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OTS 01-03 - OTS Director Seidman Offers a Flexible Approach to Holding Company Supervision

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OTS Director Seidman Offers a Flexible Approach to Holding Company Supervision

WASHINGTON, D.C., Jan. 17, 2001 - Explaining to the Exchequer Club that holding company supervision "is becoming increasingly important as we adapt our supervisory processes to meet new practical and legal challenges arising from the evolution of the financial services industry," Director Ellen Seidman of the Office of Thrift Supervision (OTS) outlined the Agency's five-part strategy for supervising thrift holding companies. This "five-part comprehensive strategy [is] all guided in intensity by the combined risk profile, financial health and stability of the consolidated entity, and degree of interdependence between the thrift and its affiliates," Ms. Seidman said. The key elements of the strategy are: enhanced off-site monitoring; strengthened reliance on functional regulation; refined risk-focused examination procedures; improved holding company financial analysis; and enhanced communications.

"Sensible holding company regulation is part of our responsibility under the Home Owners' Loan Act," said Ms. Seidman. "We need to have a progressive, flexible framework that preserves the financial stability of the thrift industry while enabling it to thrive and flourish. An ongoing dialogue is essential to achieving this result." As a part of this new approach, OTS has asked for public comment through a Notice of Proposed Rulemaking dealing with the Agency's approach to holding company capital and enhanced communications.

With respect to holding company capital, the NPR sought to make the Agency's current case-by-case approach more transparent by identifying the key factors OTS uses when evaluating the need for additional holding company capital. "OTS does not have a one-size-fits-all capital approach," Ms. Seidman said. "We believe the companies we supervise are far too diverse to develop a single, meaningful standard. Instead we have chosen to take a more flexible, case-by-case approach to capital" that is consistent with the actual and potential level of holding company risk to the thrift. The NPR contained no regulatory text dealing with holding company capital. Instead, the Agency used the NPR to inform and ask questions on capital.

Under the enhanced communications aspect of the NPR, OTS proposed that certain thrift holding companies provide advance notice before they enter into certain significant transactions that could have a material impact on the thrift. The Agency believes that the

ability to discuss large holding company transactions with management before the organization commits to them helps prevent unwelcome surprises. Ms. Seidman stressed that close communication is critical to making a case-by-case capital approach truly workable. "Quite simply," said Ms. Seidman, "if we are to have a system in which the amount of capital we expect a holding company to have depends on what it is doing and the risks it is taking that may impact the thrift, we need to know those facts, preferably in advance of major new undertakings or increases in risk."

OTS encourages thoughtful, constructive comments on both aspects of the proposal. The extended comment period ends on February 9, 2001.

Ms. Seidman also reiterated the remarks made to the Exchequer Club last month by Comptroller of the Currency John D. Hawke concerning equitable treatment of supervisory costs. She noted that the on-going debate concerning deposit insurance is a good opportunity to open this discussion. She also reiterated her support for merger of the deposit insurance funds.

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The Office of Thrift Supervision (OTS), a bureau of the U.S. Treasury, regulates and supervises the nation's thrift industry. OTS's mission is to ensure the safety and soundness of thrift institutions and to support their role as home mortgage lenders and providers of other community credit and financial services. For copies of news releases or other documents visit the OTS web page at www.ots.treas.gov.

Remarks of Ellen Seidman Director, Office of Thrift Supervision For Presentation to the Exchequer Club of Washington, D.C.

January 17, 2001

Washington, D.C.

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I appreciate the opportunity to speak with you today about OTS' initiatives in the area of holding company supervision. This is a topic that is becoming increasingly important as we adapt our supervisory processes to meet new practical and legal challenges arising from the evolution of the financial services industry; the convergence of banking, securities and insurance; and the Gramm-Leach-Bliley Financial Services Modernization Act. About two and a half years ago OTS began to rethink its approach to holding company supervision in the face of the dramatic structural changes we were witnessing within the financial services industry. This has generally been incremental and relatively quietly accomplished. However, over the past year, as we have entered into information sharing agreements with more than two-thirds of the state insurance commissioners, altered the Thrift Financial Report or TFR to include holding company data, and issued a Notice of Proposed Rulemaking, the dialog has become more public. As we go forward, it is vital that we maintain an open dialogue among all stakeholders to ensure that OTS administers a prudent, balanced approach to holding company supervision, providing much needed flexibility for the entities we

regulate to respond quickly in an intensely competitive marketplace, while enabling OTS to continue to effectively discharge its regulatory responsibilities.

Before I begin discussing our holding company initiatives, I think it would be helpful to provide you with some facts about the relevant universe. OTS currently regulates more than 1000 holding companies that collectively own about 550 thrifts. These companies are extremely diverse in terms of their size and scope of activities. Consolidated assets of thrift holding companies range from as little as \$20 million up to as much as half a trillion dollars. Most are public corporations, but many are mutually owned and operated. The overwhelming majority are domestically owned but a few are headquartered in foreign countries, including Canada, the United Kingdom and the Netherlands.

Although the preponderance of thrift holding companies are "shell" organizations that do not engage in any significant activities beyond their ownership of the thrift, approximately 170 holding companies within about 90 different corporate structures are "diversified" holding companies. Within these diversified structures, the thrift and its related activities represent less than 50 percent of consolidated net worth and earnings. In other words, these are companies whose primary line of business is something other than banking.

Of the diversified thrift holding company groups, 43 have subsidiaries primarily engaged in insurance operations, 18 are primarily securities firms, and 20 principally engage in commercial activities. Some of these companies are among the largest and best-known financial and commercial firms in the world, including State Farm, AIG, Merrill Lynch, Lehman Brothers, Archer-Daniels-Midland and Federated Department Stores, to name a few.

Although diversified firms have owned thrifts for years, the majority came into the system after 1996. Between January 1997 and December 2000, OTS approved approximately 70 applications from insurance companies, securities firms, and a small number of commercial entities seeking to organize or acquire a federal thrift. This flow was strongest early in the period and slowed some in 1999 and further in 2000.

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 financial activities under their purview and upon the marketplace to assist us with oversight of financial and commercial activities. Nevertheless, under the Home Owners Loan Act or HOLA, we have some important responsibilities concerning thrift holding companies and their positive and negative potential impacts on the thrift and the deposit insurance funds.

Over the past several years, we have been able to devote greater attention to making certain we are supervising all of the institutions we regulate in a manner that is consistent with their level of actual and potential risk. Our efforts have been guided by our experience in examining established holding companies and by what we've learned from looking at some of the newer entities.

Which areas are we looking at more closely? High on our list of priorities is the old problem of excessive leveraging. Intense competition has caused a number of holding companies to employ more leverage, and, thus, reduce their margin for error. This can create challenges in more than one way. For example, if the thrift subsidiary runs into problems, the holding company may not only have difficulty accessing the capital markets and be unable to provide a capital infusion, but it may also continue to place dividend demands on the thrift. This can make a bad situation even worse. Furthermore, if the holding company gets into trouble--perhaps because it raised debt to pursue a project that didn't work out--the thrift is going to be pressured to come up with additional earnings and dividends.

The second area drawing greater scrutiny is the trend that shows some holding companies purchasing assets or starting up business lines inherently more risky than more traditional operations. These new activities, if not managed properly, could quickly drag down earnings and ultimately threaten the viability of an organization or pose serious reputation risk for the thrift. Some areas, like sub-prime credit cards and originating large volumes of lower quality loans for sale or securitization, carry not only traditional credit risks but also significant operational, liquidity and legal risks.

We are sensitive to the fact that this desire for diversification is often driven by competition within the financial services industry. If management has the ability to take on and manage new lines of business well, and has properly reserved for and capitalized the risk, we'll not interpose ourselves but continue to closely monitor the risks. We all must recognize, however, that the benign economic environment we've enjoyed in recent years can mask problems and make marginal propositions look highly profitable.

The third, and possibly most interesting new challenge, is the highly integrated way in which many newly-chartered thrifts--as well as some old ones--are now run. Before the mid-1990s, diversified thrift holding companies generally operated their thrifts totally separate and distinct from the rest of the holding company family. The thrift had its own directors, employees, business lines and franchise value. In the event the thrift or the holding company encountered problems, the thrift could be "walled off" from the parent and operated independently or sold.

Now, however, a number of thrifts are highly intertwined with other companies or divisions within the corporate family. Thrifts are outsourcing not only administrative functions to holding company affiliates, but also some core functions such as marketing, asset/liability management, and internal audit. They also often utilize overlapping boards and management. In some cases, the thrift may be little more than a conduit, with holding company affiliates purchasing receivables from it on a continuous basis. Indeed, this leveraging of internal resources is at the heart of why many companies have sought thrift charters. Again, as regulators we fully acknowledge the competitive benefits that may be derived from such synergistic business models, but we must modify our practices to deal with the new structures.

In such situations, the health of the thrift is not only highly dependent on the health of the holding company and the corporate family as a whole, but the independent franchise value of the thrift, should there be a problem, may not be readily apparent to potential buyers. Previously available regulatory strategies, such as walling off the insured depository, may now be counterproductive, and an orderly divestiture may not even be an option.

So what's our supervisory response? A five-part comprehensive strategy all guided in intensity by the combined risk profile, financial health and stability of the consolidated entity, and the degree of interdependence between the thrift and its affiliates. The strategy consists of: enhanced off-site monitoring; strengthened coordination with functional regulators; refined risk-focused examination procedures; improved holding company financial analysis; and enhanced communications. Some of these elements are currently in place while others are in the process of being developed. I'll briefly touch on each of them.

The first part of our strategy, improved monitoring, has two parts. First, beginning with the March 2001 TFR cycle, we will collect electronically some basic consolidated financial and other holding company information on a consistent basis. The data includes total assets and liabilities, long- and short-term debt, cash flow and income information, and will supplement the paper-based reports we already get from holding companies. While modest, this initiative will enable us to begin to construct a core database to monitor capitalization levels, profitability and cash flow from operations, and to begin to build some time series to look at trends and variability of financial performance and condition.

Electronic collection of financial information and the continued development of staff resources are critical components of our examination and monitoring process. As the companies get larger and more complex, however, we cannot rely exclusively upon our own people and systems. Therefore, the second part of improved monitoring involves making better use of market information. We will supplement our basic holding company financial database with a host of public information available from a variety of sources, including regulatory filings, analyst and rating agency reports, press reports and stock price and volume movements. Clearly, we cannot rely exclusively on public reports and market discipline, but we believe that, when coupled with our own efforts, public reports and market discipline can be effective tools for identifying and sometimes mitigating potential problems at publicly held companies.

The second component of our strategy, functional regulation, is a concept OTS adopted and implemented long before Gramm-Leach-Bliley. In fact, when I came to the agency in 1997, one of my first initiatives was to establish a working relationship with the state insurance commissioners and the National Association of Insurance Commissioners or NAIC, and to strengthen our relationships with other regulators, both in Washington and in the states.

On the insurance side, this has borne specific fruit in the adoption of a model information sharing agreement by the NAIC last March, that covers supervisory, enforcement, and consumer compliance matters. To date, we have signed agreements with more than two-thirds of the states. Our regional offices have also established strong working relationships with insurance commissioners in relevant states, and both OTS and insurance staff have attended reciprocal training sessions.

On the securities side, we have had a coordination agreement in place for many years with the National Association of Securities Dealers and, more importantly, have a solid tradition of working closely together when the need arises. We have also sat down with both the Securities and Exchange Commission and the North American Securities Administrators Association on a number of occasions to discuss practical issues of mutual interest.

Regional and Washington OTS staff have invested considerable time and effort to gain an understanding of the roles and responsibilities of each functional regulator. We have learned much from these other regulators that has resulted in substantial improvements to our examination policies and procedures.

The third part of our supervisory approach--more highly risk-focused, joint holding company and thrift on-site safety and soundness examinations--is part of our effort to make better use of our resources.

Risk-focusing our holding company examinations initially involves assessing the organization's overall risk profile. In performing such an assessment we look at many factors, including:

- 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 its reliance on inter-company borrowings;
- The type and nature 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 consolidated entity.

If, after looking at these characteristics, we determine the holding company carries a greater degree of risk, we escalate the level of oversight commensurate with that risk level. Conversely, we are spending less time with holding companies that carry less risk.

The fourth and fifth parts of our new strategy, improving our evaluation of holding company capital and enhancing the lines of communication between us and the holding companies we regulate, were both the subject of an October 27, 2000, notice of proposed rulemaking.

With respect to holding company capital, we sought in the NPR to make our current case-by-case approach more transparent by identifying the key factors we use when evaluating the need for additional holding company capital. We provided no regulatory text, instead using the NPR to inform and to ask questions, providing the information on capital in part as context for the communications section of the proposal.

Unlike the Federal Reserve, OTS does not have a one-size-fits-all capital approach. We believe the companies we supervise are far too diverse to develop a single, meaningful standard. Moreover, there is no reason to believe bank regulators are better than insurance or securities regulators at setting capital standards for insurance or securities firms. Instead, we have chosen to take a more flexible, case-by-case approach to capital based upon a variety of factors, such as:

- The overall risk profile of the consolidated entity and of the subsidiary thrift;
- The presence or absence of multiple gearing, where investments in intermediate holding companies and their subsidiaries are included in regulatory capital on multiple levels;
- The types and quality of capital instruments issued by the holding company;
- The extent of outsourcing key functions to affiliates; and
- Traditional analytical measures, such as 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.

The intensity of our case-by-case holding company capital analysis--and the extent to which we might require that a holding company hold additional capital to diminish risk to the thrift--is directly influenced by the relative size of the thrift within the consolidated structure. Where the thrift is a small piece of a much larger structure, we would generally scale down our analysis and our intervention accordingly. Examiners are also guided by the nature of the thrift's operations--for example, whether it is a full-service or trust-only institution.

Our overall objective is the safety and soundness of the thrift. We view 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 taking this approach, we believe we can protect the interest of the insurance funds while providing the thrift and its parent company with an adaptable regulatory environment in which to meet their business objectives.

We believe our approach is more flexible than a one-size-fits-all minimum capital requirement because it focuses on the economics of particular transactions. Specifically, if a significant transaction at the holding company level would be unlikely to be detrimental to the thrift, we would not voice supervisory concerns, even if the transaction caused holding company capital to temporarily decline to a relatively low level. We also believe that by looking at capital on a consolidated basis, we are filling a critical gap in the regulatory system. Unlike OTS's authority under the HOLA, functional regulators generally can only look at portions of a holding company.

We realize that our case-by-case approach may seem new to some, but in fact it is how we have been looking at holding company capital for a long time. The only difference is that we've now opened up the analytical basis of our approach and asked for comments on it. Similarly, the New Basel Capital Accord proposal, released yesterday, makes it clear that holding company capital is being put into a much more explicit framework worldwide. That proposal

envisions extending bank-like risk-based capital regimes to financial--not just bank--holding companies in corporate groups that include a bank. Some aspects of the proposal deal with issues we have been wrestling with at OTS. For example, is it appropriate for a bank regulator to deduct the minimum required regulatory capital of a functionally regulated entity within the holding company when analyzing consolidated holding company capital adequacy since, most likely, that capital would be unavailable to assist the bank or thrift?

The final part of our strategy--enhanced communications--includes, but is not limited to, the notice proposal in the October NPR. If adopted in its current form, the proposal would require certain thrift holding companies to provide advance notice before entering into certain significant transactions that could materially affect the thrift. We issued the proposal because we believe that the ability to discuss large holding company transactions with management before the organization commits to them helps prevent unwelcome surprises on both sides. We firmly believe that close communication is critical to making a case-by-case capital approach truly workable. Quite simply, if we are to have a system in which the amount of capital we expect a holding company to have depends on what it is doing and the risks it is taking that may impact the thrift, we need to know those facts, preferably in advance of major new undertakings or increases in risk.

Over the last several months, we have spoken with a number of groups about their concerns with the notice proposal. It has been an interesting and constructive dialog, which we expect will be fully reflected in the comments we receive on the proposal as the extended comment period ends February 9.

It appears that the major concern with the proposal is that--notwithstanding the myriad of thresholds and exemptions intended to limit the notice to truly significant transactions--companies believe they will not be able to act quickly enough to take advantage of competitive opportunities, particularly if OTS were to raise any issues with a proposed transaction. The asset part of the proposal, and the potentially open-ended time period, seem to be generating the most unease, but we understand they are not the only concerns.

As we've articulated more fully our rationale for the notice proposal and its context, those with whom we've spoken have become interested in helping us find a process that meets our objectives while overcoming their concerns. Potential solutions remain a little vague and undeveloped, but we believe the combination of dialog and the extended comment period will bring forth some creative and constructive alternatives. Much of the focus, I expect, will be on better defining both the class of entities and the class of transactions that raise sufficient regulatory concern to justify the inconvenience of transaction-based communication, and developing effective processes to ensure better communication in general. I do want to emphasize that, where we have good, ongoing communication with both thrifts and holding companies, our regional offices have a history of responding to proposals quickly and in a manner sensitive to competitive pressures.

Sorting through the comments will be challenging. But that's what the notice and comment process is all about, and I urge you to carefully review the proposal and provide thoughtful and constructive written comments. We believe an alternative to rigid holding company capital standards, as well as effective but non-invasive holding company supervision, depends on frequent, open and honest communication between thrift holding companies and OTS, particularly at the regional level where we do all our supervision. Most thrifts and, indeed, most holding companies, have good communication with us. We need to build on that and ensure that we maintain true two-way communication about significant events that could materially impact the thrift.

Sensible holding company regulation is part of our responsibility under the HOLA. We need to have a progressive, flexible framework that preserves the financial stability of the thrift

industry while enabling it to thrive and flourish. An ongoing dialogue is essential to achieving this result.

Before I conclude my remarks, allow me to briefly touch upon one additional item--the manner in which the thrift industry is assessed to pay for regulation. Last month, in the course of a discussion about deposit insurance reform in this forum, Comptroller Hawke raised the issue of equity in the assessment of the cost of supervision of insured depository institutions of various types. The Comptroller focused on the inequity engendered by the fact that, while more than half of the current balance in the deposit insurance funds--and thus a similarly large portion of yearly earnings--is attributable to premiums paid by national banks, a significant portion of those earnings is being used not for insurance purposes but for supervision by the FDIC of state non-member banks. The result, of course, is that state non-member banks get two things for their premiums--insurance and a large portion of their supervision costs, while national banks only get one--insurance. At the risk of redundancy but with the intention of giving the issue the prominence it deserves, I want to remind you that the same situation applies with respect to federally-chartered thrift institutions. The earnings on their insurance premiums also go in part to pay for other institutions' primary federal supervision while OTS-regulated institutions must pay the full cost of their regulation.

Now, this is not an argument about federal versus state charters although one could see how it could ultimately threaten the dual banking system since several times a year, thrifts switch from the federal to a state charter and cite lower assessments as the reason. In fact, it is about a system that makes little sense for state regulators as well--one in which some regulators must charge the institutions they regulate full freight while others have access to large pools of funds provided by the entire industry in a relatively invisible fashion. The current system is simply not fair to institutions, to regulators or--ultimately--to the American public.

I think the on-going discussion about deposit insurance reform, which I believe is essential, provides us with a good opportunity to rethink the entire system for paying for bank supervision, including supervision by the states. Is it time to integrate the entire cost of supervision into insurance, basing both insurance and supervision costs on risk as well as size? Should we keep the two separate, but nevertheless have consolidated billing--with each agency, federal or state, billing for its costs on a separate line item on a bill that also includes the cost of insurance? If we go to a system in which there are, at times, rebates from the insurance fund, should the rebates be used to pay the cost of supervision? Or what about recognizing that more intense supervision of troubled institutions costs substantially more but can save the insurance funds from ever paying out, and at least taking those incremental supervisory costs incurred by OTS, OCC or the states out of the increased insurance assessment on those troubled institutions?

Like the Comptroller, I don't know what the answer is, but as we embark on this new venture in deposit insurance, and as the industry itself continues to change, we would do well to take the opportunity to think through how we want to pay for effective bank supervision in the future. And yes, of course, we must merge the funds.

Thank you.