Oral Statement of

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Mr. Chairman, Representative LaFalce, members of the Committee. Thank you for this opportunity to testify on recent bank and thrift failures, to discuss what the Office of Thrift Supervision does to try to keep failures small in terms of numbers of institutions and cost, and how we work with our fellow regulators – particularly the FDIC – to accomplish this. There has been only one thrift failure since 1996: Oceanmark Bank, FSB, failed in July 1999 due in part to a poorly executed sub-prime lending program. This failure will likely cost the SAIF about $1.3 million, an amount less than one-half of one percent of SAIF's semi-annual interest earnings.

I am proud of the men and women at OTS, and of thrift management, who, together with a spectacular economy, helped create that record. But a record economy is exactly when intense competition can lead to poor underwriting and pricing that does not cover risk—two primary ingredients in bank failures. The challenge to effective supervision, as well as to detection of fraud, is in many ways the greatest when a booming economy enables an institution to earn profits that can hide structural flaws. Failures are a part of banking, like all other businesses, and we certainly have not seen the last thrift failure. Our goal is reduction and moderation of failures: it cannot and should not be elimination.

What Have We Learned?

There are important lessons to be learned from the recent failures, as well as from institutions that have required our supervisory attention to prevent failure.

- The importance of the agencies working together effectively to identify and deal with emerging risks. This is also the major lesson my entire staff has taken away from the Y2K success and our work on thrift holding company applications, where we work with not only federal and state bank regulators, but also with securities and insurance regulators.

- The need for effective internal controls, and reliable books and records. In an era of unprecedented profitability and intense competition, banks – like other firms – have a strong temptation to cut corners on internal controls. As regulators, we have an equally strong responsibility to make certain that doesn't happen.
- A world of changing risks requires changing supervisory strategies. When a firm originates hundreds of times more loans in a year than it holds on its books or pursues nontraditional, higher-risk activities such as sub-prime lending, traditional means of evaluating capital and credit risk can fall far short. Conversely, interest rate and liquidity risk, as well as legal and reputation risks, may become far more important and require enhanced supervisory emphasis. When institutions begin to engage in these practices, we need to supplement regular full-scope exams with more frequent field visits relating to specific concerns, and with enhanced off-site monitoring.
- Supervision must follow the business. The time has long passed when a bank or thrift did all its operations internally, and therefore everything was easily accessible to examiners. In early 1998, this Committee recognized that fact in the Y2K context when you spearheaded passage of the Examination Parity Act. More generally, when a bank or thrift outsources its back office, the investment management of its trust portfolio, or other parts of its operations, examiners need to understand what is being done, be able to pursue an effective examination strategy, and have the authority to intervene when there are problems.
- We need to recognize and minimize potential accounting distortions. Unfortunately, certain accounting requirements have left the door open for serious balance sheet distortions—that is, for misstatements of reported assets and capital. The most obvious is gain-on-sale accounting, in which the use of optimistic, but non-verifiable assumptions can inflate spectacularly the reported value of "residuals"—an often illiquid asset. American accounting practices are the best in the world, and have gotten better over the last twenty years. But as regulators who ultimately need to rely on economic capital to prevent or cushion a failure, we have to understand where the potential distortions are and we have to deal with them. We already do this on an individual supervisory basis. Jointly, we are exploring additional ways to ensure that all institutions, including those that report "residuals," have adequate capital.

- Examiners must never be intimidated. Our examiners are highly trained, highly skilled individuals of long experience who, moreover, work in teams. And the vast majority of institutions we work with respect and value them. But some don't. Intimidating examiners has no place in our system; indeed it is a sure sign that the institution is having problems and is trying to hide them. OTS examiners have guidance on how to spot early signs of intimidation or "hiding the ball," and what to do about it, and they know they have the support of the entire management structure.
- Regulators must be supervisors, as well as examiners. While we use the term "examiner," we don't just take a look and find out what's happening. We analyze and evaluate it, utilizing not only our training, experience and monitoring information but also what we've learned about best practices at other institutions. If we think there are excessive risks, we have an escalating program of supervisory strategies to do something about it. This starts with conversations with thrift management and sometimes directors during an examination (or if a concern arises between exams through off-site monitoring or a field visit); and includes "Requests for Corrective Action" in a Report of Examination that require attention by both management and the Board of Directors; meetings with Boards of Directors (required for every institution rated CAMELS 3 or below and offered to all); Supervisory Directives, which direct an institution to stop a questionable practice while we determine whether a formal enforcement order is needed; and, where appropriate, ratings downgrades. If an institution does not implement corrective actions, we will proceed with an escalating set of formal investigations and enforcement actions. I am pleased to say that the vast majority of our supervisory concerns are taken care of before the examiners leave the institution or when brought to management's attention between examinations.

OTS's Supervisory Approach

My written statement goes into some detail about OTS's substantive supervisory strategy. Because of the still-overwhelming proportion of thrift assets held in mortgages, we emphasize quarterly monitoring and supervision of interest rate risk in addition to the more traditional credit, capital, earnings, operations and management risks. Each quarter about 91% of the institutions we regulate file with us detailed information about their on-and off-balance sheet assets and liabilities. More than half do so voluntarily. Their filing, and the quarterly analysis we send them in response, help them understand the interest rate risk they are taking, and how it compares to the rest of the industry and their own institution over time.

How we supervise, in addition to what we do, also helps reduce the likelihood of failures. Ten times each year, our five Regional Directors and senior Washington supervisory staff, including me, meet face to face to discuss and develop policy with respect to developing issues and concerns, including those raised by individual institutions, applications, industry-wide trends, experiences of the other agencies, the changing economy and legal developments. About three times each year, each Regional Director and his senior supervisory staff discuss each of the region's high risk or high profile institutions with senior Washington staff. Our topics: the institution's current profile, what has happened since our last discussion, and what our future supervisory strategy will be.

Each Regional Director, sometimes together with me or the Deputy Director, holds several "town meetings" each year, in which for about two hours a small number of thrift CEOs talk to us and each other about issues and concerns; needless to say, we also tell them what we're concerned about. We have begun a series of all-day seminars in each of our regions for directors of thrifts, to help them fully understand their responsibilities. We hold similar meetings for thrift CFOs and external auditors. We send out industry bulletins both nationally and regionally providing the industry with timely information on increasing risk trends and steps that can be taken to address those risks. All of these techniques, and the others described in my statement, help keep both us and the industry current. They also help make certain the entire agency gets the benefits of discussions and decision-making that draws on the collective wisdom of many talented and experienced individuals.

We Work Well With the FDIC

Finally, let me say something about our relationship with the FDIC. First, I strongly believe my active participation on both the FDIC Board of Directors and the Audit Committee makes for a better FDIC—and a better OTS. For example, we have learned a tremendous amount from the bank failures, which we understand far better because of my participation on the Board and Audit Committee. But of course, most of the interaction between the agencies occurs in the field. Our philosophy is straight-forward: we value the FDIC. Our Regional Directors and other regional staff are in regular contact with their FDIC counterparts. The FDIC receives a copy of every exam report—before it is transmitted to the institution. Not only do we honor requests by the FDIC to join us on examinations, we also reach out to invite the FDIC in when we sense a serious supervisory problem may be developing. And when they decline our invitation (as sometimes happens), we keep them fully informed. Sometimes—particularly with litigious entities or where we believe it may be possible to sell an institution in some difficulty without the disruption of closing it—we need to work through the precise timing and tactics of the FDIC's presence in institutions. This is done on a cooperative basis, with full information flowing at all times. It is a good relationship that works well, and while incremental improvements are always desirable and possible, there is no need for statutory change.

Thank you for your time. I will be happy to answer any questions.