Speeches

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TS-068 - Remarks of Ellen Seidman, Director, Office of Thrift Supervision, Exchequer Club, December 15, 1999

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As we contemplate life after Y2K in the context of the new modernized world of financial services, regulators are rethinking how best to manage risks in the banking system. Yesterday's report from the FDIC on the state of the insurance funds makes this topic all the more appropriate for my remarks to you today.

In thinking about risks in the banking system, I like to find out from bankers what keeps them up at night. And I'm not talking about David Letterman or Jay Leno. I'm talking about the banking risks that worry them most. What is it that makes them toss and turn?

I'll bet at least some of what worries bank and thrift executives is what worries me and my fellow regulators. At least in a broad sense, I'd say my greatest fear is that, at some point, we may confront another major episode of bank and thrift failures, followed by deposit insurance losses, and a taxpayer bailout. That strikes me as the ultimate nightmare.

Could this happen again? And more to the point, is this scenario possible in the post-FDICIA era? And what about in a post Gramm-Leach-Bliley world?

I don't think so, but let's take a closer look.

Over the past decade, FFIEC member agencies have been working together to improve our ability to identify, measure, monitor, and control risk in the banking system. And we have made considerable progress. In addition to the work we've been doing, Congress has given us more formidable enforcement powers--the most important being Prompt Correction Action (PCA). With PCA, our ability to control risk has been strengthened considerably--or has it? In some ways, that's the $64,000--or is it the $64 billion?--question.

PCA

As we all know, the basic idea that led to the enactment of PCA was that if bank regulators were given the legal authority to close a failing bank or thrift before it reached book (or GAAP) insolvency, economic losses to the insurance funds could be minimized, and perhaps eliminated altogether.

Under PCA, we must close the doors of a bank or thrift soon after it becomes critically undercapitalized, that is, when its tangible equity is less than two percent of assets. Why two percent? The precise reasoning behind that number is lost in the sands of time, but I suspect Congress assumed that with two percent GAAP capital, a bank would still be economically solvent, or at least not be deep into economic insolvency, by the time it was actually sold or liquidated, thereby resulting in smaller losses to the insurance funds.

Is PCA the solution to bank and thrift failures Congress was looking for? Can we be sure it will prevent another catastrophic round of bank and thrift insolvencies and deposit insurance losses large enough to trigger major premium increases that could themselves trigger still further strains on the industry? How about losses large enough to raise the possibility, once again, of fund insolvency?

On a case-by-case basis, it's beginning to look like individual failures with significant losses are still a possibility. Even if we assume that significant and undetectable fraud was involved in the recent large loss cases, and that fraud is a risk all of us understood PCA could not guard against, there's something else at work. In most of the failures we have experienced recently, the institution reported it was GAAP solvent, and in some cases not even critically undercapitalized, mere months it was closed.

How could this happen? I suggest there are a number of reasons, including:

- The accounting and regulatory treatment of residuals, the financial instruments created and retained by a bank or thrift in the securitization process. These credit enhancements, which make the securities more attractive to investors, can be exceedingly difficult to value. A large volume of overvalued residuals on an institution's books can cause sudden failure. Residuals also tend to entangle regulators in arcane accounting and valuation disputes at a time when other problems at the institution probably need to be addressed. On Monday, we regulators issued new joint guidance on this issue--with the promise of more to come.
- Second, participation by institutions in high risk, off-balance-sheet activities, sometimes operated entirely outside of the bank or thrift, can result in painful on-balance-sheet losses. Some off-balance-sheet activities have hidden liabilities--like "implicit recourse" on securitizations--or long liability "tails." For example, some institutions in the credit card business have entered into agreements that obligate the bank to continue funding sub-prime credit cards for many months after either the bank or a regulator might try to end the relationship.
- Third, incentives created by the current risk-based capital system to move high quality, low return loans off the balance sheet, while retaining lower quality, higher return loans on the balance sheet. Institutions that behave in this utterly rational manner have a higher risk of negative reclassification surprises
- Fourth, increasing use of outside or affiliated parties to run operations that used to be run entirely in the bank or thrift can hamper oversight by the depository institution and its primary regulator. The new statutory barriers to regulatory access to some of those other parties will likely make this more of a problem--particularly when an institution has something to hide.
- And finally, increasing aggressiveness against examiners by institutions engaging in high risk activities and not doing very well at it, can constrain regulators' ability to address problems quickly. By all accounts, Keystone was pretty extreme, but it by no means stands alone.

Nightmare Scenarios

But the real nightmare is not individual failures, even coupled with insolvency. After all,we long ago we made the decision, reaffirmed most recently in Gramm-Leach-Bliley, that banking funded by insured deposits will not be limited to risk-free businesses. On the contrary, by increasing the range of affiliations allowed to a bank, and, I would argue, not increasing commensurately the authority of bank regulators, we may be in the process of ratcheting up the risk level another notch. The reason the reserve ratios of the BIF and SAIF are set at 1.25, not zero, is that we expect there will be losses. (This is not meant to imply that I'm convinced that 1.25 is the "right" number--just that it is meaningful that it is greater than zero.)

No, the real nightmare occurs when exogenous forces couple with the trends noted above to cause a wave of major failures. How could this happen? I will share with you a few possible scenarios. These aren't predictions, but merely possibilities. Even though I'm not a member of the Chicken Little Club, I think it is useful to explore and think about these scenarios.

- One scenario is serious deflation--where falling asset prices cause the market value of bank assets to fall below carrying values (or book values). We know from the recent Asian experience that serious deflation can do serious damage and lead to widespread insolvencies.
- Another scenario is widespread and rapid credit deterioration--where downward GAAP loan loss adjustments do not keep pace with the decline in real asset values. The real estate crisis of the late 1980s and early 1990s is an example of this scenario.
- A third scenario is a sharp run-up in interest rates, causing the market value of virtually all bank assets to decline. The thrift crisis of the early 1980s is a perfect example of that scenario.
- A fourth scenario might be the emergence of some high impact event that causes capital markets to seize-up--perhaps a major correction in stock prices, or a technological problem that has widespread implications--bigger even than Y2K. One painful lesson of some of the more recent financial crises is that financial markets become more highly correlated during periods of financial stress. In other words, the benefits of diversification tend to erode just when they are needed most--when market prices are falling.

Any of these scenarios could, in the extreme, result in widespread bank and thrift insolvencies and insurance fund losses--despite the safeguards embedded in PCA.
I'm not predicting that any of these scenarios will occur. In fact, I'm inclined to think they won't, at least not on a broad and sustained enough basis to cause serious systemic difficulties. However, since these scenarios are not outside the realm of possibility, it is fair to ask what those of us in Washington who make policy and supervise depository institutions are doing now to deal with these possibilities.

What Should Supervisors Do?

I think we have to distinguish between events over which we have little controls, and the things we can do to deal with how regulated institutions fare as those events unfold. Looked at in that light, I believe that bank and thrift regulators already are doing many of the things we should be doing. In some cases, we may need to do them more forcefully, or more demonstratively, or simply better. But I think we're on the right track.

- First, we have placed increased emphasis on internal risk management and risk management systems, including internal modeling and stress testing.
- Second, we have reviewed, and are continuing to review, the need for additional financial disclosure and transparency.
- Third, we are rethinking the risk-based capital framework.
- Fourth, we are focusing increased attention on the operational and accounting risks of new on- and off-balance sheet activities, operations and affiliations, in addition to the risks generated by the confluence of traditional activities, aggressive accounting practices, and the current risk-based capital system.
- And finally, Y2K has forced us to get a better handle on technology issues and the technological vulnerabilities in our banking system.

Internal Risk Management

Whatever your views on the appropriateness of market value accounting for banks and thrifts, I don't believe anyone can dispute the wisdom of encouraging financial institutions to make greater use of market value systems and stress testing for internal risk management.

In recent years, we have seen more and more institutions embrace market value concepts for risk management purposes. One reason many banks are now using market value systems for internal risk management is that such systems can lead to the early identification of problems. And as in health care, early identification of a problem can speed recovery.

A second reason for the trend toward market value modeling is competitive advantage. Institutions that know the value of their assets and liabilities have a distinct, and potentially decisive, competitive advantage over those that do not. I don't think anyone can dispute the importance of correct valuation when it comes to making acquisitions, stock buybacks, or pricing loans and deposits. Similarly, the importance of being able to estimate the market value of your portfolio of assets and liabilities simply cannot be overstated. And, as many thrift executives found out in the early 1980s, the cost of not knowing the value of assets can be fatal, especially when dealing with sophisticated market participants who do understand how to value assets.

Nevertheless, market value systems are not perfect and never will be. We all know that one of the biggest obstacles to market value accounting or fair value reporting is the valuation of a loan portfolio. The factor that makes loan valuation particularly difficult is estimating the uncertainty of cash flows--the likelihood that the borrower will default and the timing of prepayments. Finding the right discount rates to calculate the present value of the cash flows is the heart of the matter.

One promising development in this quest is the considerable progress being made in portfolio credit risk modeling. Several sophisticated credit grading models have come on the market.

If these models are credible, then in addition to estimating the expected loss on a portfolio of loans and the quality of the portfolio, they should also be capable of providing the information needed to estimate the fair value of a loan portfolio. Both regulators and bankers should want to know whether the loans on the books of any given institution are above or below water today. If the models perform as promised, they can benefit both bankers and their regulators.

Financial Disclosure and Transparency

The U.S. banking agencies and the SEC have done much to increase financial disclosure and balance sheet transparency in recent years, and the Bank for International Settlements is pushing for more disclosure and greater transparency for banks around the world. In my view, this push for greater transparency is absolutely heading in the right direction.

A bank that can "fair value" its loan portfolio is more transparent--at least to examiners--than one that cannot. For example, conforming mortgages are more transparent than commercial loans because they are more standardized, more easily valued, and can be more easily sold in the secondary market.

It is easier for regulators to determine the solvency of institutions with relatively transparent balance sheets than institutions with non-transparent portfolios of difficult-to-value, complex financial instruments. By making PCA more robust, greater transparency should reduce solvency risk faced by the FDIC.

Rethinking Risk-Based Capital

There are many issues involved in rethinking risk-based capital: "accuracy" vs. complexity; reducing the possibilities for gaming the system and increasing the probability of international consistency; how to deal fairly with institutions that are not internationally active but that compete with those that are; how to increase the role of the market in evaluating the capitalization of institutions with a significant market capitalization, to name just a few.

I would also suggest that as we're rethinking risk-based capital, we explicitly consider asset transparency. Other things equal, risk weights--at the margin--could be made to favor transparent assets over those with a similar risk profile that are less transparent.

Risks of New - and Old - Activities

Our current period of record economic prosperity, coupled with increasingly intense competition from non-depository entities, has encouraged banks and thrifts to move into new and different markets, whether that's moving down the credit gradient in the loan market, expanding operations geographically, or getting into completely new lines of business. We all know that ventures into new areas can escalate a bank's or thrift's risk profile dramatically, especially if not managed properly. Moreover, even activities that are undertaken to mitigate risk, such as hedging, securitization and diversification, can increase risk if not properly managed.

Bankers have heard much from regulators in the past several years about our concerns with declining credit quality, and to some extent the warnings have been heeded. Nevertheless, competitive pressures have encouraged more institutions to commence or expand subprime lending and other higher risk activities. Subprime lending has received a great deal of attention recently. But we at OTS began sounding warnings about it as early as June 1998; we issued guidance on its cousin, high loan to value lending, in August 1998; and we have addressed both issues in several applications and in existing institutions. The agencies jointly released guidance in March of this year to insured institutions engaged in subprime lending to assist them in conducting this business soundly, and we reissued the HLTV guidance jointly in October. The asset securitization guidance issued Monday is relevant also, as much of the sub-prime business is being securitized.

We believe there are important, legitimate needs for this type of lending and that it can be done in a safe and sound manner that is helpful, not harmful, to borrowers. But it must be done that way--safely, soundly and non-abusively. From the regulatory side, initiatives with respect to subprime lending must strike the appropriate balance between protecting the insurance funds and not inappropriately discouraging banks and thrifts from meeting the credit needs of a large segment of the population.

With respect to new affiliations, OTS has faced the issues associated with diversified financial institutions for many years. Unitary thrifts have been able to affiliate with insurance and securities firms for some time now, but until a few years ago, the financial activities of these diversified firms were clearly segregated in functionally regulated affiliates. More recent applications involve not only new types of business for the thrift, but also shifting functions and operations typically done within a thrift to affiliated entities, and managing the thrift as part of an integrated corporate whole. As a result of this experience, in the recent financial services modernization debate over functional regulation and "Fed-lite," OTS actively urged Congress to retain for bank regulators adequate regulatory access to integrated related entities.

Let me give you an example of what we are talking about. The market for trust services appears to be growing as more customers of moderate means, not just the wealthy, seek such services. OTS has received an increasing number of applications from insurance and securities firms to conduct trust activities through thrift charters. In many of these applications, the thrift proposes to delegate investment authority to third parties. This is perfectly legal and frequently appropriate. However, where the delegation is to a related investment advisor who proposes limiting the choice of investments to related mutual funds, alarm bells sound. We want to know that the organization's structure, controls and operations enable the thrift to meet its duty of loyalty in a context of multiple potential conflicts of interest, and we want to know we can examine effectively for it, and take supervisory action if it is called for.

Diversified financial entities, with attendant synergies and efficiencies, are almost certainly a step forward for consumers and the economy. However, as the interrelationships among functionally regulated entities within a diversified holding company become more complex, risks to the depository institution within such a structure can increase as well as decrease. Diversification must be done properly, with the appropriate business expertise, internal controls and, where relevant, disclosures to customers. Adequate regulatory authority must complement those safeguards.

The Lessons of Y2K

Finally, the lessons of Y2K and new technological risks. The tremendous technological advances we have witnessed in the banking industry over the past ten years have produced significant benefits to institutions and their customers, and the opportunities going forward are limitless. But with opportunity also comes risk, and the Y2K experience has brought that home to all of us. But it has also taught us that by working together we can mitigate those risks.

Notwithstanding the huge resources that have been devoured by the Y2K issue, I believe this effort on balance will prove positive. For one thing, the industry and regulators have made their systems more efficient. With this effort also has come a greater appreciation of the dependency of institutions and their customers on the reliability of technology, as well as a better understanding of what needs to be done to address a technological system failure. And, most importantly, Y2K has involved the highest level managers and directors at institutions and the regulatory agencies, not just the back office staff, in understanding and dealing with technological challenges and opportunities.

Technological risk will clearly be on the rise as we move through the new millennium, but because of the work we've all done on Y2K, we will be better prepared.

Wrap up

So, can we have another round of bank and thrift failures, another deposit insurance crisis, a worst nightmare scenario?

As we approach the dawn of the new millennium, I am mindful that PCA is not a panacea, but I believe that as we regulators promote better risk management modeling, greater balance sheet transparency, a better risk-based capital framework, better control of operating and accounting risks, and better planning for technological risks, we will be able to spot economic insolvencies sooner and make PCA all the more effective.

And to get back to David Letterman, remember Number One on his list of "Top Ten Ways to Know When Your Bank Is In Trouble":

"You glimpse inside the bank vault and notice it's stacked with empty soda cans."

[FDIC Press Release Announcing Third Quarter Earnings For Deposit Insurance Funds]

[Joint Agency Release - Guidance on Asset Securitization Activities]

[CEO Letter 104, Interagency Guidelines on Subprime Lending]