

Embargoed for release until  
June 19, 2008 at 2:30 p.m.



Statement of

Scott M. Polakoff  
Senior Deputy Director and Chief Operating Officer  
Office of Thrift Supervision

concerning

**Risk Management and Its Implications for Systemic Risk**

Before the

Subcommittee on Securities, Insurance and Investment  
Committee on Banking, Housing and Urban Affairs

June 19, 2008

Office of Thrift Supervision  
Department of the Treasury

1700 G Street, N.W.  
Washington, DC 20552  
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

**Statement of Scott M. Polakoff**  
**Senior Deputy Director and Chief Operating Officer**  
**Office of Thrift Supervision**  
**on Risk Management and Its Implications for Systemic Risk**  
**Before the**  
**Subcommittee on Securities, Insurance and Investment**  
**Committee on Banking, Housing and Urban Affairs**  
**June 19, 2008**

**I. Introduction**

Good afternoon, Chairman Reed, Ranking Member Allard and members of the Subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on risk management and its implications for systemic risk. This is an important and timely topic. In particular, I appreciate the opportunity to familiarize the Subcommittee with OTS's holding company authority and its program for supervising the complex holding companies subject to OTS regulation. We also appreciate the opportunity to share our thoughts on the state of risk management in the financial services industry and our recommendations for enhancing regulatory cooperation and improving oversight of firms that pose elevated risk to our financial system.

As the members of the Subcommittee may know, OTS is the primary federal regulator for thrifts and companies that own or control them (savings and loan holding companies). This authority is deeply rooted in statute and in our history as a regulator. It is a responsibility we take very seriously.

As is the case with bank holding companies overseen by the Federal Reserve, many of the holding companies we supervise are simply shell organizations whose primary asset is the insured depository thrift. In other cases, however, the thrifts are part of a much larger organizations whose primary businesses are insurance, securities, or commercial activities. In this respect, our authority extends to a population of holding companies with a significantly broader diversity of businesses than those found in the

bank holding company population. The holding companies we supervise, for example, includes manufacturing firms like General Electric and the John Deere Company, large insurance firms like AIG and State Farm, global asset managers like Ameriprise Financial, and non-bank financial services firms like American Express – in addition to Merrill Lynch, Morgan Stanley and Lehman Brothers.

In the case of these complex companies, our review of the holding company is much more in depth than the approach we employ for shell holding companies. Our reviews analyze critical issues such as the structure of the overall corporate organization, the role of the insured depository within the firm’s business framework, the adequacy of capital at the parent level, the fit and properness of holding company management, the links between the thrift and the parent organization, the effectiveness of governance and controls at the parent, and the policies and procedures in place for assessing and managing risk at the consolidated level. These reviews are geared to identify key risk concentrations and assess material intragroup transactions that could impact the firms’ overall operations or could have a negative impact on the insured depository thrift.

All of these critical areas are subject to review on a regular basis by OTS examiners either assigned solely to these institutions on an ongoing basis, or by subject-matter experts who conduct specialized reviews over the course of the exam year. The findings of our reviews and the recommendations that flow from our work are regularly communicated to each firm’s senior management through regular meetings and ongoing dialogue, and are rolled up into a comprehensive report of examination, which is provided annually to the senior management and the board of directors of the holding company.

Without question, the events of the past 18 months sharpened our focus on the critical market and financial condition issues faced by many of the holding companies we supervise. The events surrounding the collapse of the mortgage-backed securities markets vividly illustrated the failure of many risk managers, senior management and boards of directors, to properly assess and manage the risks emanating from this line of

business. While the products involved were sometimes complex and heavily structured, the failures were not. Firms insufficiently and improperly priced risk at the origination level and investors failed to perform proper due diligence on the buy-side. There was a clear lack of understanding of the downside risk of mortgage-related products and inadequate risk management at every level. These failures, and the uncertainty that remains until this day, led to a sudden deleveraging of financial institutions – resulting in illiquid and intermittent markets in mortgage-related products, an inability to assess the underlying risk and extraordinary difficulty finding a clearing price for many products. This is all further complicated by continuing uncertainty at the underlying product level - where impending payment resets on adjustable-rate mortgages may increase delinquencies and further restrict the cash flows that underpin mortgage backed securities.

In response to the distress in the markets, the firms we supervise recognized deep losses in their asset-backed securities portfolios, bolstered capital levels in the face of write-downs and weak earnings capacity, secured and enhanced liquidity positions, and significantly scaled back businesses that were no longer viable or posed significant reputational, market, credit, or operational risk. In many cases, these firms changed management – both at the CEO level and in key corporate control centers.

These large scale changes dramatically shifted the risk profile and earnings capacity of these enterprises and OTS intensified its supervisory efforts accordingly. We sharpened our focus on overall risk controls relative to the external market realities and the impact of business strategy changes resulting from the turmoil. We assessed the adequacy of capital at the parent level, and the relationship between the insured depository and the larger enterprise.

Importantly, we used, and continue to use, a number of statutory and regulatory tools at our disposal to reduce the risk in the insured depositories themselves and insulate the thrifts from the problems of the parent organizations. Specifically, we directed holding company and thrift management to bolster and maintain strong capital levels at

the thrifts owned by larger enterprises, and we have directed management in some cases to transfer potentially risky assets from the thrifts' books to the parents'. We directed the divestiture of business lines (like mortgage banking) that posed an inordinate amount of risk to the thrifts in the changed market conditions, and we have required governance changes that enhanced the independence of the thrifts' boards and management within these larger organizations. While these are examples of actions OTS has taken in the past year with respect to our population of complex holding companies, we have also enhanced our contact with senior management of these firms, meeting with CEOs and other senior managers to communicate our supervisory approach and expectations going forward.

These steps were necessary given the market conditions, and the net effect has been less risk in the insured depositories and a more sustainable relationship between the thrifts and the parent organizations given the continued market difficulties. They also underscore for us the importance of the statutory authority OTS possesses to assess risk in the enterprise on a consolidated basis and to intervene, when appropriate, at all levels of the organization to insulate the insured depository from adverse market events.

## **II. OTS Authority to Supervise Holding Companies and Securities Firms**

### **A. OTS Holding Company Authority**

OTS has long had authority to charter and regulate thrift institutions and the companies that own or control them. The agency has a well-established program for meeting its statutory responsibilities in this regard – including a comprehensive program for assessing and rating the overall enterprise as well as the adequacy of capital, the effectiveness of the organizational structure, the effectiveness of the risk management framework for the firm and the strength and sustainability of earnings.

Enterprises subject to OTS's holding company supervision range from relatively simple 'shell' companies, whose primary asset is the insured depository thrift, to complex

global conglomerates that engage in businesses across the spectrum from insurance, securities brokerage and commercial activities. Prior to enactment of Gramm-Leach-Bliley, savings and loan holding companies were permitted to be commercial companies and as a result several holding companies supervised by the OTS are grandfathered commercial enterprises that are primarily engaged in lines of business as diverse as heavy manufacturing, utilities, and retail services. The diversity in this holding company population precludes a bank-like, risk-based capital standard for these more complex firms. OTS instead performs capital adequacy assessments on an individualized basis for the firms under our purview with requirements as necessary, depending on the company's risk profile, its unique circumstances and its financial condition. This principles-based approach stresses desired regulatory outcomes over prescriptive rules, and avoids the undesirable outcome of a focus on rules rather than the level of risk in the underlying business.

The net effect of this approach has been a strong capital cushion for the holding companies we supervise and a strong ability for the firms under our purview to support the insured depositories within their corporate structures. Earlier this year we conducted an extensive review of capital levels at thrift holding companies. We found that savings and loan holding company peer group averages are strong. Savings and loan holding companies with assets greater than \$10 billion had an average equity to assets ratio of almost 11 percent. The two peer groups of savings and loan holding companies with assets ranging from \$3-10 billion and \$1-3 billion both had impressive equity to assets ratio averages of over 16 percent. The equity to asset averages for the two peer groups of smaller holding companies (\$500 million - \$1 billion and less than \$500 million) were almost 10 percent and just over 12 percent, respectively.

These findings underscore the strength of our holding company capital regime and dismiss any concerns that a lack of prescriptive rules yields a lower capital base in savings and loan holding companies. OTS has employed capital requirements where necessary, but a rigid approach to capital in the diverse population of savings and loan

holding companies could both weaken our regime and disconnect our work from a fundamental assessment of risk.

OTS also took steps to enhance its ratings system for holding companies. Specifically, we rate holding companies on a numeric 1 to 5 scale similar to the ratings system for banks and we enhanced our program to more explicitly stress our review and assessment of risk management at the parent level in addition to maintaining a strong focus on the relationship between the parent enterprise and the insured depository institution.

These steps ensure our procedures reflect the work being done by our examination teams in these institutions and reflect OTS's continued desire to improve and enhance our oversight of holding company enterprises within our statutory purview.

## **B. OTS Program for Supervising Securities Firms**

OTS currently has the statutory responsibility to supervise Merrill Lynch, Morgan Stanley and Lehman Brothers up to and including the top-tier parent level by virtue of their ownership of thrift institutions. As of March 30, 2008, Merrill Lynch stood at \$1.042 trillion in consolidated assets at the holding company level, Morgan Stanley stood at \$1.09 trillion and Lehman Brothers stood at \$786 billion. The Merrill Lynch thrift organization, by comparison, held \$31 billion in assets, Lehman Brothers' thrift held \$12.2 billion and Morgan Stanley's thrift held \$5.1 billion.

As in other complex holding companies we supervise, we approach our supervisory responsibilities by communicating with other supervisors who share jurisdiction over portions of these entities and through our own set of specialized procedures to guide our supervision of these firms.

With respect to communication, we are committed to the framework of functional supervision Congress established in the Gramm-Leach-Bliley, whereby the consolidated

supervisors will consult on an ongoing basis with other functional regulators to ensure those findings and competencies are appropriately integrated into our own assessment of the consolidated enterprise and, by extension, the insured depository institution we regulate. We have worked closely with the FDIC and the relevant state banking supervisors in cases when an ILC is involved in the structure. Because the Federal Reserve extended some liquidity facilities to these firms in the wake of the Bear Stearns collapse, we have built a cooperative relationship with the Federal Reserve Bank of New York staff engaged in ongoing monitoring of these institutions. We also have worked diligently, though with less success, to build a cooperative relationship with the SEC. We believe a cooperative framework with the SEC is critical to our oversight of Merrill Lynch, Morgan Stanley and Lehman Brothers because the bulk of their business and assets are contained within entities regulated or licensed by the SEC. Discussions about how to improve and enhance our coordination with the SEC are ongoing between the principals. We have offered and will continue to offer to share our findings, strategies and substantive communications with the SEC. We will continue our efforts to secure the same information from the SEC.

Our procedures for examining complex holding companies, including the large broker-dealer firms, involve a rigorous risk assessment and supervisory planning process, ongoing targeted reviews overseen by examiners tasked solely to these firms, regular reporting from the firms on key financial metrics like capital and liquidity, ongoing formal and informal dialogue with senior management, dialogue and coordination with functional supervisors in the United States and abroad, and an annual report of examination – provided to the boards of directors – that summarizes our findings and formalizes our recommendations.

Our examination approach utilizes this framework to assess the adequacy of each firms' financial condition, capital, risk management and liquidity framework, and the performance and capability of management. We rely on information gained through offsite and onsite monitoring and the firm's own reporting processes in these areas. We also rely heavily on public filings, discussions with internal and external auditors,

interaction with key risk control centers like the enterprise risk management function and corporate treasury. We test our findings and assumptions through in-depth, “targeted” reviews by subject-matter experts on our staff to ensure that the policies and procedures developed by management and adopted by the boards of directors are properly implemented by business line management.

This framework, blended with our assessment of any findings resulting from our regular examinations of the thrifts within these structures, provide us with a comprehensive view of each firm, its risks, and the projected impact of those risks on the insured depository institution. Naturally, most of our work over the past year has focused on the impact of the turmoil in the financial markets on our most complex institutions – and assessing the firms’ strategies for addressing the difficulties they face realigning their businesses to current realities. We expect this will remain a key focus of our work in these securities firms for the near to mid-term future.

### **III. OTS Observations on the Turmoil in the Credit Markets**

The complex holding companies supervised by OTS face significant challenges and risks as a result of the turmoil and uncertainty in the credit markets and in the face of general economic weakness. The dramatic fall-off in liquidity following the rise in home mortgage delinquencies, the decline in the underlying value of housing stock, and the uncertainty about borrower performance as adjustable rate mortgages reset led to considerable declines in the value of mortgage backed securities (MBS). These firms derived considerable revenue from designing and packaging those products and, in many cases, holding them in portfolio. The demise of that business, and the resulting steep decline in MBS valuations, led to sizeable losses and considerable pressure on earnings for much of the past year.

The turmoil in the markets posed a dual challenge to these firms. First, they had to manage their damaged portfolios by valuing the assets as best they could given weak or nonexistent markets for the products and recognizing significant losses. Second, they

had to update their business models to reflect the fact that the structured finance businesses they had built, and from which they had derived a significant portion of their earnings in recent years, was no longer viable in the current environment. While the firms have made progress on both fronts, much work remains.

Our supervisory efforts in this environment remain focused on the adequacy of capital, the effectiveness of risk control frameworks, the soundness of valuation methodologies, access to liquidity facilities, and the effectiveness of often new and untested management teams. This is all viewed through the prism of the impact of these events at the parent on the insured depository institution and the effectiveness of the control structure to prevent unacceptable risk transfers from the parents to the thrift subsidiaries.

#### **IV. OTS Observations on Risk Management in Securities Firms**

When market events of this magnitude occur, it is entirely appropriate to ask, as you have, about the regulators' assessment of the effectiveness of risk management at these firms and to ask what went wrong. Were the sophisticated risk management frameworks in place insufficient to the task? Or did the risk managers have concerns about the firms' overall approach, but were not provided sufficient voice to either raise those concerns at the senior management levels or materially affect the direction of the firms into more risky lines of business?

It is OTS's view, consistent with findings by the Senior Supervisors' Group and others, that it is more the former than the latter. While extraordinarily sophisticated and advanced in nature, the risk management frameworks in place at these firms and others across the financial sector were clearly inadequate for the key problems of identifying major imbalances as they built over time – as evidenced by the increasingly large bets at many of these organizations on continued house price appreciation. The risk management frameworks also failed to consider an appropriate range of adverse outcomes, and of the impact of adverse scenarios related to the housing market,

structured product valuations and performance, and robustness of liquidity facilities in times of stress. Much of this had to do with the focus of the firms' risk models on the past historical performance of the various securities ratings buckets. The mistaken assumption that the past history would predict future performance, even for the most senior and highly rated MBS tranches contributed significantly to many firms' woes.

This failure of risk management at all levels of the investment pipeline led to an improper and overly optimistic pricing of risk – both on balance sheet and off – and contributed to senior managements' inability to understand and control the adverse impact of significant valuation declines, liquidity shortages, and reputation risk on their firms' balance sheets. It also contributed to managements' inability to grasp the deep interconnectivity of the marketplace and the hidden links that ultimately led to the financial equivalent of gridlock and what, in effect, were “runs” on many non-banking intermediaries.

OTS's observations further confirm the finding in the Senior Supervisors Group report that firms need “more active controls over the consolidated organization's balance sheet, liquidity, and capital,” should better involve the corporate treasury function in risk management, and should incorporate information from all businesses into global liquidity planning, including planning for the impact of stress events on the firms' liquidity.

We also have observed that risk management is most successful in complex organizations when it is much more than simply a division of the firm, however independent, that provides reports and assessments to senior management. Rather, reflecting the higher leverage of financial institutions in general – and the significantly higher leverage of securities firms in particular – risk management must be systemic and must infuse everything the firm does. We encourage firms we supervise to have a robust discussion about risk and tolerances at every level of the organization, beginning with the boards of directors and continuing through to line managers. This process, while buttressed by reporting from the enterprise management architecture, infuses a risk appetite, risk tolerance, risk understanding and risk management ethic throughout the

organization, clearly conveying expectations and providing the foundation for strong management technique and minimizing the opportunity for unwelcome surprises. The more successful firms we supervise do this very well. Others have paid a stiff price in the markets and at the hands of the regulators for their inattention to this task.

Further, we believe the interplay between capital (or leverage) and liquidity is stronger than ever and that strong capital levels (or lack thereof) has a material impact on the susceptibility of these firms to shocks or adverse liquidity events. While bank supervisors have, appropriately, been focused on better aligning capital in banks with the underlying risk through the Basel II process, we note that the more highly leveraged non-banking firms were more susceptible to shocks emanating from the lack of counterparty confidence or the drying up of liquidity. The events surrounding the collapse of Bear Stearns provide a vivid illustration of this. As has been suggested by the President of the Federal Reserve Bank of New York and others, perhaps it is time to impose more exacting expectations on capital, liquidity and risk management at these systemically important financial intermediaries.

Finally, OTS has observed that the events of the past year laid bare the inadequacy of stress testing at many financial institutions. We have made the case for enhancing and elevating this important function. The Senior Supervisors Group noted that the turmoil in the markets challenged many firms' "control over their potential balance sheet growth and liquidity needs" and we agree. One way of returning control is a clear-eyed understanding of the range of probable outcomes of pursuing a given business strategy. No firm, financial or otherwise, can make every business decision on the basis of a doomsday scenario, but prudent planning and an understanding of the downside of strategic decisions can provide opportunities through hedging or otherwise, to insulate the firm from the worst possible outcomes. Certainly discussion of the stressed scenarios at the highest levels can temper the rush to ill-considered strategies and serves to inject more sober reality into the pricing of risk.

## **V. OTS Observations on Regulatory Oversight of Securities Firms**

The OTS, as outlined above, has strong statutory authority to supervise securities firms that own thrift institutions. We believe this approach provides us with a full slate of useful supervisory options to both understand the risk and activities of the parent and to prevent any risk arising from the operations there from adversely impacting the insured depository institutions involved. Further, we have used many of these supervisory tools to bolster and insulate thrift institutions from problems at the parent level. So while we welcome a discussion with the Subcommittee and other parties about the appropriate supervisory framework for these firms, ensuring and maintaining the ability for OTS to influence events at the parent level to the benefit of the insured depository will remain a priority for us.

While OTS has an important role, we recognize there are other entities involved that also are tasked with overseeing significant portions of the firms' activities. Certainly the SEC has a key role through its oversight of the broker-dealer operation. Access by the Federal Reserve is important in the wake of lending facilities made available to these firms during and after Bear Stearns crisis.

While it is appropriate for these supervisors and OTS to have a robust presence in these firms, we also believe there is an incumbent responsibility for us to work together in a constructive manner to improve the quality of our work and to eliminate any confusion on the part of the firms about the posture of the regulators with respect to their institutions. This is particularly so in times of market stress like we've seen in recent months.

## **VI. Conclusion**

Thank you, Mr. Chairman, Ranking Member Allard, and members of the Subcommittee for the opportunity to testify on risk management in the most complex institutions we supervise and the implications for systemic risk to our financial system.

The issues raised by this discussion, including the role of these systemically important institutions in the U.S. financial system, the adequacy of risk management, the appropriateness of these firms' leverage, and how best to improve oversight of these firms, are critical issues to all of us who supervise these institutions. A solution that improves the quality of our oversight and enhances the coordination between us is in everyone's interest and is in keeping with the intent of Congress.

We look forward to working with the members of the Subcommittee and others on the continuing challenges presented by the markets and fashioning a regulatory approach that works for all of us here.

Thank you.