Remarks Prepared for

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Introduction

Thank you. I appreciate the opportunity to be here today. In the brief time we have together, I would like to talk about a variety of topics dealing with the changing landscape within the financial services industry and the challenges presented by these changes. Specifically, I plan to discuss how the recent convergence of banking, securities and insurance; the intertwining of banking and commerce under prior law; and the emergence of Internet-only financial institutions and new technology have required the Office of Thrift Supervision to rethink its regulatory and supervisory approach, especially with respect to holding company supervision. I suspect that many of these challenges are similar to those now facing you. When I talk to bankers and banking supervisors from other countries, I am always fascinated to see how much we have in common. Hopefully, you will find my remarks useful as you seek to address similar issues in your country.

Before I begin today's discussion, however, I thought it might be a good idea to spend a few minutes talking about the Office of Thrift Supervision—who we are and who we regulate.

The Office of Thrift Supervision or, as it is commonly referred to—OTS—is an independent agency under the U.S. Department of Treasury charged with regulating the savings and loan industry. The primary difference between a savings and loan association—or "thrift"—and a commercial bank is that a thrift has a retail focus with an emphasis on residential mortgage lending whereas a commercial bank primarily serves the needs of the business community by offering commercial products. Moreover, OTS-regulated institutions have an almost entirely domestic focus, although some are owned by non-United States parents.

OTS's regulatory and supervisory authority includes jurisdiction over both thrift institutions and their parent holding companies. In addition to having on-site examination authority, OTS has considerable enforcement powers, as well as the authority to promulgate regulations and charter new institutions.

Like the banking industry in the United States, the thrift industry has witnessed large-scale consolidation in recent years. When OTS was created in 1989 there were about 2,600 thrift institutions with $1.2 trillion USD in assets. As of the end of June 2000, however, the number of OTS regulated institutions had fallen to approximately 1,100, with total assets of $887 billion USD.

Despite such large-scale restructuring, the thrift industry is probably healthier than it has ever been. Returns on assets are at close to historic highs and troubled assets are at all-time lows. At June 30, 2000, thrifts boasted an average Tier 1 core capital ratio of 7.3 percent and an average Tier 1 risk-based capital ratio of 12.2 percent. The industry's underlying strength, especially its high capital levels, puts it in a good position to respond effectively to the inevitable future changes in the business climate.

As the industry evolves and consolidates, OTS finds itself supervising an ever more diverse group of thrifts and holding companies. The largest institution we supervise is approaching $200 billion USD in assets. Yet we also have many institutions with total assets of under $20 million USD. The institutions we regulate range from small, one branch, mutually owned thrifts to large, sophisticated, publicly traded thrifts with hundreds of offices located throughout the United States.

The holding companies we regulate are, if anything, more diverse. Many of these holding companies are "shell" organizations that engage in no significant activities beyond their ownership of the thrift. However, approximately 160 of these holding companies are considered "diversified" savings and loan holding companies, which means that the thrift and its related activities represent less than 50 percent of the holding company’s consolidated net worth and earnings. In other words, these are companies whose primary line of business is something other than banking.

Among this group of holding companies are some of the largest and best-known financial and commercial firms in the world.   Companies who own and operate thrifts include:

- Securities firms such as Merrill Lynch, Lehman Brothers, and E*Trade;
- Insurance companies such as AIG, ING and AXA;
- Manufacturing firms such as General Motors and John Deere;
- The agricultural firm, Archer-Daniels-Midland; and
- Retail establishments such as Nordstrom, Federated Department Stores, and Ukrops supermarkets.

This group of savings and loan holding companies illustrates the final, and possibly most significant, historic distinction between thrifts and banks. From the late 1960s until the passage of the Gramm-Leach-Bliley Financial Modernization Act in the U.S. last fall, there were no restrictions on the type of organization that could own a savings and loan association. This was not so for commercial banks. From the 1930s until the passage of Gramm-Leach-Bliley, insurance companies, investment banking companies and commercial firms were prohibited from owning banks. With the passage of Gramm-Leach-Bliley, many of these restrictions have been eliminated. The restriction on commercial firms owning banks, however, is still in place and has, moreover, now been extended to thrifts.

But for many years, the thrift charter was the only option available to United States insurance companies, securities firms and other financial and commercial organizations seeking to enter the banking business. As a result, the thrift industry tended to be in the forefront of innovation. In fact, the organizations we regulate became the first in the U.S. to develop “financial supermarkets” – entities that give customers access to a wide variety of proprietary financial products all under one roof.   The thrift industry also gave us the United States’ first branchless, “Internet-only” financial institution, which allows a customer to conduct a wide variety financial transactions from anywhere they can access the Internet.

I would like to spend the remainder of my time today discussing these new financial institutions, and more specifically, the challenges of supervising them.

New Financial Companies

Up until the mid 1990s, the bulk of the savings and loan holding companies we regulated were shell corporations that, as mentioned earlier, had no significant operations apart from holding the stock of the subsidiary thrift. The few commercial firms and insurance companies that owned thrifts operated these entities independently from the operations being conducted in other parts of the organization. The holding company and thrift had independent boards that rarely overlapped and dedicated, full-time thrift employees performed virtually all the operational and administrative functions within the institutions. Many of these firms looked at their thrift investment as a means of diversifying their operations, not as a critical component of their main business.

During the mid 1990s, however, things began to change. Just as the thrift industry began to recover from the troubles of the late 1980's, many financial firms, especially insurance companies and securities firms, decided that it would be in their best interest to offer their customers a more complete array of proprietary financial products—insurance policies, savings accounts, mortgage loans, credit cards and trust services—all under one roof. Since insurance companies and securities firms were not permitted to own commercial banks, these firms began to look more closely at the thrift charter.

At about the time financial firms began discovering the thrift charter, a relatively small number of commercial firms, including a handful of retailers, made a similar discovery. For years, retailers had been offering their customers proprietary credit cards to purchase their products. In order to do this, however, these organizations were required to abide by the legal lending requirements of each state they did business in. This created an administrative nightmare. One advantage of the federal thrift charter is that it gives management the ability to use uniform standards of operation throughout the country.

Beyond these administrative advantages, some commercial firms wanted to compete with banks by offering a selection of deposit and loan products to their retail customers. In fact, some actually sought to open branch offices in their retail facilities in order to capitalize upon the traffic that comes through their store. Ukrops, the supermarket chain, has just this strategy.

With the influx of these new entities in recent years we recognized the need to adapt our supervisory approach. Unlike traditional thrift holding companies, many of these new holding companies have formed thrifts that are highly integrated with the activities of the parent company and are highly dependent upon the parent company for financial and managerial resources.

For example, applicants often propose that employees of other companies within the corporate family perform many activities that, in a traditional bank or thrift, are done by dedicated employees of the bank. Captive insurance agents are, in some cases, marketing loan products. Within other organizations, non-bank employees are servicing loans and handling customer service inquiries. Occasionally, the bank's most senior employees, such as the President or Chief Financial Officer, may hold a similar position at another company within the corporate structure. At some of the trust-only institutions, employees at the parent company's investment advisor affiliate are actually making the investment decisions for the institution while another affiliate handles all of the institution's brokerage services.

The situation at some of the thrift subsidiaries of commercial firms is even more intertwined. In several of these thrifts, affiliates provide virtually all of the institution's liquidity needs by purchasing the institution's credit card receivables on a daily basis. In other cases, some of the institution's credit cards can only be used to purchase products from the parent company's retail store. And in most all of these cases, the institution's back office needs – accounting, record keeping, personnel, and data processing – as well as the risk management functions, are handled by an affiliate.

Clearly, these new institutions raise a host of interesting questions for both management and government regulators. For instance:

- What is the appropriate amount of capital for a holding company engaged in a wide variety of non-bank activities?
- Should we impose a holding company capital requirement on a large, multi-national firm whose thrift represents just a small piece of its business?
- How do we ensure that management has developed an appropriate system for measuring risk?
- How do we ensure that management of the thrift is acting in the best interest of the thrift?
- How does one maintain the concept of separate corporate identity at institutions that have a desire to be seamless?
- What are the best ways of dealing with operational risk at a thrift when individuals who are not employees of the thrift perform many activities?
- Do some of these new relations encroach on customer privacy?
- How do we ensure the thrift can be disentangled and divested if the parent organization is no longer able to sustain it?
- In such situations, how do we ensure the thrift has established an inherent franchise value that would be attractive to potential third-party acquirers?

In light of these new and difficult questions, OTS has begun to change its traditional approach to regulating these thrifts and their holding companies. For many years our basic supervisory approach was to devote most of our resources to examining the subsidiary thrift. We spent little time evaluating the thrift's corporate parents and looking at systemic risk beyond assuring ourselves that the holding company was unlikely to harm the thrift. Our basic philosophy with respect to holding company supervision has been that the holding company should "do no harm" to the thrift subsidiary.

We did this by focusing on transactions and contracts between the parent company and the thrift: dividend payments, lease agreements, tax sharing arrangements and administrative contracts for services such as data processing. In looking at these agreements and transactions, our goal was – and is – to ensure that they are done at "arms length" and that the thrift is paying no more than fair market value for these services. Moreover, we are attentive to the outright statutory prohibition on thrifts extending credit to affiliates engaged in commercial activities. It is this prohibition that eliminates a thrift's ability to engage in the type of lending that is at the heart of the debate over the mixing of banking and commerce.

Because the operations of the thrifts and their holding companies are today often far more integrated than in the past, this old approach is no longer enough. These new companies have forced us to develop a new, more comprehensive approach for regulating and supervising holding companies. The foundation for this new approach is that we cannot look at these new thrifts in isolation – we must look at the risk posed by the entire organization. Financial and operational characteristics that must be looked at on a systemic basis include: capital; debt burden; interest coverage; liquidity; cash flow; quality of earnings; internal controls; and operational risk.

Our Approach

Our strategy, which is consistent with the Basel supervisors' three-pillar approach focusing on capital, supervision, and market discipline, has six separate parts:

- Rigorous review of applications to establish a thrift holding company;
- Increased focus on consolidated holding company capital;
- More intensive on-site examination and evaluation of prospective holding company risk;
- Close communication and prior notification of significant transactions;
- Leveraging the concept of functional regulation to make use of the authority and expertise of other regulators; and
- Greater use of market information and market discipline.

Some of these elements are currently in place; others are in the process of being developed. Allow me to briefly touch on each of them.

The first part of our supervisory approach with respect to these new types of organizations takes place before the institution opens its doors. Prior to organizing or acquiring a thrift, a company is required to undergo a rigorous application process during which we intensively scrutinize their proposed business plan, capital structure, managerial expertise and overall integrity. The objective of this process is to ensure that the applicant has the financial and managerial resources to operate the thrift without jeopardizing the safety and soundness of the deposit insurance funds.

It is during this process that we begin to address specific concerns with the applicant's proposal. If we believe the thrift does not have its own separate corporate identity and may have difficulty operating successfully on a stand alone basis, we will require the thrift to hire more qualified full-time individuals in key positions and to perform core business functions within the thrift institution. We seek to strike a balance between allowing thrift holding companies to leverage the synergies of the overall organization and requiring a certain degree of independence. If the applicant plans to rely on a network of agents and brokers for referral business, we make sure that proper controls are in place and that these representatives will receive comprehensive training. If we believe there is a risk that key decision makers working at both the thrift and the holding company could encounter conflicts of interest, we may require the thrift to appoint several independent directors who could be better able to protect the interest of the thrift. If the thrift is heavily reliant on affiliates for funding, we may require the holding company to place compensating balances with the thrift or that the thrift diversify its funding sources. If the proposal involves an elevated degree of risk, such as Internet banking or sub-prime lending, we will require the institution to hold more capital than the minimum required under our regulations.

The second part of our approach, determining the appropriate amount of capital these new, complex holding companies should hold, is typically done in connection with the application review process. OTS does not have a standardized capital requirement applicable to all holding companies. Thrift holding companies are far too diversified for us to develop a single, meaningful capital requirement.

Instead, we have chosen to take a case-by-case approach based upon a variety of factors. Those factors include:

- The overall risk profile of the consolidated entity and of the subsidiary thrift;
- The extent of managerial and board overlap between the thrift and the holding company;
- The amount and nature of transactions with affiliates;
- The presence of multiple gearing, where investments in intermediate holding companies and their subsidiaries are included in regulatory capital on multiple levels;
- The extent of outsourcing key functions to affiliates; and
- Traditional analytical measures, such as evaluating overall leverage; the level of short-term debt and liquidity; cash flow and reliance on thrift earnings; interest coverage; quality of earnings; and consolidated tangible and equity capital.

As part of our case-by-case analysis of holding company capital, we also consider the size of the thrift relative to the size of the holding company; the nature of the thrift's operations—for example, whether it is full-service or trust-only; and the types and quality of capital instruments held by the holding company.

Our overall objective is to use consolidated holding company capital as a tool that can be ratcheted up or down, on a case-specific basis, to ensure that an appropriate equity buffer exists to shield the thrift from an unexpected problem at the parent. In conjunction with this, we are also prepared to take aggressive measures to establish appropriate firewalls to insulate the thrift from a parent that is in a distressed financial condition. In taking this approach, we believe we can protect the interest of the insurance fund while allowing the thrift and parent company a flexible regulatory environment to meet their business objectives.

The third part of our supervisory approach, more highly risk-focused, joint holding company and thrift on-site safety and soundness examinations – occurs once these applicants receive the requisite regulatory approvals and open for business. The first step in performing a holding company examination involves gauging the organization's overall risk profile, with the riskier entities receiving more attention and scrutiny.

How do we determine whether the holding company carries a greater degree of risk? We look at:

- The types of activities and assets of the holding company and its significant affiliates;
- The thrift's dependence on holding company affiliates to perform core functions;
- The thrift's funding method, especially reliance on inter-company borrowings;
- The type and character of transactions between the thrift and its holding company and other affiliates;
- The thrift's significance within the organization; and
- The financial strength and stability of the holding company.

If, after looking at these characteristics, we determine the holding company carries a greater degree of risk, the examiners assess the consolidated organization's prospective risk and escalate the level of oversight on an as needed basis.

The fourth part of our strategy involves obtaining advance knowledge of an organization's plan to incur a significant increase in debt or to engage in a major new activity. Although we strive to maintain close communications with all of the entities we regulate, we are currently working on a proposal to supplement communications. The proposal, if adopted in its current form, would require prior notice from many savings and loan holding companies and non-thrift subsidiaries before they renew, guarantee or issue substantially more debt, and before they enter into a significant transaction that would markedly increase consolidated assets or reduce capital below a specified level. The ability to review large holding company transactions before the organization commits to them and discuss them with management helps prevent unwelcome surprises, including situations where the thrift's resources are likely to be strained to help the parent company meet interest payments.

Notwithstanding the broad reach of our regulatory and oversight authority, I want to make it clear that OTS has never been in the business of regulating the non-bank related activities of commercial firms, insurance companies, investment banks, securities firms and other such companies. Rather, we rely on functional regulatory agencies to monitor and control the non-bank related activities under their purview and the marketplace to assist us with oversight of the commercial activities of these new types of entities. The concepts of "functional regulation" and market discipline make up the fifth and sixth components of our strategy.

The idea of "functional regulation" is a critical component of Gramm-Leach-Bliley. Long before this mandate, however, OTS practiced functional regulation. Historically, OTS has worked closely with state insurance and securities regulators, the National Association of Securities Dealers and the Securities and Exchange Commission as they supervise the insurance and securities related activities at thrift holding companies. We expect them to keep us informed in the event they discover a problem that could impact the thrift. Conversely, we keep these other regulators informed about problems that could affect the companies over which they have primary jurisdiction. In addition to frequent, informal communications with other regulators, OTS has negotiated numerous cooperation and coordination agreements to encourage a close working relationship.

The last component of our supervisory strategy, greater reliance on market information and market discipline, allows us to realize substantial efficiencies by tapping the enormous resources of the private sector. OTS conducts extensive off-site analysis of the companies we supervise by using a variety of internal databases that contain a host of public and non-public information on thrifts and thrift holding companies. Electronic collection of this information and the continued development of staff resources are critical components of our examination and monitoring process. We recognize, however, that as the companies get larger and more complex, we cannot rely exclusively upon our own people and systems. To that end, we are beginning to more fully utilize private sector information such as stock analysts' reports and ratings, securities filings, securities trading volume and price information to supplement our own analysis. As transparency and the availability of financial information improves, investors will become increasingly better equipped to induce changes in the behavior of key decision makers within these organizations. Clearly, we cannot rely exclusively upon market discipline to ensure the safety and soundness of diversified thrift holding companies, but we believe that, when coupled with our own efforts, it can be an effective tool for controlling risk and modifying behavior.

Internet Banking

Any discussion about new breeds of financial institutions would not be complete without mentioning Internet-only institutions. The concept of an Internet-only institution first surfaced for us in 1995, when a group of individuals who had been developing encryption technology for various government agencies came to us with a proposal to charter an institution that would conduct its business entirely in cyber-space. The Internet was relatively unfamiliar to us back then and we had a long list of questions and concerns, ranging from narrow operational issues, such as data security, to larger questions about consumer acceptance of Internet-only thrifts. Eventually, our concerns were satisfied and we approved the proposal. Since that time, fourteen other Internet-only institutions have been formed in the United States, seven of which OTS chartered. In addition, more than half of the more traditional institutions we regulate have informational web pages and approximately one quarter now have transactional websites.

In these few short years, OTS has gained some valuable insights into the business of Internet banking, which I would like to share with you. Before I start, however, I would like to point out that these observations are generalizations, and individual Internet banks may look and operate somewhat differently.

First, the basic premise upon which many of these Internet-only institutions were formed—namely that Internet-only institutions will be more profitable than traditional institutions because they do not have to support a costly brick and mortar branch network—has yet to be realized. It is true that these new Internet institutions do not have to incur the costly process of operating a physical branch office network, but the savings they have achieved by not having branches have often been more than offset by the high costs associated with acquiring and retaining customers and with updating and improving their technology infrastructure. Of course, some Internet thrifts have been more successful than others in maintaining a low cost structure, but in general, the promise of low general and administrative expenses has yet to be proven.

Second, we have observed that, in most cases, Internet-only institutions are forced to pay very high rates in order to acquire customers. As soon as they lower their rates, the deposits flow out. Thus, the second conclusion we have drawn is that most Internet-only institutions attract primarily non-core deposits. This “hot money” comes from depositors who are simply seeking high interest rates and have no loyalty toward one particular institution. It is unclear whether an institution that has few stable “core” deposits will be able to succeed on a long-term basis throughout economic cycles. Only time will tell.

Another observation we have made is that, although customers are willing to transfer funds, pay bills and open deposit accounts on-line, they appear to be very reluctant to conduct the entire mortgage loan process in cyber-space. For most people, the mortgage loan is the single largest transaction they will ever make and, at some point, they want to see and talk to the person they are trusting with their most intimate financial details. In fact, even if consumer acceptance of on-line mortgage lending grows, the technology that allows an institution to originate and close a mortgage loan on-line – things such as digital deed recordation and signatures – is still in its infancy. Thus, the third conclusion we have drawn is that most Internet-only institutions must still rely on costly third party arrangements to buy loans in the wholesale markets, which results in razor-thin margins.

Lastly, we see that most customers want quick and easy access to their money and the flexibility to walk into a branch office and see who they are doing business with or – if they so desire – to complain. Because of this, many of the Internet-only institutions are re-thinking their strategy. Some are opting to purchase extensive ATM networks that will give customers low-cost, 24 hour access to their money from anywhere in country. Others are opting to establish a limited branch office network to supplement their cyber operation.

Right now, it is unclear who will survive and which strategy will ultimately be successful and how new technologies, such as wireless banking and account aggregation, will affect them. It is clear, however, that Internet banking and new information technologies hold great promise and that they will evolve rapidly for many years to come. In the meantime, OTS has taken steps to ensure that these organizations operate in a safe and sound manner, and that we keep abreast of technological developments, while simultaneously taking care not to impede progress and to carefully balance our supervisory objectives with adoption of new technologies.

First, when we charter an Internet-only thrift, we require the institution to hold a higher level of capital relative to other de novo institutions. This capital cushion is designed to absorb the inevitable loss that will occur during the institution’s early years of operation when it makes heavy investments in advertising to gain market share, and in crucial technology infrastructure. Initially, Internet-only banks had very little difficulty in meeting these new capital requirements. In fact, they had virtually unlimited access to funds in the capital markets which made it difficult for us, in some cases, to restrain growth. In recent months, however, this situation has changed. Investors are beginning to expect Internet companies to show a profit before they invest additional funds. As a result, the Internet-only bankers have been forced to trim their marketing budgets and to cut back on other expenses in an effort to stem losses or increase profits. We expect this trend to continue as the industry begins to mature.

Second, if we are unfamiliar with the security platform that will be used, we require, as a condition of approval, each Internet-only institution to conduct an independent security review and test of its Internet banking platform. The review must be conducted by an independent computer security specialist and must include testing to determine the adequacy of protection against unauthorized external access, including individual penetration attempts, computer viruses and denial of service attacks. In addition, the review must assess the adequacy of internal security. This is a critical component to our strategy. We recognize that if there is a security breach at just one Internet-only institution, the systemic repercussions could be significant. If customers perceive these institutions to be unsafe, they may withdraw deposits in mass. As such, security is paramount.

Third, we require all institutions that do business over the Internet, whether Internet-only or not, to clearly distinguish between those products that carry federal deposit insurance and those that do not. As part of this effort, OTS will soon issue industry guidance that will deal with, among other things, best practices for website disclosures. To ensure that institutions are fulfilling their responsibilities, we have a group of individuals who review institutions' websites for problems.

Corporate Governance

As convergence and consolidation among financial services providers continues and revolutionary new technologies are adapted for their use, our supervisory challenges are manifold. It is not always enough to just oversee the activities of the thrift industry. We must also assume a leadership role at times.

Competitive pressures will continue to shrink profit margins on traditional bank and thrift products for the foreseeable future, making a strong system of corporate governance paramount to the overall success of all financial institutions. Therefore, we are encouraging thrifts to spend substantial time on planning and identifying new markets and strategic opportunities. To this end, OTS is hosting a strategic planning conference next year for OTS-regulated institutions to enhance their focus on developing and implementing effective, prudential long-term business strategies. We have also spent a considerable amount of time this past year reminding thrift directors of their fiduciary obligations to provide strategic direction and to ensure that their institutions are operating in a safe and sound manner. To assist them in fulfilling these duties, OTS has put together two booklets that outline directors' responsibilities and identify the types of management reports directors should be monitoring. I have brought along copies of these booklets for those of you who are interested.

Conclusion

As distinctions among providers and products blur, we have become increasingly reliant on other mechanisms, including external auditors, functional regulators, the marketplace and ratings agencies to supplement our supervisory oversight. We are striving to provide staff with the resources and skill sets to enable them to sift through information from these varied sources, and to synthesize and objectively evaluate what they gather to spot risks across organizations. As we have learned, risk can present itself in innumerable ways within a complex organization. Our task is to accurately gauge management's ability to manage it and to identify adverse correlations among business units that may be risk accretive rather than risk mitigating.

As we stand at the threshold of a new era in the thrift industry in the United States, we are ever mindful that we cannot leave our community institutions behind. We remain cognizant of the important role that all financial institutions play in ensuring the health and vitality of our nation's financial system. We are fully aware that any initiatives we undertake must be sufficiently resilient and flexible to encompass the broad spectrum of institutions comprising the thrift industry in the United States today.

It has been a pleasure speaking with you today. Thank you.