STATEMENT OF JAMES E. GILLERAN
DIRECTOR, OFFICE OF THRIFT SUPERVISION
ON THE CONDITION OF THE THRIFT INDUSTRY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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I. Introduction

Good morning, Chairman Shelby, Senator Sarbanes, and members of the Committee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry. It is my pleasure to report on a thrift industry that is strong and growing in asset size. While we continue to maintain a watchful eye on interest rate risk in the thrift industry, profitability, asset quality, and other key measures of financial health are at, or near, record levels. The average equity-to-assets ratio is over 9 percent, and 99 percent of thrifts are well-capitalized.

A favorable interest rate risk environment, accompanied by record mortgage originations and sales, has produced strong profitability for the thrift industry for the past five years. Equally important to this sustained period of profitability are good stewardship by thrift managers, earnings diversification, and good asset quality. Other important factors that have contributed to the industry's success are the statutory and regulatory reforms initiated to strengthen the banking system. The reforms—including comprehensive capital standards, stronger corporate governance and internal control standards mandated by the Sarbanes-Oxley Act, uniform standards for lending, operations and asset growth, and prompt corrective action (PCA) requirements—have significantly improved our banking system. In addition, the banking agencies have been effective in keeping pace with changes in the institutions we regulate. For its part, OTS continually works to provide specialized training, rigorous accreditation and professional development programs, and other supervisory tools, to ensure that our staff is capably equipped to supervise a dynamic and growing industry. In addition, our employees are of long tenure and are well-seasoned, with an average 15 years of OTS experience.

II. Condition of the Thrift Industry

As of December 31, 2003, there were 928 OTS-regulated thrifts, holding assets of $1.1 trillion. In addition, there were 485 state chartered savings banks that have the FDIC as their primary federal regulator and the vast majority of which have operating strategies substantially similar to thrifts.[1]

While financial services consolidation continues to reduce the overall number of thrift institutions, industry asset growth remains strong. This is due to growth within existing thrifts and to the fact that various financial institutions continue to choose the thrift charter because of the advantages it provides in the delivery of financial services. Charter choice is a privilege available to American financial institutions, and it continues to flourish as institutions change and adapt their business strategies and focus.

In addition to supervising 928 thrift institutions, OTS supervises thrift holding companies. As of the end of 2003, OTS regulated 605 thrift holding company structures[2] with consolidated assets of approximately $6 trillion. As the only consolidated federal regulator both chartering the depository institutions and overseeing their holding companies, OTS has a unique supervisory role. This provides us with the opportunity to monitor and regulate all aspects of the institution's operations and holding company affiliate activities. The holding companies we oversee are quite diverse, ranging from large, multinational corporations to small "shell" companies with few assets other than their thrift charter.

The demographics of thrift institutions are also quite diverse. While numerous larger thrifts provide financial products and services nationwide or across sizable regional markets, most thrifts are generally smaller, community-based organizations that provide retail financial services in their local markets. As of the end of 2003, 66 percent of thrifts had assets of less than $250 million. Although small, these

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1. The number reported in a recent financial publication regarding the ratio of federal versus state thrifts failed to include state savings banks. In the aggregate, as of the end of 2003, 42 percent of thrifts—including state savings banks—were state chartered and the remaining 58 percent federally chartered.

2. A holding company structure may contain more than one holding company. As of the end of 2003, these 605 OTS-supervised holding company structures operated 971 holding companies.

institutions reach into many small American towns fortunate to have the option of a local community banker.

Thrifts provide substantial services that encourage home ownership and affordable housing, and contribute to economic growth. Thrifts hold over $730 billion in housing-related loans and securities, including $540 billion in whole single-family loans, which comprise one half of total thrift assets. In addition, the industry maintains 60 million insured deposit accounts. Thrifts compete effectively with other financial services providers to deliver a wide range of products and services to American consumers.

Thrifts utilize the secondary market effectively, selling approximately $769 billion in single-family mortgage loans to Fannie, Freddie and other secondary mortgage market participants in 2003. In addition, as of December 31, 2003, the Federal Home Loan Banks advanced $190 billion to thrift institutions, representing 17 percent of thrift liquidity.

A. Earnings and Profitability

Recent earnings and profitability of the thrift industry have been strong, with consecutive annual records in 2001, 2002 and 2003. For 2003, the industry reported earnings of $13.7 billion, eclipsing the prior record of $11.8 billion in 2002. Annual earnings were $10.2 billion in 2001.

The industry's annual return on average assets (ROA), a key measure of profitability, was a record 1.29 percent for 2003, breaking the prior record of 1.21 percent posted in 2002. Industry ROA was 1.07 percent in 2001. This was the first time that industry ROA exceeded one percent in three consecutive years since the mid-1950s.

While the historic level of thrift earnings is partially attributable to record loan origination and sales volume, the underlying strength and stability of thrift earnings has also been driven by diversification of income sources and continued strong asset quality. The industry's success over the past decade in expanding its line of products and services, such as mutual fund and annuity sales, trust activities, and transaction accounts, has enabled it to diversify its income stream and generate more stable earnings. Income from these activities measured 0.94 percent of average assets for 2003, up more than 400 percent from 0.17 percent in 1990. Together with improved risk management techniques, higher proportions of non-interest income have helped stabilize thrift income and provide better insulation against interest rate fluctuations.

The thrift industry was an active participant in the nation's recent refinancing boom and home ownership expansion. Thrifts originated over $730 billion in single-family mortgages in 2003, accounting for one in every five mortgages made in the U.S. for this time period. Income from mortgage lending, loan servicing, and other mortgage banking activities helped boost recent earnings, and represented 0.80 percent of average assets in 2003 compared to 0.44 percent in 1990.

Looking forward, we anticipate that mortgage loan refinancing activity will decline from the current high levels, which will dampen loan origination volume and earnings. The level of new home construction starts and sales of existing homes remain strong, however, providing a potential counterbalance to recent declines in refinancing activity. Although interest rate risk is not an immediate threat for thrift institutions, OTS continues to closely monitor for changes in interest rate risk.

B. Asset Quality

The quality of thrift loan portfolios continues to be very good, with key measures of problem loans relatively low, though up slightly from the historic lows set in 2000. Troubled assets (loans 90 or more days past due, loans in nonaccrual status, and repossessed assets) represented 0.67 percent of assets at the end of 2003. The ratio of troubled assets to total assets has remained below one percent since September 1997, but is slightly above the recent low of 0.58 percent reported at September 30, 2000.

As might be expected, the level of delinquent loans generally increased through the duration of the recent economic slowdown. The increase was modest, however, particularly given the record low levels set in 2000. Moreover, the industry’s noncurrent loan ratio declined in 2003 to 0.58 percent of assets from a post-2000 high of 0.65 percent in December 2002. Less seriously delinquent loans—those 30-89 days past due—were 0.71 percent of assets as of the end of 2003, slightly lower than the level (0.74 percent) at the end of 2000. Loans 30-89 days past due have generally remained at these levels since 2000 despite some quarterly fluctuations.

Loan charge-off rates have risen since 2000, reflecting the modest pace of economic activity. Net charge-offs as a percent of total assets were 0.26 percent in 2003, up from 0.24 percent in 2002 and 2001, and 0.19 percent in 2000. Thrifts’ charge-off rates are typically lower than those of commercial banks since thrift loan portfolios are heavily concentrated in single-family mortgages. Charge-off rates for single-family mortgages are generally very low compared to other types of loans. The charge-off rate on all single-family mortgage loans was just 0.05 percent in 2003, or $50 for each $100,000 in loans.

Thrifts’ provisions for loan losses generally increased in response to the rise in noncurrent loans and loan charge-offs. Total loan loss provisions were 0.21 percent of average assets in 2003, 0.30 percent in 2002, and 0.28 percent in 2001—all up from 0.20 percent in 2000. Increased loan loss provisioning kept the industry’s total loan loss allowance relatively stable despite increased charge-offs. Total allowances measured 0.60 percent of assets for 2003, down slightly from 0.64 at the end of 2000.

The slight declines in 2003 loan loss provisions and loan loss allowances reflect the improved economic outlook and signs of recovery from the most recent recession.

As real estate financing activity surged in recent years due to historically low interest rates, OTS has monitored housing values across the United States. While there may be some regional pockets in the United States where a "bubble" could exist, this does not appear to be a nationwide problem. Because local economic and demographic factors are the primary influences on home prices, significant home price declines have occurred historically only in markets experiencing severe economic distress. Given the generally improving economic conditions nationwide, a recent FDIC[3] study concludes, for example, "that a widespread decline in home prices appears unlikely, even when mortgage rates begin to rise from current low levels."

This is not to say that mortgage lending is not without its risks, especially when mortgage interest rates rise. For example, highly leveraged borrowers and those in high-priced home markets tend to rely on adjustable-rate mortgages, making them vulnerable to interest rate "shock" once short-term interest rates begin to rise. Likewise, home price appreciation may slow as rising mortgage rates make homes less affordable, especially higher-priced homes.

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3. *FDIC Outlook*, March 2, 2004.

C. Capital

Capital measures for the industry are strong, stable, and well in excess of minimum regulatory requirements. While industry growth can often pressure capital ratios, even as industry growth has continued, thrifts have maintained high levels of capital through prudent earnings retention and receptive capital markets. Equity capital was 9.1 percent of assets at the end of 2003. Ninety-nine percent of all thrifts, holding 99.9 percent of industry assets, exceeded the PCA well-capitalized standards. Although the number of undercapitalized institutions fluctuates over time, only two thrifts were less than adequately capitalized at the end of 2003. One of which has since been recapitalized. Consistent with PCA, we are monitoring these institutions to ensure that management responds aggressively to resolve areas of supervisory concern.

D. Funding Sources

The industry has become somewhat more reliant on wholesale funding as deposit growth slowed due to changing savings and investment patterns and robust competition from mutual funds. Although deposits remain the primary source of funding for the industry, the ratio of deposits to total assets declined steadily over the past decade. In 1990, deposits funded 77 percent of thrift assets. By the end of 2003, the ratio had declined to 58 percent.

With deposit levels declining, the thrift industry has accessed greater levels of wholesale funding, primarily in the form of Federal Home Loan Bank (FHLB) advances. At the end of 2003, FHLB advances funded 17.4 percent of total thrift assets, up from 7.4 percent in 1991. In addition, other types of borrowings, such as repurchase agreements, subordinated debt, and federal funds purchased, funded 11.3 percent of assets, up from 5.5 percent in 1991.

E. Problem Thrifts

The number of problem thrifts—those with composite safety and soundness examination ratings of “4” or “5”—fluctuates over time but remained low in recent years. There were eight problem thrifts at the end of 2003—the lowest level since OTS’s inception. Assets of problem thrifts comprised only 0.1 percent of industry assets at the close of 2003.

Thrifts assigned a composite “3” rating, while not considered problem institutions, also warrant more than the normal level of supervisory attention. At the end of 2003, there were 57 thrift institutions assigned a 3 rating, which is unchanged from the prior quarter and down significantly from 72 one year ago. Of these 57 thrifts, 98 percent were “well-capitalized,” and thus have a capital cushion that increases their ability to work through difficulties in an orderly manner.

Supervisory attention is also focused on concerns identified at institutions in the areas of Compliance, Community Reinvestment Act (CRA), and Information Technology (IT). At the end of 2003, there were 46 thrifts rated "3" or below in Compliance, including three thrifts with "4" ratings. Eight thrifts were rated less than satisfactory in their CRA examinations. Reflecting the rapid changes in technology, focus on privacy and security concerns, and increased demand for technological expertise, two thrifts were rated "4" or "5" on their IT exam, and 36 thrifts were assigned "3" ratings. In all cases, we initiated prompt supervisory strategies to effect management corrective actions to address areas of concern. The vast majority of OTS regulated institutions are in compliance for CRA and IT.

III. Evolving Role of the Thrift Industry

A. Community Lenders with Residential Focus

While thrifts provide a wide variety of loan products, including consumer and commercial loans, they continue to focus primarily on residential mortgage lending. Thrifts originated 21 percent of all single-family mortgage loans made in the United States in 2003. Thrifts are major originators of adjustable rate mortgage (ARM) loans. In 2003, about one-third (31 percent) of all new ARMs were originated by thrifts.[4]

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4. Based on data from the Mortgage Bankers Association of America and Federal Housing Finance Board.

In 2003, the industry originated $730 billion in single-family mortgages, the highest annual volume on record, exceeding by more than 50 percent the prior record of $472 billion in 2002. Since 1999, the thrift industry has originated over $2 trillion in single-family home loans; which, at an average home value of $200,000, represents 10 million homes in America. Single-family mortgage loans and related securities comprised about 62 percent of thrift assets at the close of 2003. Thrifts are also active lenders for multifamily lending. In 2003, thrifts originated $20.1 billion in multifamily mortgages. At the end of 2003, thrifts held in portfolio $53.7 billion, or 4.9 percent of their assets, in multi-family mortgage loans. This brings the percentage of assets held in residential-related loans and securities to 67 percent.

Thrifts also provide vital services to other segments of their communities by making commercial real estate loans to hospitals, nursing homes, farms, churches and stores, and on other commercial properties. Such loans comprised 4.3 percent of thrifts' assets at the end of 2003.

While thrifts continue to focus on mortgage lending, they have steadily expanded their product offerings in the areas of consumer and commercial business lending. The industry's ratio of consumer loans-to-assets was 6.5 percent at the end of 2003, up from 4.5 percent at the end of 1990. Utilizing the expanded small business lending authority granted by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the industry's ratio of commercial loans-to-assets stood at 3.6 percent at December 31, 2003, up from 1.5 percent at the end of 1997. Based on our semi-annual subprime lending survey, there were 32 OTS-regulated thrifts with subprime lending programs as of the end of the third quarter 2003. These thrifts have formal lending strategies directed to subprime borrowers as opposed to lenders that may make an occasional loan to a borrower with a low credit score, for example. Aggregate subprime lending for these 32 thrifts increased 11 percent to $14.8 billion at September 2003 from the prior year.

B. Diversified Financial Services Providers

In addition to core lending products, thrifts continue to expand the range of savings and investment products offered to their communities. The thrift charter provides an excellent platform with a comprehensive and uniform regulatory structure that allows for the efficient delivery of a wide range of financial products and services. Thrifts have taken full advantage of the strength of their charter to serve retail customers both in their local communities and beyond.

The success of thrifts in providing a broad range of financial services is evident in the industry's level of trust assets administered, which has risen dramatically over the past eight years. The facility of the charter in this area has also attracted a number of new firms to use the thrift charter as the vehicle for providing these services. For 2003, trust assets administered by the industry totaled $563.5 billion versus $13.6 billion at the end of 1995.

IV. Risks Facing the Thrift Industry

A. Credit Risk

The thrift industry's sound financial condition permits it to address potential credit quality problems from a position of strength. Thrift industry credit risk is primarily driven by the performance of residential mortgage loans. Given the current strength of the housing market in most areas of the country, single-family residential loan delinquencies and charge-offs have remained at low levels.

Future deterioration in any of the fundamentals that affect housing strength, such as worsening unemployment rates, could adversely affect thrifts' asset quality. As community-based lenders, the majority of thrifts' loans are made to consumers. Direct loans to consumers, including single-family mortgages, measured 55.9 percent of thrift assets at the end of 2003. Given this concentration, thrifts' asset quality is very dependent on stable real estate values and consumers' continued employment and ability to service their debt. We know of no major problems facing us in either regard.

Thrift credit exposure is not limited to the consumer loan sector. Thrifts are also exposed to the business sector, with 3.6 percent of thrift assets held in commercial loans and another 12.0 percent of assets held in construction loans and nonresidential and multifamily mortgage loans. A slowdown in the economic recovery could pressure the cash flow of commercial borrowers. Alternatively, a strong recovery that spurs a steep rise in interest rates may also impact commercial borrowers, since business loans typically carry floating rates of interest. Credits that are highly dependent on low interest costs for positive cash flow would be most vulnerable to rapid increases in interest rates.

Credit review is a significant priority in our examination process, with the scope of our review formed by economic trends and expectations. Our analysis shows that as interest rates rise after a trough, many mortgage lenders lower credit underwriting standards to maintain high loan origination volumes. Such vintages often significantly underperform other vintages. Consequently, as rates have begun to rise, OTS examiners have begun focusing even greater attention on thrifts' underwriting processes, credit quality, reserve policies, and capital adequacy. The loan monitoring, loan collection, and work-out procedures of thrifts are also receiving increased scrutiny. Our best performing thrifts are diversified and we support the industry looking for ways to be less reliant on interest income. We emphasize, however, that expanding into new areas requires investment in the right people, systems, and internal controls, and internal audits.

B. Interest Rate Risk

OTS closely watches interest rate risk given the thrift industry's natural concentration in longer-term mortgage loans, which are generally funded with shorter-term deposits and borrowings. Since interest rates typically rise during economic recoveries, monitoring interest rate risk will be especially important in the upcoming quarters. Interest rate sensitivity can manifest itself in several ways in a rising rate environment, including a declining value of long-term assets with below market rates and increased funding rates which tends to compress thrifts' net interest margin.

OTS maintains an interest rate risk sensitivity model that stress-tests thrift portfolios to evaluate potential exposure to changing interest rates. We are unique in that regard. OTS regulations also require thrift management to monitor and manage interest rate risk on an ongoing basis and maintain exposure at prudent levels. With the OTS model and prudent thrift management practices, the industry is well-positioned to assess and respond to portfolio sensitivity resulting from changes in interest rates.

As of the end of 2003, under a simulated instantaneous 200 basis point rate shock, 80 percent of all thrifts were classified as having low levels of interest rate risk, 15 percent as having moderate levels, and 5 percent as having higher levels of interest rate risk. These numbers have trended higher the past two quarters because of the tendency of some institutions in a steep yield curve environment for institutions to invest in long-term assets (e.g., 30-year fixed mortgages) and to fund such investments with short-term liabilities (e.g., short-term certificates of deposit and short-term Federal Home Loan Bank advances). Approximately 50 percent of the mortgage instruments held in portfolio by OTS-regulated thrifts were originated in 2003.

Institutions demonstrating higher levels of interest rate risk receive close supervisory scrutiny. Given that interest rates typically move in a more gradual fashion, thrift management often has significant opportunity to institute remedial actions to limit the potential impact of a changing interest rate structure. While the current interest rate environment and yield curve structure are generally favorable for thrifts' operations, the failure to react to rising interest rates that come with economic recovery or changes in the yield curve structure could adversely impact thrift earnings. We see no major problems in that regard at the current time.

In 2003, many thrifts took advantage of the low rate environment to extend liability maturities at favorable terms. The lengthening of liability maturities provides a buffer for thrifts against the impact of rising rates. In addition to strategic funding decisions, mortgage loan demand has shifted thrift loan portfolios increasingly toward holding more fixed-rate loans with shorter-terms (10, 15 and 20 years) than the traditional 30-year product, and higher levels of adjustable-rate loans and hybrid loan types.

Shorter-term fixed rate mortgages amortize principal more quickly than traditional 30-year loans, which provides thrifts with greater cash flow to invest as rates rise. Adjustable-rate mortgage rates will reset to higher levels in a rising rate environment. Likewise, hybrid loan products that are fixed for periods of 3, 5, 7 or 10 years and then convert to adjustable rates will reset rates and provide a buffer against rising rates. Collectively, these asset/liability trends could mitigate some of the adverse impact that rising rates typically have on thrifts.

Even with the favorable rate environment and strategic thrift asset/liability management, OTS remains cautious of the potential impact of a rapid increase in market interest rates. OTS employs a scenario-based modeling approach, applied on a quarterly basis, to estimate the potential exposure that thrifts have to various rate change scenarios. In addition, we require thrift management to monitor interest rate risk regularly, set appropriate risk limits, and manage potential exposure at acceptable levels. OTS will remain vigilant in monitoring institutions for adverse trends and ensuring that thrifts are properly focused on the potential impact of changing interest rates.

C. Compliance Risks

Compliance risk is another risk that the industry faces and one that OTS also closely watches. The increased volume of consumer transactions, along with the increase in consumer protection and other regulations governing those transactions, necessitates an active compliance management function within financial institutions and in oversight programs within the banking agencies. Certainly in today's environment, the importance of effective compliance management is elevated by: 1) the need to ensure the privacy and security of consumer financial information as more information is shared and outsourced, and as the threat of identity theft persists; 2) the need to guard against money laundering and terrorist financing activities in a post-September 11th environment; and 3) the need to stem the tide of abusive lending practices and ensure fair and equal access to credit for all Americans.

As with its management of other risks, OTS, due to recent internal examination restructuring and enhancements, is now in a stronger, more proactive position than ever to effectively examine for and address potential compliance problems and risks within a comprehensive examination context. We are training more examiners in the area of compliance, we are conducting compliance reviews more frequently, and we are using a risk-focused approach. The CORE components of all compliance examinations include a review of BSA/Patriot Act, Privacy and Fair Lending.

Our fundamental examination objective is to ensure that institutions have in place the resources to support an effective compliance management program that is commensurate with the size, complexity and risk profile of the institution. To promote and reinforce full compliance with these critical laws, OTS routinely conducts in-depth training for OTS examination staff.

D. Intense Competition

Business convergence and continued consolidation in the financial services industry have created an increasingly competitive environment. This stimulates thrift managers to focus on strategies to improve efficiencies in the delivery of financial products and services, customize product offerings to meet customer needs, and ensure quality customer service. Some managers may seek to enter new business lines that are not fully served by the financial community. Subprime lending, whether home equity or credit cards, is one such business. Well-managed subprime lending, with responsible marketing, pricing and terms, is an important element in improving and expanding credit access. We support subprime lending but are vigilant to assure ourselves that it is not delivered in a predatory manner. Any pattern or practice of predatory lending is immediately criticized and eliminated.

Guiding an institution through lending expansion is, of course, the responsibility of each institution's management and board of directors. The willingness of management and directors to understand and manage risk is one of the primary underpinnings of a safe and sound operation. Thrifts must adopt prudent strategies to operate successfully in an increasingly competitive environment. We emphasize to our examiners and supervisory staff the need to focus on ensuring that thrifts have the requisite managerial expertise, sound policies and procedures, and adequate systems before entering new lines of business. We also encourage institutions to work with our examiners and supervisory staff when pursuing new business activities in order to address problems as they arise and to avoid surprises between examinations. Our best performing thrifts also have strong internal controls and internal audit procedures.

E. Business Transitioning

We are closely monitoring how thrifts transition from the current intensive "mortgage-banking" mode to a more diversified lending environment. In recent periods, low mortgage rates have spurred refinancings and record origination volumes, and income from this increased lending has helped boost overall thrift profitability. As the economy continues to recover and interest rates rise, lending activity—especially –refinancings-- have declined. At the same time, thrift managers will continue to be pressured by shareholders to maintain current earnings levels despite reduced lending activity. These pressures may include reducing overhead costs to help maintain earnings or entering into new activities or reaching for greater fee income. While we expect some industry staff reductions in response to decreased lending volumes, our examination and supervisory staff will closely evaluate thrifts' responses to ensure that the quality of loan underwriting and internal controls is not compromised. We also follow-up with thrift management to ensure that institutions effectively manage new business lines.

F. Technology/Operational Risks

Operational risk, including the risk of loss due to technical failures and human error, seems to be an ever-present concern in the financial services industry. Advances in technology have created new opportunities for thrifts, especially in marketing and broadening customer services. Thrifts also utilize technology to increase their understanding of certain credits, enabling better product pricing. The growth of Internet banking, outsourcing of core banking functions, and the rapid pace of technological and financial innovation creates new challenges and concerns for thrift management. The use of technology for these purposes is encouraged.

Our IT examiners, and, increasingly, specially trained safety and soundness examiners, focus on how well thrifts' use of technology is designed and monitored to minimize operational risk and ensure thrift and customer security and privacy. The lessons learned from financial difficulties experienced by many "high tech" companies, the widespread power disruptions in the Northeast last summer, and the impact of the September 11th attacks has illustrated the need for contingency planning. Thrift institutions' contingency planning, back-up, and recovery programs are receiving increased supervisory attention from our examination and supervisory staff.

IV. OTS Regulatory and Supervisory Focus and Strategies

A. Early Detection and Resolution Strategies

OTS uses regular on-site examinations and quarterly off-site financial monitoring to identify thrifts that warrant closer supervision. When problem institutions are identified, OTS acts promptly to ensure thrift management and directors institute corrective actions to address supervisory concerns. In addition to a host of financial analytics and early warning systems, two processes that we use to monitor problem institutions are the Regional Managers Group meetings, which are held ten times annually, and quarterly high risk case briefings. These meetings enable senior OTS staff and regional managers to discuss high risk or high profile institutions regularly throughout the year. The tools are invaluable to share our collective experiences, develop effective supervisory strategies and enhance consistency across the agency. These processes allow senior Washington staff to closely monitor problem institutions, while the regions retain primary responsibility for ongoing supervision.

We have refined our off-site monitoring process by increasing early warning systems to help identify adverse industry trends and potential problem areas. We maintain dedicated financial analysts at our headquarters and in the regions to ensure that off-site tools are maximized. OTS examiners and analysts utilize our Risk

Monitoring System (RMS) to assist off-site financial analysis. This risk identification model utilizes combinations of financial ratios to identify areas that need prompt attention and further analysis. The RMS also provides our examiners and analysts with direct links to thrift web sites, thrift stock price data, securities filings, and general economic information, all used to closely monitor and analyze thrift operations between on-site exams. In addition to the RMS, we operate our Net Portfolio Value (NPV) model to simulate the potential interest rate risk exposure resulting from a variety of interest rate shock scenarios.

B. OTS Supervisory Initiatives

1. Consolidated Examination Structure

Two years ago, OTS began to combine its separate safety and soundness and compliance examinations in order to attain greater efficiencies in its examination process, improve its assessment of risk within the industry, and provide examiners with broader developmental opportunities. OTS views compliance as a safety and soundness issue. Examination teams have recently begun to conduct joint examinations and to issue one examination report on both safety and soundness and compliance matters. OTS is now engaging in a more comprehensive assessment of an institution's risk profile by examining its compliance with consumer laws and regulations simultaneously with its prudential supervisory analysis as an integral part of the evaluation of an institution's business strategy, and over time, it expects to reduce the costs and burden of examinations on institutions. The majority of responses from institutions has been overwhelmingly favorable.

During this time, safety and soundness and compliance examiners have been actively engaged in an intensive cross-training program to learn the full knowledge and skills needed to lead melded examinations. OTS continues to maintain a cadre of compliance experts, however, to assist examination teams in handling complex compliance matters. In addition, OTS program staff have been working to produce combined examination procedures, policies and handbook manuals.

2. OTS Organizational Changes

Following a major restructuring of regional and field operations in 2002, OTS recently reorganized its Washington supervision oversight operations in order to manage the evolving direction of the thrift industry more effectively. OTS established three primary entities within a newly structured Office of Examinations, Supervision, and Consumer Protection. The first oversees the most complex institutions as well as holding companies with significant international operations. A second entity oversees the examination and supervision of all other regulated institutions. The third oversees all policy development affecting examination and supervision of institutions' activities, including capital markets, trust, consumer protection, accounting, and information technology. During the past year, OTS has also begun to participate on the Basel Committee on Banking Supervision in order to ensure that pending international capital standards take into consideration the various needs of thrift institutions. In addition, we are well along the path of securing equivalency status under the European Union's (EU) Financial Conglomerates Directive to provide for coordinated, consolidated supervision of thrift holding companies with European operations.

C. Regulatory and Supervisory Coordination

Convergence in the financial services markets has been proceeding at a rapid pace in recent years and will continue as companies attempt to maximize synergies across business lines. OTS has supervisory responsibility for thrift institutions and thrift holding companies, many of which engage in insurance and securities activities. These activities are often conducted by multiple legal entities within a corporate structure and across numerous regulatory jurisdictions. Given the scope of activities in thrifts and thrift holding companies, it is critical that we maintain healthy relationships with all financial regulators and supervisors.

OTS maintains regular contact with state and federal functional regulators. Our goal is to coordinate supervisory activities and knowledge to limit overlapping regulatory efforts, and to identify regulatory gaps that may exist across functionally regulated business sectors. We have also expanded our regulatory contacts abroad to ensure effective supervision of thrift holding company structures that maintain significant operations in foreign markets.

1. Functional Regulator Coordination

Domestically, our regional offices have working relationships with insurance and securities regulators in states where these companies conduct operations. Our coordination activities also involve meetings, regular communications, and joint activities and programs, often through various supervisory coordinating entities such as the National Association of Insurance Commissioners (NAIC), the National Association of Securities Dealers (NASD), and the North American Securities Administrators Association (NASAA).

We have worked extensively with the NAIC to minimize regulatory overlap as more insurance companies acquire thrifts. These efforts resulted in the establishment of information sharing agreements with insurance regulators from 47 states and the District of Columbia. Our activities include shared attendance and participation in official agency programs, conferences and training seminars. These events foster cross sector learning and provide opportunities to cultivate regulatory relationships.

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

2. FFIEC and Federal/State Cooperation

Domestic and international financial services supervisors know well that supervisory cooperation produces innovative solutions to industry issues and provides invaluable perspective on cross sector trends and risks. OTS works closely with the other Federal banking agencies (FBAs) and State bank regulators in various forums and capacities. For example, in connection with proposed OTS regulations on mutual savings associations and mutual holding companies, we have met with seven state banking commissioners. The Conference of State Bank Supervisors (CSBS) was very helpful in arranging these meetings. I currently serve as Chairman of the Federal Financial Institutions Examination Council (FFIEC), which has significantly increased uniformity among the FBAs in prescribing principles, standards, and report forms for examinations and the supervision of financial institutions.

3. Coordination on the Basel Process

Internationally, although we are not currently a member of the Basel Committee,[5] OTS attends—along with the other participating FBAs—the Basel Committee meetings and participates in key subcommittee meetings and working groups. The international community of financial services supervisors provides an excellent forum to share experiences and work cooperatively to develop innovative and effective supervisory guidance. Participation in these forums has been critical in understanding global trends that may impact or threaten thrifts or thrift holding companies.

For example, our involvement in the Basel process has provided us with important insights into the potential domestic impact of the proposed Basel II changes. In particular, we are concerned that Basel II may be adopted in the United States before being sufficiently tested to assess its competitive impact. In addition to concerns regarding competitive equity, the Basel discussions and ensuing debate have highlighted deficiencies regarding the continued application of Basel I to the vast majority of institutions expected to continue to utilize it.

5. As noted below (see "Items for Legislative Consideration"), OTS is actively seeking membership on the Basel Committee on par with that of the other FBAs.

We are particularly concerned about the safety and soundness implications of leaving thousands of small-to-mid-sized institutions on a less risk sensitive regime while our largest institutions move to a more risk sensitive system. In such a bifurcated construct, Basel I institutions have an incentive to replace lower-risk assets with higher-risk assets since their capital requirement is apt to be too high for the former and too low for the latter, as measured against Basel II institutions. We therefore believe that FBA efforts and resources should be directed at borrowing from the lessons learned in Basel II to develop a capital adequacy system—applicable to all but the largest internationally active institutions—that is more risk sensitive than Basel I, but less complex and more accessible than Basel II.

In addition to the international Basel Committee meetings, OTS actively participates in all domestic task force meetings on Basel.

4. OTS Role as Consolidated Coordinating Supervisor

OTS has engaged in active dialogue with representatives from the EU on matters relating to the EU's directive on the supervision of financial conglomerates. The EU is seeking to ensure that financial conglomerates domiciled outside the EU member countries are subject to an equivalent level of consolidated supervision by foreign supervisors and to enhance coordination among relevant supervisors. OTS is the consolidated supervisor of U.S. based thrift holding companies, including a number of financial conglomerates active in the EU. OTS is seeking equivalency status under the EU's Financial Conglomerates Directive (FCD).

The FCD requires the designation of an equivalent consolidated supervisor to act as regulatory coordinator with the relevant EU supervisors. The FCD sets out certain broad review criteria in the areas of risk management and internal controls, in addition to more specific requirements for the reviews of capital adequacy, risk concentrations and intragroup transactions. OTS has the regulatory authority and supervisory processes in place to collect relevant information and conduct the necessary supervisory reviews.

OTS has initiated dialogue with several foreign supervisors to determine the scope of their interest thrift holding company activities. We will continue to work closely with relevant EU supervisors to ensure that there are no underlaps or overlaps in the supervision of thrift holding companies that are deemed to be conglomerates under the FCD.

V. Items for Legislative Consideration

Among the factors that have contributed to the health and profitability of the thrift industry is a vibrant, flexible and dynamic community banking charter. I believe that the thrift charter is the preeminent community retail lending charter. It promotes homeownership while serving the diverse financial needs of retail customers in communities across America. Not only is it a charter worth preserving, but also worth improving. We have identified numerous areas that warrant legislative consideration to improve the thrift charter by reducing regulatory burden and improving OTS supervisory authority. Principal among these are the following:

- Eliminating the disparate treatment of thrifts under the federal securities laws. This includes eliminating the investment adviser and broker-dealer registration requirements that apply to thrifts, but not banks, under the Investment Advisers Act (IAA) and the Securities Exchange Act of 1934 (1934 Act).

- Amending the International Lending Supervision Act (ILSA) to support adding OTS to the Basel Committee. This includes extending ILSA to thrifts to promote consistency in supervising the foreign activities of insured institutions.

- Enhancing the ability of federal thrifts to make small business and other commercial loans by increasing the percentage of assets limitations on these categories of lending. This will enhance the ability of thrifts to contribute to economic recovery and provide small and medium-sized businesses greater choice and flexibility in meeting their credit needs. Specifically, we support raising thrifts' aggregate commercial lending limit from 20 percent to

40 percent of assets, and modifying the sub-cap for commercial lending other than small business lending from 10 percent to 20 percent of assets.

- We also urge increasing the $250 million small institution 18-month examination exception up to $500 million.

We look forward to working with you and your staff on these and any other legislative items that you want to address.

VI. Conclusion

The thrift industry has grown and diversified over the past several years while reporting excellent financial results. Thrifts continue to play a vital role in providing mortgage funding and other retail products and services to their communities. At OTS, we will continue to evaluate our policies, staffing and infrastructure to ensure that the agency is well prepared to handle new or emerging risks. We strive to provide the appropriate level of supervisory support to the institutions we regulate through guidance, industry training and regular communications. We are confident that the industry will continue to fulfill its primary focus of serving retail customers with mortgage funding and other financial services in a profitable and prudent manner.