

Remarks
by
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Good afternoon fellow "Directors."

It is a pleasure to be part of this second OTS Directors' Forum. I'd like to discuss several matters of interest to you today:

- Issues of current concern to OTS;
- How to tell when Directors are not doing their job;
- The importance of business plans; and
- Lessons learned from the industry's—and OTS's—successful rollover into the year 2000.

The Thrift Industry is Strong - But There Are Some Warning Signs

Today's thrift industry is strong. Over the last two years, thrifts have successfully coped with a low, flat yield curve that hurt portfolio margins, but drove mortgage originations to record levels. The industry's ability to adapt was a sign of nimbleness that is heartening. However, as interest rates have moved up and the yield curve has steepened, mortgage originations, particularly refis, have declined, and the industry is being challenged again to: find new customers and new ways to serve old ones, develop new products (or bring back the old), and do all this while keeping overhead expenses low and internal controls in place.

As Directors, you are responsible for your institutions' long-term profitability. As regulators, we are also interested in long-term profitability, although admittedly we are a little skeptical when the excuse for consistently bad short-term results is "things will get better in the long run." But the long-term starts now, and we think you can better guide your institution's long-term strategy if you have better information about today's red flags.

First, we see more and more institutions getting into more risky lines of business, or taking more risk in traditional businesses (such as speculative construction lending, or construction lending outside the institution's regular business area), without proper management, standards, oversight, or controls. The world of financial services is changing. "Doing what we always did" with "the customers we've always had" may not, indeed probably is not, the way to stay profitable in the long run. It may well make sense to move into areas of somewhat greater risk, if the increased risk is accompanied by greater returns. But if you do this, you must do it properly, with the full and active participation of a well-informed Board.

By this, I mean that you as Directors must :

- Make certain management has fully analyzed and understands the risks - and that the Board does too;
- Have in place policies, competent management, and back office systems, appropriate to the business being done;
- Establish limits commensurate with the risk of the investment or activity and the risk profile of your institution;
- Monitor actual performance to make certain you are not fooling yourself - that the higher returns you were looking for are in fact being realized; if they are not, you need to figure out what is wrong and change the program or move out of the business; and
- Put up more capital - that's capital, not debt - to account for the greater risk.

This region, of course, includes some of the largest, and most sophisticated, institutions OTS supervises. But that makes these admonitions concerning how you get into new lines of business more – not less – compelling. A small, mutual institution may not have the highest ROA or ROE in the system, but the chances of it getting itself into big trouble fast by trying trendy new things is equally small. Rather, it's the medium-size and large institutions, with strong pressure from shareholders and analysts to meet perhaps unrealistic growth and return targets, that are most in need of a strong Board that will give management support **and** direction; encouragement **and** the courage to say “no.”

A second major concern is a significant increase in interest rate risk, particularly among the institutions that have been taking the most risk. This has been accompanied by a decline in post-shock equity ratios, and a fairly stunning increase in unrealized losses on securities available for sale. Remember, interest rate risk is where the industry's problems all started in the late 70s. Unlike that period, however, today ARMs are an established product, there's an active secondary market, and there is a range of liability instruments that can reduce interest rate risk. With these strategies and instruments, it is a lot easier to avoid excessive interest rate risk while conducting your traditional business. At OTS – unlike the other regulators – we have the tools to help you do so before things get out of hand. As with credit risk, you'll see us demanding more capital if you're going to take on significant interest rate risk. We will also pay increased attention to consolidated holding company capital, particularly where the thrift's "equity" is supported by debt at the holding company level.

We understand that this business has become more and more competitive, and that particularly for those of you who for the first time have public shareholders and a large capital base, the pressure to reach for yield is intense. But now, while the economy is strong and the thrift industry is healthy, is the best time to look inward and ensure that everything both you and we are doing, or should be doing, is in place. When times are good, you have far more time, energy and resources with which to institute carefully thought-through improvements in strategy and operations than when the market or the regulator forces your hand.

How Directors Run Into Problems

Over the past two years, both as Director of OTS and as a member of the FDIC Board of Directors, I have had the opportunity to review the accomplishments and the failures of both thrift institutions and commercial banks, and of their Directors.

By and large, Directors of OTS-regulated thrift institutions are hard-working, diligent, and community-focused. However, in good economic times, like those we have experienced during the last seven years, it is easy to let down your guard and allow your oversight responsibility to go on "cruise control." While I can assure you that OTS has been, and will continue to be, aggressive in initiating administrative and judicial proceedings against Directors and Officers of thrifts when they fail to meet their responsibilities to the institution, neither you nor we want to get to that point. So, let's run through some of the warning signs - the behaviors that tell us something is wrong at an institution and that at least some of the problem can be laid at the feet of the Board of Directors.

First, when things go really bad, particularly in good times, it's almost inevitable that we'll find **complaisant, acquiescent and or ambivalent Directors** who (a) let a controlling person or persons completely dominate the business and the decisions of the institution; or (b) ignored, or failed to act on or correct, regulatory and other violations pointed out by the examiners, or internal control weaknesses documented by outside auditors; or (c) generally failed to inform themselves about the financial condition of the thrift.

A second, related, and critically important problem, is **failure to have adequate internal controls**. This results in problems not being discovered until it's too late to do much about them. Adequate internal controls are critical, not just to minimize liability exposure and examiner criticism, but also to allow Directors to meet their responsibility to effectively monitor the institution. Cutting expenses by reducing internal controls is not only foolish, it is dangerous.

Third, one of the things a good internal audit program will pick up is **inadequate underwriting**. Of course, the Board is not in the business of underwriting loans. However, the thrift's Board must require adequate underwriting standards and make certain those standards are followed. Undocumented exceptions to underwriting policies, or exceptions that are documented but ignored, are a sure sign of trouble.

Fourth, a related problem is **concealing nonperforming loans**. Again, the Board's role is making certain there is a policy in place concerning the restructuring of loans and that the policy is followed. For loans that are large in comparison to the size of the thrift, you may need to be involved in any restructuring decision. In any event, you must make certain that loans are not restructured if there is no reasonable likelihood the loan will be repaid.

Fifth, as I mentioned earlier, we are concerned about increasing risks from new or expanded lines of business that are not properly thought through and controlled. Part of that control is making certain the institution is not **embarking on imprudent expansion or excessive growth without the needed management talent**. A fairly common problem, and one that is clearly the

responsibility of the Board, is a thrift growing beyond the competencies of existing management. If you're going to embark on new businesses, or change your scale, you must be ready to make changes. And if a change becomes necessary, don't lower your standards just to fill vacant positions or to accommodate someone within your organization. Decide on the skills necessary for the position and insist that the individual have them. Steady growth is vastly superior to spurts and jumps in volume. As you know, history is full of sorry tales of failures caused by unmanaged or mismanaged growth.

Sixth, **transactions with affiliates**, related parties or controlling persons of the institution, or other improper conflicts of interest or self-dealing, can also bring trouble. It is possible to do business with related parties correctly, but it requires a Board of Directors that is cognizant of what's happening, and willing to bend over backwards to make certain that the thrift is truly getting a fair deal. Board members must leave their self-interest at the door.

A Good Business Plan is Critical to Long-Term Profitability

All this makes it sound as if the Director's primary function is helping the institution stay out of trouble. But of course, while that's important, it is not your major job. Your principal job is to set the institution's course, establish its strategy, and keep pushing to make certain that strategies are evolving in anticipation of—or at least in response to—changing market conditions. That's where having a business plan comes in. And not a "canned" plan off some vendor's shelf, but a blueprint for your institution, that is logical and well documented. The success of your institution depends largely upon the decisions you make. A business plan allocates resources and measures the results of your actions, helping you set realistic goals and make decisions.

A business plan is a reality check. The process of putting a business plan together, including the thought you put in before you begin to write it, forces you to take an objective, critical, unemotional look at your institution in its entirety. It will direct you toward lines of business that build on your strengths and serve the market you want to serve, and keep you away from those that may be good for someone, but aren't for you. Putting together your business plan will help you and your managers think in an organized and structured manner about competitive conditions, marketing opportunities, and situations that are or may be beneficial or harmful to your institution.

A business plan motivates. The development of your business plan is one of the best ways for you to work with your management and employees to establish and describe your institution's vision. The process will help get all your employees reaching for the same goals and working together as a team. Conversely, it is impossible to motivate people when they do not know where they are going or what they are trying to achieve.

A business plan sends messages. The completed business plan communicates your institution's ideas and message to employees, fellow Directors, potential investors, and your community in an organized, credible manner.

A business plan is a performance tool. Your written business plan is an operating tool that, when properly used, will help you manage your business and work effectively toward its success. Your business plan will allow you to set realistic goals and objectives for your bank's performance, and if maintained, will also provide a basis for evaluating and controlling the bank's future performance.

A business plan is a living document. Once you've created a business plan, it's critical to monitor results against it, and to keep asking whether there are strategies that will make the institution do even better. The business plan will help you see changes in the market you serve, in technology, in your competition, and focus on keeping your institution on top. We live in a world of rapid change; what worked in the past may not be the best course for the future. The process of developing and working toward a business plan will help you find the best way.

I challenge those of you who don't have a business plan to establish a committee of the Board to start the process. And those who do have plans, take a fresh look at them at your next Board meeting. You'll probably find something that can be improved or updated, and new ways to energize your employees.

Two New Tools

OTS staff has put together two documents that were given to you today: The Directors' Responsibilities Guide and the Directors' Guide to Management Reports. A great deal of thought and experience has gone into these guides. They carry forward the themes I've discussed today and that you have heard and will continue to hear through the rest of this forum.

Our new guidance will assist you in fulfilling your role as Directors. So please read them and keep them handy as you carry out your duties. Copies are also available on our web site: www.ots.treas.gov, and, in bulk, through our fulfillment contractor, TASC0 at (301) 645-6264.

Lessons of Y2K

I want to end by briefly touching on the subject we've all spent so much time on over the past four years—the Y2K rollover. But rather than urge you to prepare and communicate, I'm here to congratulate you on a successful rollover, and to reflect on some of the lessons learned, which hopefully we all can carry forward to other endeavors.

I think there are three primary lessons:

- First, it was critically important that we got out ahead of the problem, in terms of both remediation and public confidence.
- Second, the rollover exercise brought home to OTS and, I hope, to you, that technology is not a matter for the backroom or the basement: it's a matter for the Boardroom. Going forward, how you use technology will be one of the very most important strategic decisions your thrift will make, and thus it is firmly within the province of the Board.

- Third, we learned—or relearned—the necessity for and benefits of cooperation: within our institutions, between OTS and those we supervise, among the bank regulators (both federal and state), among all parts of the economy.

In strange ways, of course, Y2K was easy. We knew basically what the problem was many years in advance, when it would occur, and pretty much what had to be done to fix it. And the entire world was in it together. Future technology problems will not be so clear-cut. But I hope by going beyond self-congratulation and relief to reflect on how we did it, we'll be in better shape to meet and beat—together—all those more subtle problems that lay ahead.