Speeches

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TS-067 - The Thrift Industry is Strong - But There Are Some Warning Signs. Remarks by Ellen Seidman, Director, Office of Thrift Supervision, Directors' Forum, Dallas, TX

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by
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Good afternoon fellow "Directors."

It is a pleasure to be part of this first OTS Directors' Forum. I'd like to discuss with you today what we're seeing in the industry and the role Directors play in the success of their institutions.

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

At June 30, 1999, assets held by OTS-regulated thrifts reached $846.69 billion. The continued economic expansion, along with a still-vibrant housing sector, remain important in the industry's strong financial performance. Total industry profits were $2.12 billion, reflecting a return on assets of 101 basis points and a return on average equity of 12.44 percent on average equity capital of 8.1 percent of assets. Reduced non-interest expense, or overhead, and higher fee income contributed to the record performance.

Despite rising interest rates, mortgage originations remained strong at $79.2 billion. At the same time, thrifts responded to the rising interest rates, and the resultant return of a market for adjustable rate mortgages, by moving away from a mortgage banking strategy to one of holding more loans in their portfolio. As we'll discuss later, however, a large number of institutions seem to be maintaining or increasing their holdings of long-term fixed rate instruments, thereby increasing their interest rate risk.

Capital remained strong, with 97.2 percent of thrifts meeting or exceeding the well-capitalized standards. Troubled assets fell to $5.5 billion, or 0.65 percent of assets, in the second quarter, the lowest level since that measure was first used in 1990. Problem thrifts, those with CAMELS ratings of 4 or 5, declined in the second quarter to 10, or 0.9 percent of all thrifts.

Over the last two years, the industry has successfully coped with a low, flat yield curve that hurt portfolio margins, but drove mortgage originations to record levels. The industry's ability to adapt is a sign of nimbleness that is heartening. However, as interest rates move up and the yield curve steepens, mortgage originations, particularly refis, are coming down, and the industry will be challenged again - to find new customers and new ways to serve old ones, develop new products (or bring back the old) and to do it while keeping overhead expenses low and internal controls in place.

As we go forward, there are a number of concerns we at OTS will be focusing attention on, both because we've seen these things go wrong before and because these problems are beginning to surface now.

First, there's the problem of institutions getting into more risky lines of business or taking more risk in traditional business (such as speculative construction lending, or construction lending outside your regular business area) without proper management, standards, oversight, or controls. Particularly in this audience, I want to be very clear about what I'm saying. As Directors, you are responsible for your institutions' long-term profitability. As regulators, that's also what we're interested in, although admittedly we're a little skeptical when the excuse for consistently bad short-term results is "things will get better in the long run." In this changing world of financial services, "doing what we always did" with "the customers we've always had" may not, indeed probably is not, the way to stay profitable in the long run. It may well make sense to move into areas of somewhat greater risk, if the increased risk is accompanied by greater returns. But this must be done properly, with the full participation of an active, informed Board. You've got to:

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

We're also seeing a significant increase in interest rate risk, particularly among the institutions that have been taking the most risk. And this has been accompanied by a decline in post-shock equity ratios. Remember, interest rate risk is where the industry's problems all started in the late 70s. Unlike that period, however, today ARMs are an established product, there's an active secondary market, and there is a range of liability instruments that can reduce interest rate risk. So it's a lot easier to avoid excessive interest rate risk while conducting your traditional business. As with credit risk, you'll see us demanding more capital if you're going to take on significant interest rate risk.
Loss allowances were down slightly in the second quarter, from 70 to 68 basis points. Given the potentially offsetting trends of increases in direct loans on the books and improved asset quality, this may be appropriate, but not where institutions are moving into businesses with greater credit risk.

Finally, while capital remains strong, there has been a slight decline in equity capital. We believe this is mainly due to higher unrealized losses on securities available for sale. This, in turn, reflects the combination of an abnormally high - albeit declining - amount of securities available for sale and a rise in interest rates, which decreases the value of those securities. Obviously, the history of the thrift crisis teaches us to pay attention to unrealized losses, and we will. We'll also be paying increasing attention to consolidated holding company capital, particularly where the thrift's "equity" is supported by debt at the holding company level.

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

How Directors Run Into Problems

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

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

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

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

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

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

Fifth, as I mentioned earlier, we're concerned about increasing risks from new or expanded lines of business that are not properly thought through and controlled. Part of that control is making certain the institution is not **embarking on imprudent expansion or excessive growth without the needed management talent**. A fairly common problem, particularly with today's earnings pressures, and one that is clearly the responsibility of the Board, is a thrift growing beyond the competencies of existing management. If you're going to embark on new businesses, or change your scale, you must be ready to make changes. And if a change becomes necessary, don't lower your standards just to fill vacant positions or to accommodate someone within your organization. Decide on the skills necessary for the position and insist that the individual have them. Steady growth is vastly superior to spurts and jumps in volume. As you know, history is full of sorry tales of failures caused by unmanaged or mismanaged growth.

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

A Good Business Plan is Critical to Long-Term Profitability

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

A strategic vision of your institution;

Your most important communication tool;

A document to obtain the support of investors;

A tool for planning, measuring and improving performance;

A basis for sound decision-making; and

A way to motivate employees.

A reality check. The process of putting a business plan together, including the thought you put in before you begin to write it, forces you to take an objective, critical, unemotional look at your institution in its entirety. It will direct you toward lines of business that build on your strengths and serve the market you want to serve, and keep you away from those that may be trendy but aren't for you.

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

A message sender. The completed business plan communicates your institution's ideas and message to employees, fellow Directors, potential investors, and your community. A business plan helps you do that in an organized, credible manner.

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

A management development tool. Putting together your business plan will help you and your managers develop as managers because it can give you practice in thinking and figuring out problems about competitive conditions, promotional opportunities, and situations that are or may be beneficial or harmful to your institution.

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

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

Two New Tools

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

The reason for issuing these guides and, for that matter, holding this forum today is that over the past several years, turnover has been high among thrift directors because of the influx of new institutions, mergers and acquisitions, and retirements. Beyond those dynamics, however, we are seeing the impact of new delivery systems, such as the Internet, and other market and demographic influences that we can be sure will make tomorrow's thrift operations different from today's.

Our new guidance will assist you in fulfilling your role as Directors. So please read them and keep them handy as you carry out your duties.

We shouldn't end without a Y2K update. Thrifts, like banks and credit unions, are prepared. As of September 30, only 15 banks and thrifts in the entire country - out of more than 10,000 - were rated less-than-satisfactory. We, and our fellow bank regulators, are working closely with those 15, and we expect all of them to be up to snuff in the very near future. Your job now is to keep your institution ready, and to make absolutely certain your customers understand how well-prepared you are. Your institution will be receiving information from us in the next several weeks about the events of this final period, including the reporting we'll be expecting during the rollover weekend and the first week of January. Please take an interest in it, to make certain your institution will be doing "business as usual" come January 2000.