislation is not enacted, OTS must be prepared to continue to supervise and contend with the impact of new and emerging business strategies that thrift institutions and their affiliates will craft.

V. Conclusion.

The thrift industry has made great strides since the passage of FIRREA in 1989, and is in the best financial condition in many years. All those affiliated with this accomplishment deserve our thanks and congratulations.

The emerging financial issues that we must address relate to three broad categories—the use of new powers and development of new financial products, the impact of technology, and the oversight of lending risks and related activities. Regardless of how we respond to the challenges posed by each of these areas, market forces will ultimately dictate the direction that our financial institutions must take to remain competitive. It is our job to facilitate that process, not by being advocates of change and proponents of the industries we regulate, but by remaining detached and objective, yet working with our regulated entities to achieve the most favorable resolution of issues consistent with principles of safety and soundness.