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THE CONDITION OF THE U.S. BANKING SYSTEM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE EXAMINATION OF ISSUES RELATED TO THE CONDITION OF THE UNITED STATES BANKING SYSTEM, INCLUDING THE EFFECTS OF THE SUGGESTED DETERIORATING BANK ASSET QUALITY, AND IMPROVED RISK MANAGEMENT AND CONTROL SYSTEMS NEEDED TO RESPOND TO CHANGING ECONOMIC EVENTS

JUNE 20, 2001

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THE CONDITION OF THE U.S. BANKING SYSTEM

WEDNESDAY, JUNE 20, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The Committee will come to order. I am very pleased to welcome this distinguished panel of witnesses before the Banking, Housing, and Urban Affairs Committee this morning: Alan Greenspan, the Chairman of the Federal Reserve Board; Jerry Hawke, the Comptroller of the Currency; Donna Tanoue, the Chair of the Federal Deposit Insurance Corporation; and Ellen Seidman, the Director of the Office of Thrift Supervision.

The purpose of today's hearing is to review the condition of the banking system of the United States. The witnesses have been asked to testify regarding the safety and soundness of the banking industry and its impact on the economy, as well as any potential problems they foresee facing the financial services industry.

It has always been a charge of this Committee to concern itself with the safety and soundness of the financial system, which is, after all, fundamental to the effective functioning of our economy. In fact, the safety and soundness of the American financial system has been one of the strengths of our economic system in comparison with many other countries around the world.

This hearing is not prompted by any triggering event or problem. Rather, it is our intention to have a practice of holding periodic oversight hearings on the state of the banking system. By making this a regular event, we would hope to elevate scrutiny of the system when times appear to be good and there may be a tendency toward complacency, as well as to diffuse potential alarm when a hearing is held at a time when problems may exist. We would hope that such periodic hearings would be a useful discipline on the system and perhaps serve as a stabilizing influence.

It appears that the past decade of economic growth has significantly strengthened the condition of the U.S. banking system. It is my own view that enactment by Congress of the Financial Institutions Reform, Recovery, and Enforcement Act, FIRREA, of 1989, in response to the thrift crisis, and the Federal Deposit Insurance Corporation Improvement Act (FDICIA), of 1991, in response to the

commercial banking problems of the late 1980's and early 1990's, made a contribution to that improved condition. The capital and regulatory standards put in place by those statutes helped the system to take advantage of the growing economy of the 1990's. The improved coordination of supervision by the regulators has made a substantial contribution and we are encouraged to see the increased coordination that is taking place amongst the regulators. We think that is a very positive development.

This morning, we will hear from the regulators that the banking industry is better situated today to withstand the softening of the economy than it has been in the past. Banks have a greater variety of products and more geographical diversification in their assets. They have higher earnings, more capital, better risk-management techniques, and higher asset quality than in the past. Nevertheless, problems do exist and there are some trend lines that I think are of some concern.

Asset quality has degraded over the past 2 years and loan loss provisions have increased substantially. Noninterest income of banks has been affected. And net interest margins have declined. The manufacturing sector has also been slowing down, which affects commercial loan quality. Mounting employee layoffs adversely affecting consumer loan quality. And consumers are more highly leveraged today than any other measured point.

The Committee will want to review all of these issues with the regulators this morning. Mainly, we want to get an assessment not only of how the system looks today, but also how it may look 6 months or a year from now. The consensus forecast is that economic growth will pick up in the third and fourth quarters of this year and resume at a faster pace next year. If this happens, one can assume it will have a beneficial impact on the banking system.

But we need to have some sense of how well equipped the system is to cope with a weak economy, as well as a growing economy. And we want the regulators to lay out for us not only how they see the landscape, but also any recommendations they have which would help to improve or ensure the safety and soundness of the financial system. So, I want to welcome our four distinguished witnesses.

I yield to the Ranking Member, Senator Gramm.

COMMENTS OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, first, let me thank you for this hearing. I cannot think of a more important issue for the Committee to concern itself with than oversight of the greatest banking and financial system in the history of the world.

We have gone through a slowdown and readjustment and, to some degree, to quote a famous oracle: "Seen the end of, irrational exuberance, in the equity market. Anything irrational ultimately has to come to an end."

I hope and believe that the American economy is still fundamentally sound. If the consensus projections are right, many of these indicators should be improving even as we have this meeting, but oversight is always a good thing.

I want to congratulate you, Mr. Chairman, on your leadership in this area. I want to thank our regulators, especially those who are leaving at the end of a tenure which I believe they can be proud

of. I look forward to hearing, them and from having an opportunity to ask questions. Thank you.

Chairman SARBANES. Very good. Thank you.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Mr. Chairman. I cannot think of a more appropriate hearing than to have this hearing today, taking a look at the four bank and thrift regulatory agencies under our jurisdiction on the condition of the U.S. banking system, as your first hearing as Chairman of the Banking Committee during this 107th Congress.

I want to thank the panel members for joining us today and Senator Gramm for his excellent leadership during the unusual course of events that have occurred the past year during this Congress.

Clearly, the banking industry is in overall excellent condition at this time. They have earned a record $19.9 billion during the first quarter, exceeding the previous record set in 2000. This year marks the eighth consecutive year in which banks earned a return on investment in excess of 1 percent. Prior to 1993, the industry never had an ROA in excess of 1 percent. So these have been remarkable times in many ways.

Nonetheless, there are points of concern during a time of economic slowdown where asset quality problems have worsened over the past 2 years and loan loss provisions have increased, margins have come down, in part because of more competition from a wide variety of bank and nonbank lenders. Loan losses have continued to rise and bank deposits have not increased as quickly as bank loans. I believe that the condition of the banking industry is indeed solid, in large measure due to the regulatory oversight of the individuals before the Committee today.

As the new Chairman of the Financial Institutions Subcommittee, I have a particular interest in the deposit insurance system. And I applaud Ms. Tanoue on her leadership at the FDIC and all that she has done there. I have appreciated their recommendations on FDIC's reform. It is difficult to argue with the FDIC's observation that the current system is in fact pro-cyclical. That is, in good times, most institutions pay nothing for insurance coverage. And in bad times, when they can least afford it, institutions potentially can be hit with huge premiums. At the same time, insured deposit limits have not kept pace with inflation. I am also concerned about significant inflows of insured deposits into the system and the impact that this has had on deposit reserves.

These are difficult issues. And I look forward to working with the regulators, industry groups, and consumers to develop a sensible, fair reform approach. I have had an opportunity now to engage in some discussion with Chairman Sarbanes and I look forward to the possibility of holding hearings in the Financial Institutions Subcommittee on the FDIC's reform proposal. We should be able to have a comprehensive deposit insurance bill put together in a bipartisan consensus fashion, hopefully after the July 4 recess.

So, again, Mr. Chairman, thank you for holding this hearing and I look forward to working with you and with Ranking Member Gramm closely on our agenda over the remainder of this year.

Chairman SARBANES. Thank you very much, Senator Johnson.

Senator Shelby.

COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

I want to thank you for calling this hearing. It is very important for this Committee to be holding a hearing on the condition of the banking system.

The banking system plays a crucial role in the development of the American economy. While I believe the market—the initiative and efforts of individuals and firms—provides the fundamental driving force behind the success and the strength of the American financial system, I recognize that we have adopted some regulatory safeguards from such market forces. These measures are intended to temper instability in the banking system that could have devastating effects on the overall economy.

This hearing, Mr. Chairman, provides us with an excellent opportunity to consider the performance of the regulatory framework that we have put in place. It is my hope that the Committee adopts a balanced approach today and closely considers both regulations that protect the integrity of the system, as well as those which are ineffective, overly burdensome, and weaken banking institutions.

I look forward to the testimony from today's witnesses and I commend you for calling the hearing, Mr. Chairman.

Chairman SARBANES. Thank you very much.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. Again, let me commend you and the Ranking Member for holding this hearing today. I think it is important to get an oversight of the status and the health of the banking system. And from your comments and my colleagues' comments, the system is generally healthy.

But it is a system that has been changing dramatically over the last several years—significant consolidations, blurring of lines between traditional financial institutions. This is a very appropriate time to make an assessment of the status, the health, and the future of the banking system.

It also gives us an opportunity to put in context specific issues that we will deal with as we go forward—continuation of discussions about financial privacy that began under the auspices of the Gramm–Leach–Bliley debate. As Senator Johnson indicated, discussions of comprehensive deposit insurance reform.

In addition, it will give us an opportunity to probe some of the comments that I hear back in Rhode Island that businesses find it harder to get credit, certainly small businesses, not in the context of the credit crunch of about a decade ago, but just simply the difficulty of working with these larger institutions. This is an important opportunity to examine the financial services industry and I thank you for your foresight in calling the hearing, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Reed.

Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I just want you to know that I think it is good that you are moving forward here with an oversight hearing on the condition of the banking system. As the previous Chairman and now Ranking Member of the Housing Subcommittee, I personally focused on safety and soundness of housing programs such as FHA and the government-sponsored enterprises. Obviously, I am enthusiastic to see us focus on the safety and soundness of the banking system.

I am a big believer in oversight. Each Congressional committee should take seriously its oversight responsibilities for the agencies under its jurisdiction. I look forward to hearing from each of the principal regulators of our banking systems.

I would just second the comments of my colleague from Texas, Senator Gramm, that we have the greatest banking system in the world. And I believe that America is better for it.

Thank you.

Chairman SARBANES. Thank you, Senator Allard.

Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and Ranking Member. I congratulate you both for very positive leadership in the whole process of dealing with the regulatory oversight function and the advancements that I think have occurred in the financial system in the last decade, including the recent legislation modernizing financial markets.

I also want to congratulate and welcome the regulators. I think that they have done an outstanding job in actually treading through waters that, in retrospect, look a lot calmer than they probably felt when you went through them. There were a number of shocks and dislocations that were more difficult to manage than I think may appear the case today.

Finally, I would just like to say that I think the balance that is struck between the private sector's participation, obvious participation, and the effectiveness of our regulatory structures has been a fundamental underpinning of that great sound banking system that is an important part of our economy and the growth of our economy through the years. This is one of those places where I think we have the balance just about right.

Chairman SARBANES. Senator Bunning.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I believe it is a very good idea to have the regulators periodically come before the Congress. Chairman Greenspan often comes up here and we can ask him questions about monetary policy, as well as the banking system questions.

Mr. Chairman, I would like to thank all of our witnesses for testifying today and I would like to thank you for holding this important hearing. But the other regulatory agencies do not get a chance to visit us as often. I believe it is important that we communicate. Sometimes we feel that regulations written do not accurately re-

flect our legislative efforts. I hope we can do a better job of communicating our intentions as you continue to advise us.

I do not think there is any debate that the safety and soundness of our banking system is of paramount importance. The system is working well, but we must remain vigilant to ensure its continued success. That success is critical, not only to ensure our Nation's financial stability, but also given the importance that our system holds in the financial world markets, it is even that more critical.

I thank you all for coming here today and I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Bunning.

Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. And let me thank our witnesses once again for appearing before us. We always enjoy hearing from them. They offer very valuable and worthwhile testimony. I thank you for being here.

I want to thank you, Mr. Chairman, for hosting today's hearing also with my other colleagues. I thank Phil Gramm for his leadership during his tenure on the Committee and look forward to Chairman Sarbanes' leadership of this Committee. I have had the privilege and pleasure of serving with you for some 20 years. I am delighted to call you Chairman of this Committee now after watching your wonderful work over the years.

I want to thank Donna Tanoue. A couple of years ago, Mr. Chairman, Donna came to Hartford, Connecticut and took a whole day to get there. It was terrible weather. In terms of just reassuring the folks up there, keeping that office functioning, as she made tremendous efforts to ensure the safety and soundness of our financial institutions. I am very grateful to you for the work you did during those years and for your visit to Hartford.

Mr. Chairman, yesterday we had a hearing in this very room, and some of my colleagues were here. I know Jon Corzine was and I think you were, Mr. Chairman, as well as John Robson, the new head of the Export-Import Bank, and Secretary Taylor of the Treasury. John Robson made a case that the risk levels, the risk profiles, for lending had improved significantly. That was the argument, and a number of our colleagues as a result of that, the budgetary request from the Administration was reduced for the Export-Import Bank by 25 percent, arguing that because risk assessments have improved, that we may not need as much budgetary authority to support lending. Some of us on the Committee found that a bit incongruous in light of some of the recent reports out of Asia and Latin America regarding instability, to put it mildly.

Based on the testimony that has been submitted, we will be hearing how our Nation's banking system, thrifts and financial holding companies, seem to be flourishing. I am not arguing with that testimony, and I have such high regard for all four of our witnesses, I do not question that at all. However, I remain a bit concerned. I hope I can hear this either in the testimony or in some of your question and answer period, what the potential impact that

global financial downturns could have on our domestic financial institutions.

I have listened to all of you at various times talk about the global economy and how we no longer can live in an isolated world where events in Asia, and Latin America do not impact our own financial institutions. In light of yesterday's testimony and today's, I hope we might get a chance to touch on that. And again, I thank all four of you for your fine work.

Thank you, Mr. Chairman.

Chairman SARBANES. Well, thank you very much.

We will now turn to the panel. Let me just say that you have all submitted to the Committee some very thoughtful statements and we are deeply appreciative of that. I think if we could hold it to about 10 minutes each in your presentation. I know a lot of work has gone in and we want to try to hear you out. On the other hand, we have limited time and Members want to ask their questions. If you can keep it under 10 minutes, the more the better, but I leave that to you. And then we will go to a question period.

Now, Ms. Seidman, I know you had a previous engagement and have to leave, I think, at about noon, and we understand that when the time comes. Chairman Greenspan, why don't we start with you and then we will move straight across the panel to Mr. Hawke, Chairman Tanoue, and Ms. Seidman.

STATEMENT OF ALAN GREENSPAN
CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Thank you, Mr. Chairman.

It is the first time I have appeared before you as Chairman in a long, long time.

Senator BUNNING. Mr. Greenspan, can you pull the mike up so that we can all hear you?

Chairman GREENSPAN. Is that better? Good.

Mr. Chairman and Members of the Committee, I am pleased to be here this morning to discuss the condition of the U.S. banking system. In my presentation today, I would like to raise just a few issues. I have attached an appendix in which the Federal Reserve Board staff provides far more detail relevant to the purpose of these hearings.

There are, I believe, two salient points to be made about the current state of the banking system. First, many of the traditional quantitative and qualitative indicators suggest that bank asset quality is deteriorating and that supervisors therefore need to be more sensitive to problems at individual banks, both currently and in the months ahead. Some of the credits that were made in earlier periods of optimism—especially syndicated loans—are now under pressure and examination. The softening economy and/or special circumstances have particularly affected borrowers in the retail, manufacturing, health care, and telecommunications industries. California utilities, as you know, have also been under particular pressure. All of these, and no doubt other problem areas that are not now foreseeable, require that both bank management and supervisors remain particularly alert to developments.

Second, we are fortunate that our banking system entered this period of weak economic performance in a strong position. After rebuilding capital and liquidity in the early 1990's, followed by several years of post-World War II record profits and very strong loan growth, our banks now have prudent capital and reserve positions. In addition, asset quality was quite good by historical standards before the deterioration began. Moreover, in the last decade, as I will discuss more fully in a moment, banks have improved their risk-management and control systems, which we believe may have both strengthened the resultant asset quality and shortened banks' response time to changing economic events. This potential for an improved reaction to cyclical weakness, and better risk-management, is being tested by the events of recent quarters and may well be tested further in coming quarters.

We can generalize from these recent events to understand a bit better some relevant patterns in banking, patterns that appear to be changing for the better. The recent weakening in loan quality bears some characteristics typical of traditional relationships of loans to the business cycle—the procyclicality of bank lending practices. The rapid increase in loans, though typical of a normal expansion of the economy, was unusual in that it was associated with more than a decade of uninterrupted economic growth.

As our economy expanded, business and household financing needs increased and projections of future outcomes turned increasingly optimistic. In such a context, the loan officers whose experience counsels that the vast majority of bad loans are made in the latter stages of a business expansion, have had the choice of: One, restraining lending, and presumably losing market share; or two, hoping for repayment of new loans before conditions turn adverse. Given the limited ability to foresee turning points, the competitive pressures led, as has usually been the case, to a deterioration of underlying loan quality as the peak in the economy approached.

Supervisors have had comparable problems. In a rising economy buffeted by competitive banking markets, it is difficult to evaluate the embedded risks in new loans or to be sure that adequate capital is being held. Even if correctly diagnosed, making that supervisory case to bank management can be difficult because, regrettably, incentives for loan officers and managers traditionally have rewarded loan growth, market share, and the profits that derive from booking interest income with, in retrospect, inadequate provisions for possible default. Moreover, credit-risk specialists at banks historically have had difficulty making their case about risk because of their inability to measure and quantify it. At the same time, with debt service current and market risk premiums cyclically low, coupled with the same inability to quantify and measure risk, supervisory criticisms of standards traditionally have been difficult to justify.

When the economy begins to slow and the quality of some booked loans deteriorates, as in the current cycle, loan standards belatedly tighten. New loan applications that earlier would have been judged creditworthy, especially since the applications are now being based on a more cautious economic outlook, are nonetheless rejected, when in retrospect it will doubtless be those loans that would have been the most profitable to the bank.

Such policies are demonstrably not in the best interests of banks' shareholders or the economy. They lead to an unnecessary degree of cyclical volatility in earnings and, as such, to a reduced long-term capitalized value of the bank. More importantly, such policies contribute to increased economic instability.

The last few years have had some of the traditional characteristics I have just described: the substantial easing of terms as the economy improved, the rapid expansion of the loan book, the deterioration of loan quality as the economy slowed, and the cumulative tightening of loan standards.

But this interval has had some interesting characteristics not observed in earlier expansions. First, in the mid-1990's, examiners began to focus on banks' risk-management systems and processes; at the same time, supervisors' observations about softening loan standards came both unusually early in the expansion and were taken more seriously than had often been the case. The turmoil in financial markets in 1998, associated with both the East Asian crisis and the Russian default, also focused bankers' attention on loan quality during the continued expansion in this country. And there was a further induced tightening of standards last year in response to early indications of deteriorating loan quality, months before aggregate growth slowed.

All of this might have been the result of idiosyncratic events from which generalizations should not be made. Perhaps. But at the same time another, more profound development of critical importance had begun: the creation at the larger, more sophisticated banks of an operational loan process with a more or less formal procedure for recognizing, pricing, and managing risk. In these emerging systems, loans are classified by risk, internal profit centers are charged for equity allocations by risk category, and risk adjustments are explicitly made.

In short, the formal measurement and quantification of risk has begun to occur and to be integrated into the loan-making process. This is a sea change—or at least the beginning of one. Formal risk-management systems are designed to reduce the potential for the unintended acceptance of risk and hence should reduce the procyclical behavior that has characterized banking history. But, again, the process has just begun.

The Federal banking agencies are trying to generalize and institutionalize this process in the current efforts to reform the Basel Capital Accord. When operational, near the middle of this decade, the revised accord, Basel II, promises to promote not only better risk-management over a wider group of banks but also less-intrusive supervision once the risk-management system is validated. It also promises less variability in loan policies over the cycle because of both bank and supervisory focus on formal techniques for managing risk.

In recent years, we have incorporated innovative ideas and accommodated significant change in banking and supervision. Institutions have more ways than ever to compete in providing financial services. Financial innovation has improved the measurement and the management of risk and holds substantial promise for much greater gains ahead.

Building on bank practice, we are in the process of improving both lending and supervisory policies that we trust will foster better risk-management; but these policies could also reduce the procyclical pattern of easing and tightening of bank lending and accordingly increase bank shareholder values and economic stability. It is not an easy road, Mr. Chairman, but it seems that we are well along it.

Thank you.

Chairman SARBANES. Very good. Thank you very much, Mr. Chairman. You are right on the money on the time, too. We appreciate that very much.

[Laughter.]

Mr. Hawke, we would be happy to hear from you.

STATEMENT OF JOHN D. HAWKE, JR.
COMPTROLLER OF THE CURRENCY
U.S. DEPARTMENT OF THE TREASURY

Mr. HAWKE. Thank you, Mr. Chairman, Senator Gramm, Members of the Committee. I appreciate this opportunity to discuss the condition of the banking system and welcome this hearing by the Committee.

If one were to take a snapshot of our banks today, it would show a system that evidences great strength. Capital and earnings are at very high levels by historical measure. Yet, if one were to look at a moving picture of the system spanning the past few years, it would disclose trends that cause concern. Let me elaborate.

The last decade has been a period of economic prosperity and strong growth in the banking sector. Commercial bank credit grew by over 5 percent per year during the 1990's. During this period of prosperity, most banks strengthened their financial positions and improved their risk-management practices.

As a result, the national banking system is in a much better position to bear the stresses of any economic slowdown. National banks are reporting strong earnings with a return on equity (ROE) for the first quarter of this year of 15.2 percent—a level considerably higher than the ROE of 11.5 percent prior to the last economic slowdown in 1990–1991. Fifty-five percent of banks reported earnings gains from a year ago. Asset quality for the national banking system is better. The ratio of noncurrent loans—that is, loans that are 90-plus days past due and in a nonaccrual status—to total loans is 1.3 percent, compared to 3.3 percent in the first quarter of 1990, the year marking the start of the last slowdown. And capital levels are at historical highs. As of the first quarter of 2001, the ratio of equity capital to assets was 8.9 percent, compared to 6.0 percent in the first quarter of 1990.

Greater diversification of income sources improved the quality of bank earnings during the 1990's. This diversification trend should improve the capacity of banks to weather difficult economic times and better manage the risks embedded in their operations. The trend away from reliance on traditional interest income is in part an active effort by banks to better manage risk. As a supervisor, we strongly support the efforts of national banks to diversify their revenue streams through financially related activities.

Banks have also made gains during these years in diversifying risks. Loan securitization has become a significant funding tool. Banks have broadened the geographic scope of their operations and increased the range of financial services they offer, providing them with a greater capacity to weather adverse economic developments. Advances in information technology along with more sophisticated risk measurement tools now provide bank managers with advanced risk-management tools that were unavailable a decade ago.

There are, however, trends that concern us, and banks cannot afford to be complacent about the risks that will continue to surface in the current economic environment, particularly in the areas of credit and liquidity.

While the level of loan losses is still relatively low, since 1997 the OCC has been concerned about a lowering of underwriting standards at many banks. This relaxation of standards stems from the competitive pressure to maintain earnings in the face of greater competition for high-quality credits, particularly from nonbank lenders. In some cases, banks' credit risk-management practices did not keep pace with changes in standards. We now are beginning to see the consequences of those market and operational strategies in a rising number of problem loans.

One area where this is most noticeable is in our annual review of Shared National Credits. In 1999 and 2000, adversely rated Shared National Credits increased 53 percent and 44 percent, respectively. In addition, the severity of classifications increased in both years. While this year's Shared National Credit review is not yet complete, we expect problem credits will rise further, reflecting the effects of prior lending excesses, a slowing economy, and improved risk recognition by bankers themselves.

And this emerging deterioration of credit quality is not just an issue for large banks. As corporate earnings have weakened, the spill-over effects on credit portfolios are beginning to show up in the smaller institutions.

Funding risk at banks is also increasing as households and small businesses reduce their holdings of commercial bank deposits. Banks have traditionally relied on consumers and small businesses in their communities as a major source of funding. With the rapid run-up in the stock market in the 1990's, however, and the widespread popularity of money market mutual funds, households and small businesses have increasingly shifted their savings and transaction accounts into pension funds, equities, and mutual funds.

Our job as bank supervisors is to maintain a sound banking system by encouraging banks to address problems early so that they can better weather economic downturns and are in a position to contribute effectively to economic recovery.

By acting early, in a measured and calibrated way, bank supervisors can moderate the severity of problems in the banking system that will inevitably arise when the economy weakens. By responding when we first detect weak banking practices, supervisors can avoid the need to take more stringent actions during times of economic weakness. We make our greatest contribution to a sound economy by working to preserve the ability of our banks to make creditworthy loans when the demand exists.

Since 1997 the OCC has implemented a series of increasingly firm regulatory responses to rising credit risks and weak lending and risk-management practices. These efforts, which are highlighted in my prepared statement, have focused on maintaining an open and candid dialog with the banking industry and our examiners about rising risk in the system and the need for improved risk-management by bankers.

National banks have responded positively to these initiatives. Bankers are adjusting both their risk selection and underwriting practices. Credit spreads are wider, recent credit transactions are better underwritten than they were as little as 12 months ago, and speculative grade and highly leveraged financing activity has slowed in both the bank and public credit markets. The OCC has also taken a number of steps, particularly examiner training and banker education, to address our concerns about increasing liquidity and funding risk.

We recognize that we need to ensure a balanced approach as economic conditions weaken. We have implemented, and will continue to follow, a careful but firm approach to addressing weak practices and increasing risks. In this regard, we are constantly mindful that the alternative approach of silent forbearance can allow problems to fester and deepen to the point where sound remedial action is no longer possible—a lesson that all bank supervisors learned painfully in the late 1980's and early 1990's.

If we learned anything from past economic crises both in the United States and overseas, we know that a sound banking system is essential to continued economic growth. I can assure you that the OCC will remain vigilant in our efforts to continually improve the risk-management of national banks and thereby contribute to a viable, healthy industry to support our economy.

Thank you, Mr. Chairman.

Chairman SARBANES. Well, thank you very much, Mr. Hawke.

Ms. Tanoue, let me say that I know that you have announced you will be stepping down I think on July 11 or 12. I want to join with the comments that were made by Senator Dodd and other expressions that you have received in thanking you very much for your distinguished service and your leadership at the FDIC over these now somewhat more than 3 years. We really appreciate the contributions that you have made. You have done real public service and we are all very grateful to you for it. We would be happy to hear your statement.

STATEMENT OF DONNA TANOUE, CHAIR

FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. TANOUE. Thank you very much.

Mr. Chairman, and Members of the Committee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the condition of the bank and thrift industries and the deposit insurance funds.

I am pleased to join with my colleagues here today to report that the banking and thrift industries continue to exhibit strong financial results. The two insurance funds reflect the favorable condition of the industry as well.

The most important message that I wish to leave with you today is that there are flaws in our deposit insurance system and they warrant your attention. The best time for constructive debate on changes to the deposit insurance system is now, during a period of financial health for the industry, rather than in the charged atmosphere of a crisis. Even in these good economic times, the Bank Insurance Fund has not been keeping pace with insured deposits. Consider this—the Bank Insurance Fund, or BIF, reserve ratio stood at 1.39 percent at year-end 1997. A combination of factors pushed it down to 1.35 percent by year-end 2000. And very rapid deposit growth has pushed the BIF reserve ratio even further down another three basis points, to 1.32 percent at the end of the first quarter of this year. The Savings Association Insurance Fund, or SAIF, has been more stable and stood at 1.43 percent of insured deposits at the end of the first quarter, the same as year-end 2000.

But we shouldn't assume that the current good times for the industry will last forever. We are already seeing signs of stress that indicate that continued strong industry performance will be much more difficult to achieve in the future. The signs of stress include shrinking net interest margins, increasing numbers of problem loans, and concentrations of higher risk loans as a percentage of capital. In addition, as highlighted in our testimony, the FDIC is keeping a close watch on certain subprime lending activities, developments in the agricultural sector, and the efforts of banks to address their funding needs. While all of these signs of stress are real, I do not want to overstate them. Depository institutions remain in a position of strength. And we should take advantage of this strength to reform the deposit insurance system now, instead of waiting until the industry weakens and the flaws in the system become more evident.

Our deposit insurance system has 2 primary flaws. First, 92 percent of the insured institutions in our country pay no premium for coverage—rendering the risk-based premium system ineffective, reducing the incentive for banks to avoid risks, providing incentives for rapid growth, and forcing safer institutions to subsidize riskier ones. Second, our current system could also have a harmful economic side effect, a procyclical bias, a tendency to make an economic downturn longer and deeper than it might otherwise be.

During a severe downturn, the current statutory framework would require that the FDIC charge banks high premiums, perhaps as high as 23 basis points, limiting the availability of credit to communities when they need it most and impeding economic recovery.

The FDIC essentially has put forward 5 recommendations, and I would like to go over them very briefly.

Recommendation one—the FDIC should be given the authority to charge all institutions premiums on the basis of risk, independent of the level of the deposit insurance fund. The FDIC, like other insurers, should price its product to reflect its risk of loss.

Recommendation two—the laws should be changed to eliminate sharp premium swings. If the fund falls below a target level, the law should allow premiums to increase gradually. Charging premiums more evenly over time, allowing the insurance fund to absorb some losses temporarily, and increasing premiums more

gradually than is required at present would soften the blow of an economic downturn.

Recommendation three—the FDIC should be given the authority to rebate portions of deposit insurance premiums based on past contributions to the fund, when the deposit insurance fund is above a specified target level. Tying rebates to the current assessment base would increase moral hazard. Fairness dictates that rebates should be based on past contributions to the fund. Allowing the FDIC to pay rebates would create a self-correcting mechanism to control the growth of the fund.

Recommendation four—the Bank Insurance Fund and the Savings Association Insurance Fund should be merged. The FDIC has recommended this for years, in large part because the resultant fund would be stronger and more diversified.

Recommendation five—deposit insurance coverage should be indexed for inflation so that deposits do not see the real value of their coverage erode over time. While the Congress should decide on the initial coverage level, indexing would provide a more systematic method of maintaining the real value of deposit insurance coverage.

I would like to thank you, Mr. Chairman, and all the Members of the Committee once again for the opportunity to testify today and to present the FDIC's reform proposals, and also for your very kind and supportive words. I hope that this Committee and the Congress, working with my successor, will be able to address these issues and bring about the needed reforms.

In closing, I also would like to thank my colleagues at the FDIC who produced the reform recommendations and so work so incredibly hard to ensure a safe and sound financial system for the American people. It has been a pleasure and a privilege to work with all of you and with them.

Thank you.

Chairman SARBANES. Thank you very much.

I might just note that the hearing on Donald Powell, who has been nominated by President Bush to become the Chairman of the FDIC, will be held here next Tuesday morning at 10 a.m. Once he has a chance to settle into his position and is part of the hearing process that Senator Johnson mentioned, I assume we will then have him back before us again to discuss in substance—we will get as much out of him as we can next Tuesday.

[Laughter.]

He is the new boy on the block, and I am sure we will have to give him a little time to settle in and then bring him back.

Ms. Seidman.

STATEMENT OF ELLEN SEIDMAN, DIRECTOR
OFFICE OF THRIFT SUPERVISION
U.S. DEPARTMENT OF THE TREASURY

Ms. SEIDMAN. Thank you.

Chairman Sarbanes and Members of the Committee, it is a pleasure to be with you today to bring you up-to-date on the state of the OTS-supervised thrift industry. It is a particular pleasure because the current state of the industry is in such stark contrast to its condition not very long ago.

As of the end of March 2001, OTS supervised 1,059 institutions, with $953 billion in assets. That is about 10.7 percent of all depository institutions and 12.5 percent of assets. And yet, in 2000, and again in 2001, thrifts originated over 20 percent of all one- to four-family mortgages made in the United States, including mortgages made by nondepository institutions. Over 48 percent of aggregate thrift assets are in whole one- to four-family loans. Ninety percent of all thrift institutions hold under a billion dollars in assets and 43 percent are smaller than $100 million. These are your community banks.

Almost 40 percent of the institutions are still in mutual form, although they hold only about 7 percent of industry assets. These institutions have a particularly strong community orientation, which I know many of you are personally familiar with.

During 2000, the industry earned $8 billion, a pace that continued in the first quarter of this year with earnings of $2.16 billion. Return on assets stood at 91 basis points for 2000, 92 basis points for the first quarter of this year, and has been over 90 basis points for the last 3 years, a feat not accomplished by this industry since the late 1950's.

Increasingly, earnings are coming from sources other than net interest margin. Whereas, in 1990, noninterest income as a percent of gross revenue was 5.1 percent, it was 12.4 percent at the end of 2000. Thrifts hold an increasing number of noninterest-bearing deposit accounts. That is, checking and other transaction accounts that provide both a relatively inexpensive funding source and a source of fees, and manage over $420 billion in trust assets compared to just under $14 billion just 5 years ago.

Equity capital stands at 8.1 percent of assets and 98 percent of the institutions are well capitalized. Asset quality, as would be expected in an industry heavily concentrated in one- to four-family mortgages, is extraordinarily good, with troubled assets at 0.6 percent of assets in the first quarter and charge-offs at 0.19 percent.

While there has been some increase in noncurrent loans, primarily in the 10 percent of thrift assets that consist of commercial, construction, and nonresidential mortgage loans, recently we have seen a decline in loans 30 to 89 days past due.

Moreover, good asset quality has been accompanied by a marked reduction in interest rate risk, which is the bane of the traditional thrift institution. As of the end of the first quarter, 73 percent of all thrifts were classified as low risk for interest rate sensitivity, 18 percent medium risk, and only 9 percent as high risk.

Since 1989, OTS has had in place a stress test based supervisory strategy for evaluating the interest rate risk of all institutions we regulate. As a result, both we and the institutions we supervise are able to quickly assess and deal with any increase in interest rate risk sensitivity, whether resulting from changing interest rates or from funding from noncore deposit sources, including Federal Home Loan Bank advances with embedded options.

The number of problem institutions, those with CAMELS ratings of 4 or 5, remains low at 14, with only 0.5 percent of industry assets. The number of institutions with CAMELS ratings of 3 showing some weakness, particularly weaknesses that have not been corrected as a result of prior exams, increased during 1999 and

2000, as was consistent across both the thrift and the banking industry, but has recently started to decline. And 91 percent of the 90 3-rate institutions are well capitalized, which means they have a capital cushion that will enable them to work out their difficulties in an orderly manner.

Supervision at OTS is the responsibility of our 5 regional offices. All of our examiners—safety and soundness, compliance, information technology, and trust—work out of the regions and are supervised by experienced regional directors. However, through two unique supervisory tools, OTS maintains consistency across the country and with agency policy, enhances interagency communications, and stays on top of developing events at high-risk or high-profile institutions.

Ten times each year, the most senior D.C. supervisory and legal staff, including me, get together with the 5 Regional Directors. We discuss current issues and problems, develop policies that are effective because they are developed by the people who will actually implement them, and resolve differences.

Our other unique supervisory tool is the regular use of videoconferencing between Washington and the regional offices to discuss high-risk or high-profile institutions. We do this 3 times a year for each region, a total of 15, 2 to 5 hour sessions, with each regional director and his senior staff and senior D.C. supervisory and legal staff, and cover well over a 100 institutions annually. We use these sessions primarily to make certain that supervisory strategies are effective and are being stepped up where problems linger.

We have also spent a good deal of time over the past 2 years working with the institutions we regulate to help them focus on long-term profitability. This is particularly important in the increasingly competitive financial services environment, where there is a tremendous temptation to reach for yield without proper planning, systems, monitoring, reserving or capitalization. This can lead not only to financial difficulties, but also to violations of laws designed to protect consumers.

During 1999 and 2000, we held 5 directors' forums, one in each region, in which we reached a total of 1,275 thrift directors. In these forums, we discussed the responsibilities of a director, including the responsibility for the institution's long-term strategic direction. This April, 450 thrift directors and CEO's joined about 50 OTS senior supervisory staff for a conference focused entirely on long-term profitability, in a world that is not only changing at a rapid pace, as evidenced by the 2000 census, but that has also gotten far more difficult for community banks.

The coming years will continue the challenges for both thrifts and OTS. As we discuss in more detail in the written testimony, issues such as the effective implementation of functional regulation, deposit insurance reform, and better aligning the thrift charter with the modern-day realities of thrifts' role as strong retail lenders and providers of retail services, will merit our attention, and yours, over the next period.

In summary, I am very pleased to report that both OTS and the institutions it supervises are strong and prepared to meet the challenges ahead. I will be happy to answer your questions.

Thank you.

Chairman SARBANES. Thank you very much.

We have been joined by Senator Bayh since we had the opening statements. Before we go to questions, Evan, did you have any comments?

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman. I will wait my turn. But I am grateful to our distinguished guests for appearing before us today and I appreciated their comments.

Chairman SARBANES. I am struck by the improvement that I think has taken place within the regulatory agencies in terms of putting oversight systems into place as you interact with the private sector, and also by the developments that are taking place in the private sector, to which Chairman Greenspan and others alluded. I just want to ask some very basic questions of the agencies.

You cannot function well if you do not have competent, expert staff. So, I want to address the staffing problem of your agencies. I want to make a few observations with questions and let you respond as you see proper in terms of your personnel.

First, there have been a number of stories and estimates that a large percentage of employees at key Federal agencies are going to retire soon. They are approaching eligibility for retirement, leaving the agencies with significant operational problems, as well as a loss of institutional knowledge and human capital. Do you know what percentage of your agency employees will be eligible to retire within the next 5 years? In your estimates, what percentage are likely to actually retire? And what, if anything, is being done to address this potential problem?

Second, a recent paper published in *The American Economic Review* said that the number of newly minted Ph.D's in economics who are American citizens might fall below 300 by the year 2005, in stark contrast to about 600 in the late 1980's and early 1990's. Senator Gramm's degree is assuming more and more of a scarcity value here.

Senator GRAMM. The good students are now foreign-born.

[Laughter.]

When Alan and I got out, the quality started down.

[Laughter.]

Chairman SARBANES. What steps are your agencies taking to assure their ability to recruit and retain economists who are qualified to understand the complex risk-management associated with modern financial institutions?

Third, we have received reports that some agencies have had persistent problems holding on to experienced examination staff. What are the causes of this brain drain and what steps are you taking to retain your expert personnel?

Finally, in recent years, the FDIC, the OCC, and the OTS have been reducing their staffing levels, as I understand it. How does this impact your agency? Do these reductions make sense in the face of increasing industry consolidation, resulting in ever larger and more complex financial institutions? Do these reductions make sense in the context of an economic slowdown with some of the problems that come with such a slowdown, to which you have alluded in your testimony? I would be interested in hearing from

each of you on this staffing question. Mr. Chairman, why don't we start with you?

Chairman GREENSPAN. I think there are 2 major forces in addition to the issue of the longevity question, which I think varies by organization.

One is the major shift, in fact, accelerated shift, toward high-tech type of evaluations within the banks of their loan portfolios; and second, the need for supervisors and regulators to obviously be fully conversant with the technologies that are involved and the conceptual issues that have arisen over the years in advanced risk-management.

There are remarkably few people out there who are really very well skilled in this area and they are obviously in high demand. We are fortunate in that we have a few and, in a certain sense, you only need a few, to understand what effectively is happening within the banks and what type of oversight is necessary with respect to the technologies that we confront.

I do not think we can out-compete, in a financial sense, the prices, the wage levels, the compensation, that a number of these people will get in the financial community, but we do find that there are enough dedicated people who wish to work within, for example, the Federal Reserve, and I presume in the other agencies, because the work is exceptionally interesting. It is an interesting, different type of supervision and regulation than we have had in decades past.

So, I do think there is a problem. I do not, at least from the point of view of the Fed, sense that we are in any way falling short in our capacity to keep up with the ever-increasing conceptual needs of supervision and regulation. But it is a never-ending task, and I would suspect that we have to keep up with it in a way which on occasion we may find ourselves falling behind the curve, but for the moment, the best way I can tell is I do not get a number of memoranda coming through my desk which indicate problem X, problem Y, problem Z. And that is usually a fairly good measure because, believe me, when we do have problems, my "in" box gets filled up.

Chairman SARBANES. Mr. Hawke.

Mr. HAWKE. Mr. Chairman, let me start by saying that I am constantly in awe of the quality and dedication of the people at the OCC. We really have an outstanding workforce that is tremendously dedicated. I think that is demonstrated by the fact that a great many of our senior people are well beyond the time when they could retire, and for the reasons that the Chairman was just explaining, stay with us and continue to make an enormous contribution.

The average experience of our examiners is 13 years. That means we have a substantial number of very experienced examiners. On the other side of that coin is that we also have a substantial number of examiners who have not lived through troubled times in the banking system.

Many of our examiners were not on board during the time of real stress in the system in the late 1980's and early 1990's. One of the things that we have been doing recently in the face of increasing problems with credit quality is training our examiners to under-

stand better how to identify and respond to risks of a sort that they have not seen before in the system.

We have made some reductions in the staff, largely to achieve efficiencies in the organization. We are exploring ways of using technology to increase the efficiency of our operation. We initiated a project that we call "Supervision In The 21st Century." We are running a pilot project with a number of banks now to see how we can use technology to decrease the amount of time that examiners have to spend on the road and increase the efficiency of the information flow to our examiners. So we are trying to make our operation more efficient and increase its effectiveness at the same time.

In terms of recruiting, which was another part of your question, we have increased our recruiting at college campuses. We are making a special effort to increase the diversity of the pool of candidates from which we draw examiners. That is something we consider to be very important.

Chairman SABARNES. Thank you.

Ms. Tanoue.

Ms. TANOUE. Mr. Chairman, you touched on a real challenge that exists at the FDIC. On the one hand, we have been trying over a number of years to reduce the workforce commensurate with the workload. On the other hand, we recognize that over the next 5 years, probably about 20 percent of the workforce will be eligible for retirement.

What we have been trying to do, as we downsize the workforce is to cross-train and provide additional development opportunities for people, say, that are in the liquidation area, that are not currently very busy, to train them in other areas that they might be ready to step up to. We have also kept an inventory of those people who do retire and their specific areas of expertise.

In terms of economists, we also have stepped up the recruiting. We recruit and interview at the American Economic Association's annual meetings and actually, this year's meeting in New Orleans was extremely successful.

In terms of the recruitment and retention of examiners, as the Comptroller mentioned, we too have increased our recruiting efforts and are trying to increase the diversity within our workforce. We have not encountered significant problems in terms of recruiting examiners.

In terms of retention, we have a concerted effort to make sure that our employees, whose talent and expertise is immeasurable, feel valued. I think that sometimes is more important than the levels of compensation, particularly in public service.

Chairman SARBANES. Thank you.

Ms. Seidman.

Ms. SEIDMAN. Thank you. I too want to emphasize the public service element of the situation. Currently, 30 percent of OTS employees are over age 50 and 12 percent are over 55. Those are some of our very best employees. Because of the pension system we have, they have been eligible for retirement actually for quite a while now. And yet, they are staying. And they stay because they believe in what we do and because we work very hard to make sure that they continue to improve and continue to increase their abilities.

When I first came to OTS, we had not hired in 7 years. Needless to say, with a workforce that had gotten older, that was not a long-term, stable situation. I immediately put into effect an examiner recruitment and training program, which has been quite successful over the course of the last several years. We have been able to add quite a number of examiners to our workforce, many of whom are second-career people.

We use a combination of classroom training and mentoring, so that we can take advantage of the skills, the knowledge and also, the experienced bank examiners' "sense of smell." Our more experienced examiners tell me, and I believe them, that they can walk into an institution and sense something is wrong pretty quickly. We are trying to impart that to the younger examiners. We have a professional development program that is available to all of our employees and that is extremely successful.

What we find, frankly, is the reason we lose examiners is the travel. It is a very hard life. And so, we have worked very hard to increase tele-commuting opportunities and to increase other opportunities for examiners to work closer to home or in their home, while simultaneously never losing sight of the fact that if you are not in an institution when you examine it, you are going to miss stuff. There has to be a balance there.

On the staffing reduction, yes, we have recently had a staffing reduction. It was done entirely in Washington. We have worked very hard to make certain that our staff in the field, from which all our exams are done, as I pointed out, has stayed strong and at full force.

We have done more and more work across regions. We had about 800 days of examiner time in 2000 where examiners worked out of region. And while that seems to contradict the concerns about travel and tele-commuting, it is a real opportunity for them to see different places, different ways things are done and to learn new things, and they value that also.

So this is not an easy question. It is one that we work enormously hard at and that, frankly, has been one of the things that I have worked hardest at since I have been at OTS. But it is an area that I think we have a good handle on.

Chairman SARBANES.Thank you. I have other questions. I will reserve them until the second round.

Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, let me thank you again for the hearing. Let me say that I do believe, and I am convinced, that there are a lot of dedicated people who want to work for the Government. I can hire people from MIT for $18,500 because it is cheaper than going to graduate school.

[Laughter.]

But the point is they are here to punch their ticket and they are going to be gone. I do think it is important to have a few people with gray hairs on their head around. We do have a pay problem and it begins on the Board of Governors of the Federal Reserve, not the Chairman, but members. I can personally say that people that I thought should be appointed to the Board have refused to be considered, in part, because of pay. I think we are very foolish in government when we are tight with paying people good salaries. I

would rather have fewer people that are better paid and more competent, than to have big agencies. I just wanted to throw that in.

I have two questions: one that I would like to ask you, Chairman Greenspan, and then one I would like to ask everybody.

I am concerned about the GE-Honeywell problem and the action by the European antitrust division to question the merger. Even though being domiciled for an international company is not as relevant as it once was, by traditional definitions, these are both American companies.

Maybe I am overreacting to that. As I am sure you are aware, Mr. Chairman, in April, the European Union proposed a financial conglomerate directive basically concerning financial conglomerates operating in Europe. They raised, at least in a formal sense maybe for the first time, the question about whether to accept the regulatory supervision and decisions of the home country regulators or whether to actually go behind that in exercising regulatory authority over the conglomerate if much of it is in another country, outside Europe.

Now, I understand that these are problems that we are going to have to come to grips with because the plain truth is there is no such thing as an American company any more. These are world companies. But I would like to get your thoughts about this and, particularly, any concerns you have about it.

Chairman GREENSPAN. Senator, I think we are dealing in this area with some of the very deep cultural values of differing countries. The issue of bankruptcy, for example, seems to be a technical one. We have, however, very great difficulty unifying international bankruptcy codes, largely because the view of debtor-creditor relationships is a deep-seated view of fundamental relationships in a society. And I can tell you the differences that we have run into in that particular regard are really quite surprising.

The same thing exists, as far as I can judge, in the antitrust area. In the United States, for example, our fundamental premise is the health—I should say, the advance—of consumer interests and that all focuses on enhancing competition, which is fundamentally the underlying rule of all American antitrust statutes. We do not, for example, particularly try to protect the competitors of individual firms who are involved in antitrust suits. Our focus is solely on the consumer.

That is not true in Europe. And it is not true in a lot of places, that there is a fundamental view about the nature of competition, in some cases, classified as cutthroat and therefore undermining the stability of the society and its values. Since it is increasingly very difficult to differentiate the nationality of individual conglomerates, I think somewhere down the line major antitrust jursdiction are going to have to reconcile their differences. But I do think that the issue you are raising is an important one and one which must be resolved if we are going to continue to get the benefits of globalization, which, in my judgment, are many.

Senator GRAMM. Well, I would just like to say, and I won't ask my second question because I have run out of time, but I am especially concerned about the action of the European Union because they have adopted a privacy policy that is unworkable, and as a result, they want to impose it on everybody else.

We can question the logic of their environmental policy and their regulatory policies. But my concern is that we do not end up having bad policies imposed on us as Europeans try to protect themselves against competition when they have lost their competitive edge based on their policies that they have implemented either through their super-national government or at the national level. This is something that we are going to have to look at very closely.

I thank you, Mr. Chairman.

Chairman SARBANES.Thank you, Senator Gramm.

Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman. I appreciate you raising the issue about staffing. I wear another hat in the Appropriations Committee and this is an issue of concern to me as well.

Chairman Tanoue of the FDIC, on April 5, made 5 recommendations which she again restated here today. That is, the merger of the bank insurance fund and SAIF, indexation of insurance coverage, changing the premiums on institutions' risk, risk-based premiums, shift from a designated reserve ratio of 1.25 to a target level, and a rebate based on historic contributions.

I would like to put the question to Chairman Greenspan and Comptroller Hawke and Director Seidman about the impact on the banking and thrift industries of implementing the FDIC's proposals for risk-based premiums, the merger of BIF and SAIF, and the raising of the insurance per-deposit account. And I wonder if you could just briefly share some thoughts with me on those three points in particular.

I have an 11:30 a.m. commitment that I cannot avoid and I may wind up leaving before all of the answers are made. But I want them on the record. And I appreciate the insights that you might be able to share with us.

Chairman Greenspan.

Chairman GREENSPAN. Senator, I think that Director Tanoue has raised some very thoughtful issues with respect to the question of deposit insurance and its impact on the economy. These are very important issue which we at the Federal Reserve Board have not considered as a board. I think it would be better that I address those issues in the context of speaking for the Board, which I cannot at the moment, rather than for myself. So if you would like an official response from us, I would be fairly glad to provide that in writing.

Chairman Greenspan official response:

You asked about the impact on banks and thrifts of the implementation of three FDIC proposals.

Risk-based premiums: The FDIC recommends that the current statute be amended to permit it to adopt a more flexible risk-based premium plan, with premiums based on a large number of variables that research suggests are related to the fund's exposure. We support that proposal.

A robust risk-based premium system would be technically difficult to design. However, the Board believes that the potential benefits are worth the effort. A tighter link between insurance premiums and risk exposure to the fund would, by affecting the ex ante behavior of banks and thrifts, reduce moral hazard and the distortions in resource allocation that accompany deposit insurance. Risk-based premiums would be another factor increasing the cost of risk taking and simulate what the private market would do to the cost of deposits if there were no deposit insurance.

However, to be effective in changing behavior and to reflect differences in risk exposure, the range in premiums would have to be significant. Capping risk-based premiums, say, as the FDIC suggests, at about 30 basis points, in order to avoid induc-

ing the failure of weak entities, would sharply reduce the benefit of the proposal. The Board believes that capping premiums may end up costing the insurance fund more in the long run should weak institutions fail anyway, with the delay increasing the ultimate cost of resolution. We would thus recommend that, if a cap is required, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking.

Merger of BIF and SAIF: We support the FDIC's proposal to merge the BIF and SAIF funds and believe that the public and both sets of depository institutions would be better off if this merger occurred. Because the charters and operations of banks and thrifts have become so similar, it makes no sense to continue the separate funds. The insurance products provided to the two sets of institutions are identical and thus the premiums should be, as they are today, identical as well. Under current arrangements, the premiums could differ significantly if one of the funds fell below the designated reserve ratio of 1.25 percent of insured deposits and the other fund did not. Merging the funds would also diversify their risks and reduce administrative expenses.

Per-deposit account insurance limit: The Board does not support the FDIC recommendation to index the current $100,000 ceiling on insured deposits.

We can see no evidence that depositors are disadvantaged by the current ceiling. Depositors who want more insured deposits are adept at opening multiple accounts, which is consistent with standard investment advice to diversify asset holdings. The trend for some time has been not only for households to diversify among deposit issuers, but also to diversify their holdings among different types of financial assets as attractive new market instruments have developed. There has been no break in that trend that seems related to any past change in insurance ceilings and it seems doubtful to us that the shift from deposits to equities that was so significant in the late 1990's would have been affected at all by a higher per account ceiling. Indeed, the weakness in equity markets in recent months has been marked by an increase in deposit flows to banks and thrifts.

Depositories do not seem to have had any significant problems raising funds under the current ceilings. Indeed, the smaller banks, which one might have expected to have the greatest difficulty, have had the most success. Adjusted for bank mergers, in the second half of the 1990's the smaller banks have grown more rapidly and—at over a 20 percent annual rate of growth—have increased their uninsured deposits at almost twice the rate of the largest banks. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits.

The Board has concluded that, with no evidence of harm to the public or to depositories, and with no evidence that indexing is needed now to stabilize the banking or financial system, there is no reason to expand the moral hazard of the safety net by indexing the insured deposit ceiling. There may come a time when the Board finds that households and businesses with modest resources are finding difficulty in placing their funds in safe vehicles and/or that there is reason to be concerned that the level of deposit coverage could endanger financial stability. Should either of those events occur, the Board would call our concerns to the attention of the Congress and support adjustments to the ceiling by indexing or other methods.

Senator JOHNSON. I understand your point of view on that, Mr. Chairman, and I would very much appreciate presenting this issue to the Board and—

Chairman GREENSPAN. I can answer the economic issues, but not without getting into the implications of where the Board may or may not come out with respect to her thoughtful recommendations.

Senator JOHNSON. Very good.

Mr. Hawke.

Mr. HAWKE. Senator, I am quite supportive of the idea of risk-based premiums. Of course, I sit on the FDIC Board and participate to some extent in the formulation of the FDIC's proposals. There are some points of difference that we have with the FDIC on some aspects of it, but I would say nothing fundamental.

On the question of deposit insurance coverage limits the jury is still out. It is not clear to me whether increasing deposit insurance coverage limits is going to have the effect that many community banks, in particular, hope it would have, which is bringing new deposits into the system. I am concerned that it may just result in

a shifting of deposits among banks as opposed to bringing new deposits into the system. I would have less concern about coverage limits in an environment of fully risk-related premiums.

One issue that is of major concern to us is the fee disparity between State and national banks, which we think should be addressed in the context of deposit insurance reform.

Right now, national banks pay essentially the full cost of their supervision. Yet, State banks pay only about 1/10 of the cost of their supervision. They pay for what the States provide, but they pay no share of the cost of their Federal supervision. In the case of State nonmember banks, that cost is taken out of the deposit insurance fund, between $500 and $600 million a year, which creates a significant inequity between State and national banks. We think this is an issue that needs to be addressed in the context of deposit insurance reform.

Senator JOHNSON. And Ms. Seidman.

Ms. SEIDMAN. Yes. Let me just say that I, as a Member of the FDIC Board, have also been enormously supportive of the efforts of Chairman Tanoue and the staff. It has been a process that I think has moved a very, very important issue to the front burner and focused us in on some of the major problems.

I believe that the issues of risk-based pricing and the procyclicality of the system are issues we need to deal with and we need to deal with them well and we need to deal with them reasonably quickly and we need to deal with them in a comprehensive fashion.

I have been in favor of merging the funds for as long as I have had an opinion on any of these subjects and my opinion certainly has not changed as the SAIF has increased above the BIF in its reserve ratio. The merger is the right thing to do. These 2 funds at this point insure exactly the same kinds of institutions. Two of the 5 largest institutions in the SAIF do not have a thrift in their corporate family.

In terms of raising the insurance limit, I am basically where the Comptroller is. I do think the jury is out. I think there is a real issue about whether this would just result in more money flowing into things other than community banks.

I think there is an issue about what we really believe deposit insurance is about, that is, a policy decision for the Congress to make. Finally, I think most importantly, unless we have true risk-based pricing, I do not think that issue should even be discussed.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you.

Senator Shelby.

Senator SHELBY. Thank you.

I want to follow up on the insurance. Would you discuss the risk of the merger of the funds versus the upside? What are the risks if you merge the funds? What are the risks out there? I do not see any.

Ms. TANOUE. There are none.

Senator SHELBY. There are no risks.

Ms. TANOUE. No. Simply put, a merger of the funds would result in a stronger, more diversified fund.

Senator SHELBY. Ms. Seidman.

Ms. SEIDMAN. Absolutely. There is no risk to not doing it and there are risks to leaving it the way it is.

Senator SHELBY. And the risks to leaving it the way it is.

Ms. SEIDMAN. There are essentially two risks to leaving it the way it is. One is that the funds are indeed less diversified than they would be if merged. Bank of America, for example, I think has something close to 9 percent of the BIF, and a significant portion of the SAIF. Even though it has a significant portion of the SAIF, combining the two would drop it down. Washington Mutual would come way, way down in terms of exposure. So with merger, the fund would have much less exposure to the largest institutions.

The second risk that is out there is, and as Chairman Tanoue has testified, that the BIF has been dropping in its reserve ratio at the same time the SAIF has been stable. If that trend continued, you could end up back where we were in 1995, although, of course, it would be reversed, and you would see a situation where institutions with BIF-insured deposits would be paying big premiums and institutions with SAIF-insured deposits would not be. That is a very bad situation.

Senator SHELBY. Do you want to add anything?

Ms. TANOUE. I agree. The greatest threat is the potential for premium disparity. And many members on this Committee are familiar with that experience.

Senator SHELBY. We have talked about this in this Committee for many, many years on other occasions. But most insurance that I have ever heard of is based on risk, is not it?

Ms. TANOUE. Absolutely.

Senator SHELBY. I mean, it is based on the underwriting of a risk, except to a certain degree, the FDIC.

Ms. TANOUE. That is a central recommendation that we put forward—to put into place a more effective risk-based pricing system for all insured institutions, all of whom present risk exposure to the fund.

Senator SHELBY. What is the current strength of the FDIC fund? Where do you stand today as far as the value of it? What is the size? Roughly.

Ms. TANOUE. The BIF balance is slightly in excess of $30 billion.

Senator SHELBY. Thirty billion dollars.

Ms. TANOUE. And SAIF balance is slightly in excess of $10. So something in excess of $40 billion combined.

Senator SHELBY. Do you think that is adequate reserves?

Ms. TANOUE. Well, the issue of what level the fund should be is a perennial one and a very important one. There really is no set answer to that question. It always involves a trade-off in terms of what level of risk you want to cover, what you feel is sufficient to protect taxpayers versus whether you want a fund to be growing and growing and growing, or whether you want some of those monies to be returned back to communities to be put to good use.

Senator SHELBY. You were both talking about upping the coverage limit on the Bank Insurance Fund. There are certain risks there, are there not? If you run the limits up from $100,000 to, say, $300,000, there could be risks to the taxpayer regarding that down the road, could there not?

Ms. TANOUE. Yes Senator, there is a concern about increased moral hazard.

Senator SHELBY. Absolutely.

Ms. TANOUE. And Ellen Seidman just made a very important point. That is, we believe very strongly that the issue of a coverage increase should not be considered in and of itself. The issue of risk-based pricing must be taken into consideration first before any kind of discussion of the coverage increase is considered.

Senator SHELBY. I agree with you.

Thank you, Mr. Chairman

Chairman SARBANES. Thank you, Senator Shelby.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

One of the reasons the financial system is so strong is that the economy has been strong in the last several years. But there are some potential developments. One is an ominously low household savings rate. And the second is with our tax policy now, we have lessened the surplus, which in a sense is public savings. Without savings, it is hard to form capital.

We are also beginning to see some deterioration of the robust productivity numbers of the last several years. All together, your view with respect to how the banking system is going to cope with what seems to be an inability for American households to save.

Chairman GREENSPAN. The problem of savings has been a major problem in this country for a very protracted period of time, Senator. And as you know, as a consequence of that, we effectively are borrowing a significant amount of savings from abroad, which is our current account deficit.

The reason it hasn't shown up as a significant economic problem is that we have really an extraordinary degree of productivity from our savings in the sense we have managed to use the limited amount of savings, in a very effective way, so that the type of capital which we are producing has tended to be the high productivity-producing capital.

So in part, because of our financial system and, indeed, our banking system in general, we have been able to direct the limited savings that we do have into the most effective uses. In that regard, one must look at the American banking system as a very major player in our ability to improve productivity over the years with, as you point out, quite a diminished level of domestic savings.

Part of that is the result of the fact that we have created a very flexible system and we are able to allocate resources in a most effective manner. Is that going to continue indefinitely in the future? For the moment, I would suspect, yes. But in the distant future, I think that remains to be seen.

Senator REED. I wonder, Mr. Hawke, Ms. Tanoue, Ms. Seidman, if you have a comment?

Mr. HAWKE. Senator Reed, one aspect of the problem that you have mentioned concerns us and that is the deterioration in the core deposit base of banks, particularly community banks. Our community banks tell us that loan demand remains strong, but their ability to raise traditional core deposits is declining. They are increasingly turning to other sources of liquidity, in particular, the Federal Home Loan Bank system. That has raised some concerns

of its own for us. But I think it is important that liquidity of community banks be considered and addressed. It is an important issue that we hear about everyday.

Senator REED. Chairman Tanoue.

Ms. TANOUE. Our testimony places a great emphasis on that point as well. But I would add that there is some evidence that liquidity pressures are easing. In the last two quarters, we have seen a tremendous in-flow of deposits. It would be very, very important to keep an eye on that and to see whether that is sort of a blip in terms of against a trend or whether it is a new trend.

Senator REED. Do you have any sort of indication what is causing this influx of deposits, initially?

Ms. TANOUE. Essentially, it is a return by consumers to safer havens for their money.

Senator REED. Ms. Seidman.

Ms. SEIDMAN. Our testimony also discusses the liquidity issue and I think it is a real one. We just put out a bulletin yesterday on managing liquidity risks. But I want to take a little different tact here.

We have all spent a lot of time over the last several years thinking about underserved communities and about the role of the banking system with respect to the underserved communities. Frankly, for a lot of the small community institutions, that is where their future is.

In many of those communities, savings are in the mattress. Money is in the cookie jar. I think it is really important for our bankers and, again, particularly community bankers, to be reaching out to those communities, not just to make one-off loans, but to bring those people fully into the financial services mainstream with deposit products and investment products, as well as loan products.

I noticed there was an article in today's *New York Times* about this. It is an issue that we have discussed with any number of our institutions. It is obviously not going to make the savings rate jump way up. But it could provide some greater stability to consumers toward the bottom of the economic spectrum.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bunning.

Senator BUNNING. Thank you.

My gosh, I had very few questions and now I have listened to everybody else's and I have lots more. Let me just start out with what Senator Gramm talked about in keeping good people. The Federal Reserve Board appointees have 14 year terms. Is that correct?

Chairman GREENSPAN. That is correct, Senator.

Senator BUNNING. That is almost as good as a Federal district judge. It just depends on what age you are appointed.

[Laughter.]

Those funds that we are paying that 14 year term to are substantial. So, I disagree with Senator Gramm. I think we are paying our people adequately, like we do pay our Federal district judges and our appellate judges.

I want to ask you the question I always ask you, Chairman Greenspan, about inflation. Any new or striking points of inflation in the current economy and/or close future economy you forsee?

Chairman GREENSPAN. It is very difficult to see anything short-term, Senator. We do know that as the rate of growth has slowed down, unit labor costs have gone up as they invariably do in such a period. But we have seen no evidence that those costs are being passed through into final prices in any material way.

Similarly, we see a fairly extraordinary increase in energy costs. And here again, separating corporations into nonenergy, nonfinancial, we have tried to trace the movement of energy costs into prices. We find that almost all does not go into final goods prices, but is squeezing profit margins, which is the same thing as unit labor cost.

Our best measures of consumer inflation are the personal consumption expenditure deflators which the Department of Commerce produces. And here, the so-called core inflation index, that is, total consumer inflation, less what we perceive to be the volatile parts of food and energy, that so-called core inflation has been relatively stable and shown no evidence of it.

But having said that, I would suggest to you, as I always do say, that we have to be very careful about any evidences of emerging inflationary instability because history has told us time and time again that the most effectively productive economies are those with stable prices. And we certainly hope to be able to see sufficiently far in advance to fend off any emergence of inflationary forces.

Senator BUNNING. Chairman Tanoue, you think that there should be an increase, or at least that was one of your recommendations to increase the amount of insured deposit. Did I misinterpret that?

Ms. TANOUE. Actually, the FDIC has never taken a position in terms of making a recommendation in terms of increasing the coverage level. What we have recommended is that wherever the Congress chooses to set that initial base level, we have recommended that the level be indexed to inflation to maintain the real value.

Senator BUNNING. I know the Chairman did not want to answer that because he has personally answered it before. He disagrees that we should move from the $100,000 deposit insured savings accounts. And I understand it is not a position of the Fed, but it is a personal position, that you did not want to get into that.

Chairman GREENSPAN. I think when the issue is put on the table as potential legislation, which in effect that is what is involved here, it should be the opinion not of the Chairman but the opinion of the Board of Governors.

Senator BUNNING. Okay. The BIF and SAIF funds, and I want to follow up on my good friend, Senator Shelby—if there is no risk, why in the world aren't we doing it?

Ms. TANOUE. That is a good question. I think, and many people have advocated, that the merger of the funds occur. But usually what happens, I think as a practical matter, is that other issues are tied with the issue of the fund merger. But, really, that is an essential change and it should be done.

Senator BUNNING. But, I mean, are the community bankers, are the larger bankers—who is stopping it? Because if it is the right

thing to do, there has to be some opponents out there that are stopping it.

Ms. TANOUE. Generally, there are many issues relating to deposit insurance reform, many of which are very complex. This is an issue that is probably best taken up within a comprehensive approach to these issues, and this is what we have recommended.

Senator BUNNING. Thank you very much.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Bunning.

Senator Corzine.

Senator CORZINE. Yes. I think the BIF/SAIF combination begs a question about whether there are greater efficiencies or certainties to regulation that might come from a more broad-based combination, particularly given the increasing concentration of assets that might be in the thrift industry and that $950 billion. One could at least ask that question. I would love to hear comments on that.

But the main question I would like to hear is, some view about the interconnectedness, the systemic exposures that you all have mentioned in testimony, but it hasn't been followed up with regard to syndicated loans, particularly I think in light of nonfinancial institutions increasingly involved in the lending process.

I think that was what Ranking Member Gramm was talking about a little bit with respect to the GE and Honeywell merger. But it is a problem that is of concern in New Jersey with one of our telecommunications companies and I think with Nortel as well.

I know that derivative risk is interconnected and systemic of nature and has a credit element. I am concerned that these kinds of things do not show up until you have one problem that then cascades. And I am concerned that we are not focused as much on this, at least in this discussion today, as I might be if one were worried about the deterioration of credit quality in a system basis.

I guess you could take that to some of the global, sovereign institutions with what one might be concerned about in Argentina or Turkey. I would love for anyone to comment on both the general status of this. But how is the regulatory structure or do you feel that we are adequately able to track those interconnected points better than maybe we were at another point in time?

Chairman SARBANES. I think that is a very good question and it is part of what we were trying to get at with this oversight hearing. In other words, to start probing and looking ahead to get some sense of things that are happening that may be new in terms of appearing on the scene, what their implications are, and how the regulatory system deals with it.

Mr. HAWKE. Senator, I mentioned in my testimony the Shared National Credit process, which is one of the principal mechanisms the bank supervisors have for looking for the kinds of credit exposure that you have described. In the Shared National Credit process, we look at the syndicated credits of over $20 million in size, and we have a very large number of those credits this year. We do it jointly with the Federal Reserve and the FDIC, so we all participate in looking at the same credits. And we are trying very hard to make sure that we are approaching them in a uniform way. But in that process, we get well educated about where sectoral risks are and how banks are handling these large credits. That process for

this year has not run its course yet, and we are awaiting the outcome of this year's analysis.

Senator CORZINE. Do you also look at derivative credit exposures in that process or mostly at the—

Mr. HAWKE. Not in the Shared National Credit process as such, but we just put out a report this week on derivative activities at our banks. The notional amount of derivative activity has increased, but that really doesn't reflect what the risk is in the area of derivatives. Rather, it reflects the level of business activity.

Derivative activity is focused in a very small number of very large banks. We and the Federal Reserve, I am sure, watch that very carefully in the banks that we supervise. We have a core group of experts who work with those banks. At the present time, we do not have any great cause for alarm in that area.

Senator CORZINE. Any of the other panelists like to comment?

Ms. SEIDMAN. I would just like to comment that while the items that you have been talking about are very important for the larger institutions, I think for the mid-size and smaller institutions, the biggest risk that we see is this problem of reaching for yield in an ultra-competitive world and moving from one line of business for the day to another, never quite really doing any of it well. And usually, we are able to get in there on time and put a stop to it before people get over-extended. But every once in a while, it moves very fast and then it gets very hard to do.

Senator CORZINE. Could I ask you to comment maybe on the first question?

Ms. SEIDMAN. On the first question? Okay. First of all, in the thrift industry, the increasing concentration has in fact diversified geographic risk, which is probably the greatest risk for mortgage lenders. So, I do not think that it has made the industry more risky.

In terms of consolidation, Gramm–Leach–Bliley was able to get through after all those years because in many ways the regulatory issue was not tackled. We now have a regulatory systems in the financial services industry where the insurance commissioners, the securities commissioners, the banking regulators, not only us, but also all 50 of them in the States, the SEC, are all intimately related.

We are working very hard, all of us, to make this system work. For example, OTS has information-sharing agreements with 45 of the State insurance commissioners. But it is a difficult system.

My personal opinion is that sometime in the course of the next decade, it will be up to Congress to face up to those difficulties.

Senator CORZINE. Thank you.

Chairman SARBANES. Senator Bayh and then Senator Miller, and then Senator Schumer. Let me say that Ellen Seidman is going to have to leave shortly. So if either of you have questions specifically directed to her, you probably ought to take that question now. But if not, Senator Bayh, why do not you go ahead.

Senator BAYH. I hope you will not be offended, Ellen, if the answer is no.

Ms. SEIDMAN. It is quite all right. I know that the Chairman is the really big draw here.

Senator BAYH. Mr. Chairman, I would like to thank you for holding this hearing. One of our comparative advantages economically as a country is our deep and broad and secure financial markets, particularly our banking system. And we neglect the stability at our peril. So I think this hearing is very appropriate and timely.

I hope the other panelists won't be offended if I address three brief questions to Chairman Greenspan building on something that Senator Reed mentioned.

There was a recent analysis done by Goldman Sachs suggesting that because of what they predict to be a decline in capital investment, the productivity growth rates may average 4/10 of 1 percent less over the next decade than had been previously forecast. It was their analysis that this would translate into a $1.1 trillion reduction in the anticipated surplus.

My understanding of the historic patterns of productivity growth trends is that we have occasionally seen accelerating productivity growth that we experienced over the last several years. But that, invariably, it regresses to some sort of mean. I am interested in your view on productivity growth going forward and, in particular, Mr. Chairman, what this means for the projected budget surplus.

Chairman GREENSPAN. The current services budget surplus has essentially been based on a 2½ percent productivity increase annually. The Goldman Sachs analysis brought it down to 2¼ percent, as I recall. They were coming originally from 2¾ percent. Those are disputable calculations. I will say that there is not—

Senator BAYH. Would Senator Corzine agree with that?

[Laughter.]

Chairman GREENSPAN. I was purposely directing it at you, Senator not your colleague on the right.

Senator BAYH. I appreciate that, Mr. Chairman. Thank you.

[Laughter.]

Chairman GREENSPAN. Besides, Senator Corzine is no longer interested in that.

Senator BAYH. This is true.

[Laughter.]

Chairman GREENSPAN. I was about to say, however, there are very legitimate questions with respect to how one comes at these types of forecasts, and it was a fairly sophisticated approach and I read it very closely. But you have to remember that we economists go by issues rather quickly and sometimes when you dig a little deeper, there are some open questions. So just to say specifically that, in my judgment, I do not think we are down that far. In other words, I would not agree with the conclusion.

The issue of translating the change in productivity growth into the surplus is relatively straightforward. But remember, we are talking about current services budgets here. These are the only adjustment to what is under current law a presumption that discretionary expenditures go up with the cost of living, a scarcely overliberal interpretation of what usually happens to these data.

So, I do not see any fundamental, long-term changes. In other words, I do think that when a 2½ percent productivity growth estimate came out, a lot of people thought it was overly conservative. What one may readily argue at this stage is that it is less conservative than it was at the time that it was done. But I do not see

anything in the data, per se, at this particular point which should lead one to make any major revisions in the current services surplus. Obviously, as the Congress moves forward on taxes and on the expenditure side, you shift to actual budget surpluses which are clearly going to be less than the current services number.

Senator BAYH. Well, I am encouraged to hear your comments about productivity estimates. My concern had been with the low rate of personal savings combined with some of the recent tax actions taken by the Federal Government that our margin for error, the buffer that we had in this country with the size of the surpluses, had been reduced. And if you combine that with uncertainty and productivity growth, then perhaps we would then have a fiscal problem somewhere down the line. The desire to take some of the risk out of the projections through triggers and things of that sort. But that is a debate that we have had and we have moved on.

I would like to ask one other question before my time expires. The robust growth in the U.S. economy has provided a buffer for the rest of the world against such things as financial contagion from Third World problems, long-term capital problems, things of that nature. I would be interested in your view, with the slowing of the U.S. economy, how much is the vulnerability of the global economy increased to some of these external shocks?

Chairman GREENSPAN. Senator, that is a very good question which we have been focusing on for quite a while. One of the problems that we have is that when you actually take correlations of growth relationships—in other words, for example, between the United States and Europe—we find a much higher synchronization of the growth rates in Europe and the United States than our very elaborate macromodels can generate. Meaning that we can incorporate the trade accounts, we can incorporate the financial flows, and a number of things which are quite visible to us. And we put them together, try to get evaluations of how they all affect the United States and Europe, and then simulate various results from which we can get a correlation between the growth rates, essentially what is reflected in our models of the individual countries.

But when we look at what actually happens, the correlation is much higher, which is another way of saying, we do not yet fully understand all of the elements in the international arena which are affecting individual countries. So whatever it is that we think is happening, it tends to have a significantly larger impact on our trading partners and what is happening amongst our trading partners has a greater effect on the United States than we can readily understand directly, which leads us to be, obviously, quite sensitive to what we see going on abroad. And indeed, we have put a great deal of effort in trying to understand that in a way which we did not 20 years ago when those relationships did not exist at the levels they exist today.

Senator BAYH. Thank you, Mr. Chairman. Thank you to the rest of the panel.

Chairman SARBANES. Chuck, Chris was here at the outset and for quite a while and went away. So, I will recognize him now, and then you.

Senator DODD. Thank you. Let me thank my colleague from New York, too. I will be brief. Secretary Powell is testifying one floor

below you, so we are going back and forth here and juggling and I apologize coming in and out of the room like this.

I would like to turn the attention of all four of you to an issue that I gather has not been raised in my absence, one that I find very, very troubling and has recently come up in the context of the bankruptcy bill debate, certainly in the Senate. I do not believe the issue came up in the House, although it may have. And that is, according to credit card issuers, of course, bankruptcy reform is needed because far too many people are defaulting on their credit card debts. As a result of these defaults, obviously card issuers pass these costs on to other credit card users, thereby raising fees and rates. Credit card issuers have been extraordinarily persuasive, I might add, in both the House and the Senate when coming to this bankruptcy bill in terms of what is included. There has been very little discussion, other than some amendments that were raised, about the underwriting practices, when it comes to the issuers of unsecured debt. And so, I would like to address your attention to that issue, if I could.

I am told that under the present economic conditions in the country and the slight downturn, there were reports this morning, in fact, the national news media, that as many as 1.5 million Americans could end up taking the Bankruptcy Act this year alone. And about a third of those will be people between the ages of their 20's and 30's. In fact, an increase. Five years ago, the American Banking Institute indicated that personal bankruptcies were filed by only 1 percent of those people under the age of 25. In 1998, the latest numbers I have, that number is up to 5 percent. I do not know what the latest numbers are, but it seems to me they are probably moving up from what they were.

I recently offered some legislation in the context of the bankruptcy bill that would say that for people who are under the age of 21, that you would have to demonstrate, one, an independent means of paying your debts or obligations, two, have someone cosign for you, or, third—any one of these three, not all three, but any one of these three—or proof that the applicant had completed a certified credit counseling course, some way of at least raising the level, raising the bar a bit.

Many of you in the past I know have taken the position that loans made without consideration of an individual's ability to pay constitutes unsafe and unsound business practices. So, my questions are for you, one, are the credit card loans made solely on the basis of a student ID and a signature? And that is what the case is. I am not exaggerating this. Merely signing a card and showing your student ID on a college campus will get you a credit card.

I am told by colleges around the country that you are looking at as many as 50 credit card applications arriving at freshmen's doors at college. The debt now is going up near $3,000, almost $3,000 per child. They are children in many cases here. There is little or no responsibility being exercised by the credit card companies, in my view. And so I am very worried that this matter is going to get further out of hand and add to further financial burdens of some of the most vulnerable people as they have tremendous costs obviously associated with higher education.

I am not suggesting any caps on fees or fixing interest rates and the like. But it seems to me that there is a commensurate responsibility, not only of the consumer, but also of the credit card issuer when it comes to this ever rising consumer debt question.

I wonder if you might comment on the wisdom that the credit card companies are engaging in, whether or not this is unsafe or unsound to be issuing credit cards to people merely on a student ID identification and a signature, whether or not the three criteria that I have mentioned you think raise too high a bar for the credit card issuers to me. And I would appreciate your responses. Mr. Chairman, can we start with you?

Chairman GREENSPAN. Jerry Hawke, I am sure knows more about this than I, since he regulates a lot of these people. But that gives me a wide open avenue to say irresponsible things, maybe.

Mr. HAWKE. I know more about it because my son is one of the recipients of those solicitations, and I happen to know a lot about his capacity to pay.

Chairman SARBANES. That is the way to be a fast learner on that issue, that is for sure.

[Laughter.]

Senator DODD. And we have had some very tragic stories, by the way. At campuses that offer, by the way, who receive thousands and thousands of dollars for exclusivity contracts on college campuses. Every now and then we introduce bills and we hear from constituent groups. This recieved relatively minor attention. I cannot tell you the number of people I have heard from around the country who agree that this is something—from parents, primarily.

Chairman SARBANES. Go ahead.

Mr. HAWKE. I think practices vary, Senator, among companies. I had the occasion just a few weeks ago to visit one of our very largest credit card banks. And, unlike some others, they underwrite every applicant individually. They have a battery of people who make traditional kinds of credit underwriting decisions on a case-by-case basis.

With others, it is much more a commoditized product. It is done with credit-scoring on a much more mechanical basis. They factor in loss rates and, as you pointed out, that all gets included in the pricing.

There is one point that you made that I think is enormously important, particularly in the context of a subject that we have not talked about this morning: predatory lending. That is the lack of underwriting and the extension of credit without any consideration of a borrower's ability to repay. I think that that is what lies at the heart of what we would generally refer to as predatory lending. It is a situation in which lenders—and these are not, for the most part, credit card lenders, but other types of lenders, and for the most part, nonregulated entities—target the equity that people have built up in their homes, for example, and push credit out to them for the purpose of trying to recover large fees ultimately from the equity in their homes.

We have been putting great emphasis on the need to follow traditional bank underwriting in all kinds of credit-granting, that is, to assure that the applicant for credit has the capacity to service and pay off the loan from conventional resources without looking to the

collateral that might be pledged as the source of recovery. I feel confident that if we can get that principle well established and well implemented, it will go a long way to dealing with the subject of predatory lending.

Senator DODD. Do you think the criteria we placed is an undue burden or too high a bar to require a credit counseling course for someone that young an age might be required to take? Is that too heavy a burden?

Mr. HAWKE. I would be hesitant to express a view on that because I am not entirely sure what—

Senator DODD. If we cannot get your view, whose view do I get? You are the people who are going to be responsible for this sort of a thing. If we are going to make the case, who do I rely on if I cannot rely on you folks to give me an answer to this?

Mr. HAWKE. I think part of the answer to the problem of predatory lending and other kinds of lending that involve an extension of credit to people who really cannot afford it is credit counseling. Financial literacy is an enormously important subject and one that is worthy of a lot of attention because the lack of financial literacy lies at the heart of many abusive practices.

Senator DODD. These numbers, going from 30 percent of all bankruptcies taken by people in their 20's and 30's, starting out in life with bankruptcy?

Mr. HAWKE. I think that is staggering.

Senator DODD. And the number is going from 1 to 5 percent. Isn't that worrisome, if kids under 25, 5 percent of bankruptcies? I find that jump rather alarming, do not you?

Mr. HAWKE. I do, yes.

Ms. TANOUE. Senator Dodd, I would just add some context in terms of credit cards. Personal bankruptcies obviously have a direct impact on credit card losses. For the last 2 years, personal bankruptcies and credit card losses have been trending downward. But for the first quarter of this year, there actually is an uptick in personal bankruptcies.

Senator DODD. Right.

Ms. TANOUE. Possibly in anticipation of some of the tighter rules that you are talking about. But any weakening in the economy might be likely to result in more bankruptcies and thus, rising losses in credit card loans.

I would also like to mention that, in terms of some of the predatory practices, I can think of at least one very, very serious case that we are dealing with where a credit card issuer is engaging in certain types of practices, certain types of disclosure practices and sales practices, that are very much on the margin.

And we are looking very hard at what the appropriate enforcement measures might be with respect to some of the standards that have been set under the FTC Act and with respect to regulations currently under the banking regulators' jurisdiction.

Senator DODD. Ms. Seidman, do you have something to add?

Ms. SEIDMAN. Well, first of all, I am the mother of a 17 year old, so this is, as with the Comptroller, a very intimate subject right now. I think that the issue that you have raised with respect to the standards is interesting and important, and I want to comment on

the third one, which is the credit counseling standard. I think the Comptroller is right not to just say, yes, and here is my reason.

As you know, in connection with homeownership for lower income families, many, many of the institutions and particularly, Fannie Mae and Freddie Mac, have been requiring credit counseling to get one of the low downpayment loans.

Last year, Freddie Mac did a study that indicated that a lot of what is called counseling is completely, totally and utterly useless. In contrast, some types of counseling, particularly the kind done one-on-one by the nonprofits, really do seem to have a real impact.

So, I am a little bit concerned about that third prong. Without some standards for what you mean by credit counseling, you are not going to have much of a result.

Senator DODD. If I dropped the third one, then—

Ms. SEIDMAN. No, no. The problem is you have to improve the third one, not drop it.

Senator DODD. It is a choice. You do not have to do all three. You could have it cosigned by someone else or demonstrate the ability to pay.

Ms. SEIDMAN. I hear you.

Senator DODD. That sounds like an outrageous request to me, that an institution is lending you, in effect, money with a credit line of $3,000, $4,000, $5,000, $7,000, and you need nothing but your signature and a student ID. Now, come on. This is outrageous.

Ms. SEIDMAN. I understand. I also think it is terribly outrageous that the universities are not only allowing this situation, but also participating in it. And I think there are a lot of places where we have to get after this.

Senator DODD. But I do not hear—it is kind of silent. And I am looking to you folks to say something. We offer amendments, but it always helps to have folks who are out there dealing with these institutions to speak out on this stuff.

Ms. SEIDMAN. Right. And I think we have given you our opinion. I would just say that that third prong is I think an issue.

Senator DODD. I understand that. I thought I was making it relatively innocuous, in a sense. I am trying to do something that requires something other than just your signature and showing an ID to get $5,000 worth of credit.

Ms. SEIDMAN. Longer-term financial literacy training is the critical piece, to get that into the schools.

Chairman SARBANES. But this problem is growing. I think the Fed this morning had some release about the percent of disposable income now that is constituted in debt service payments. It is up to 14 percent, as I recall the figure.

Chairman GREENSPAN. That is correct, Senator.

Chairman SARBANES. The average credit card debt per household, the *Chicago Sun-Times* reported, has grown over $8,000, three-fold in the past decade.

Senator DODD. They are kids.

Ms. SEIDMAN. They are kids.

Senator DODD. And we are looking for some guidance and help. We went through two bills and I heard nothing from regulators about the wisdom of putting some brakes on this thing here.

Ms. SEIDMAN. Senator, let me get back to you on this one.

Chairman SARBANES. Good.

Senator Schumer.

COMMENTS OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you.

Just one thing I would suggest about this at least to think about, is the same kind of rule that brokers have—a suitability rule be implemented for all kinds of loans, the student loans as well as the mortgages and all of that kind of thing, which would make some sense without nailing down what specifically had to be done.

I think a suitability rule works, at least in the securities industry, and maybe should be applied to loans as well. And it is something to think about. I would like to address the first question to Chairman Greenspan.

The question I most get asked, which of course relates to the health of financial industries, and that is, it seems that the reed—some would say thin reed. I am not sure that is right—that our economy is hanging on right now is consumer confidence, which, with all the buffeting that is gone on, has stayed at a reasonably decent level.

The question I have, the question that I get asked more than any other, is, given the fact that layoffs have increased and accelerated over the last period of time, and people read about those and worry about those when they reach a certain level, how in general historically have layoffs affected consumer confidence? How direct a correlation is there?

And second, does the present acceleration of layoffs or the recent acceleration of layoffs make one worry about consumer confidence levels, that even if the economy stayed where it is, that consumer confidence would decline with those layoffs and then cause the economy to go down further?

Chairman GREENSPAN. Senator, most of the major estimates of consumer confidence, the proxies for actual psychological consumer confidence, if I can put it that way, employ some sort of measure of what either is the expected unemployment rate at some future point or whether you yourself or members of your family are likely to be laid off. And there is even one sophisticated one: what is the probability that you will be laid off? So, they actually embody that specific notion within their statistical measure.

There is no question that the issue of layoffs has to be a factor in determining the propensity of people to spend money to make a number of commitments which require the maintenance of an income.

So the answer I would give to you is that, yes, layoffs do tend to impact on consumer confidence. We have had a significant pickup in initial claims on insured unemployment, which is the broadest measure that we have on layoffs. It is doubtless impacting to a certain extent on consumer confidence, at least in the proxies that are effectively employed using that. But we have not yet seen any serious deterioration in the actions that people take.

Senator SCHUMER. Right.

Chairman GREENSPAN. And what you have to argue is that the ultimate measure of consumer confidence is not the statistical calculations we make about proxies of what tends to correspond to our judgments of consumer confidence, but what do people do?

Senator SCHUMER. Right.

Chairman GREENSPAN. So far, they have exhibited a fairly high degree of confidence. Consumer expenditures have not been going up in any material way, but they have held their own.

Senator SCHUMER. The worry is that after month after month of people reading of these layoffs, worrying about them more in their own families, the neighbor down the street or whatever, that it affects the consumer's spending.

Chairman GREENSPAN. That has been our history, Senator. And I think it is clearly an issue which we at the Federal Reserve watch very closely.

Senator SCHUMER. But so far, we have not seen that—has the measure of layoffs accelerated over the last 3 months, that we would not see it yet even if it were going to occur, or has it been steady over the last 6 or 7 months?

Chairman GREENSPAN. The rate of layoffs has gone up. In fact, as I said, the broadest measure we have of layoffs is initial claims and that, as you know, has gone from under 300,000 a week to in excess of 400,000, so that all of the measures that we pick up on a weekly basis in those insured data—insured unemployment data systems—as well as our much broader employment series, does show a pick-up.

Senator SCHUMER. I do not know what we can do about it here, although it relates to another question. But if one were looking generally at the economy, the level of worry one should have about consumer spending continuing should increase. It should be higher today than it was a few months ago.

Chairman GREENSPAN. I agree with that and I think that is a correct view. But I think there is an interaction here which is also very complex.

Senator SCHUMER. No question. Let me ask you this. Given the decline in productivity which we have discussed—

Chairman GREENSPAN. The decline in the rate of growth in productivity.

Senator SCHUMER. The rate of growth, although did not it actually decline in one quarter?

Chairman GREENSPAN. It went down in the first quarter, but I would suspect that it will not be continuing in the second quarter.

Senator SCHUMER. Given the decline in, at minimum, the rate of growth of productivity, and I hope you are right.

Chairman GREENSPAN. I agree with that.

Senator SCHUMER. Okay. And how important that is to long-term growth, and this is the question that Evan Bayh asked, but should we be more worried today about the size of the tax cut, which I believe at some point you said had an effective rate higher than—actually would affect the budget higher than the 1.35. I think you used, I read somewhere that you, I think, said it was closer to $2 trillion in its overall effect, given interest.

Chairman GREENSPAN. I do not believe I said that.

Senator SCHUMER. Strike that. No, I did not read it directly from you. I read it on a memo that you had said it and I had not read anywhere where you said it. So strike that.

Chairman GREENSPAN. Let me just say this. I have never made such a calculation.

Senator SCHUMER. Okay. Good. But given the change that we have seen in the economy over the last several months since the tax bill was proposed, not since it was signed, do we have greater worry about our status as a surplus government as opposed to a deficit government?

Chairman GREENSPAN. It depends on what happens to the expenditure side of the budget.

Senator SCHUMER. Let's say it grows at the rate of inflation.

Chairman GREENSPAN. Well, clearly, if you take $1.35 trillion out of the current services surplus, the actual surplus available for expenditures would be less than the current services surplus. I mean, that is arithmetic and I acknowledge that.

Senator SCHUMER. No, no. But you are not worried at this point that we are going to, even though the economy is not as strong as when the initial tax cut was proposed, or even the $1.35 trillion was arrived at, you are not worried about us sliding back into deficit spending?

Chairman GREENSPAN. I am not, Senator.

Senator SCHUMER. You are more optimistic than I am. One more to the other two. What do you think of the suitability rule applying to borrowing, lending, as opposed to investment in securities? I would ask that of Mr. Hawke.

Mr. HAWKE. I think that is an interesting idea, Senator Schumer. But I am not sure that I would really like to see bankers making suitability judgments about the extension of credit beyond the basic kind of credit underwriting standards that I was talking about.

I think the basic rules of sound credit extension subsume a suitability test. And that is, can the borrower service and repay the loan out of current resources without recourse to the collateral? If the lender makes that kind of judgment, I think that is basically what we need to assure that credit is not being pushed out to people who really cannot afford it. If you go beyond that and try to impose on bankers some judgmental responsibility for determining the purposes for which the loan is being taken out or other aspects of suitability of the sort that a registered broker-dealer might have to make under the securities laws, I think that raises other issues. But the basic standards of sound underwriting that have been traditional in the banking business for years provide a kind of suitability test, and if they were observed, I think that that would take us a long way.

Chairman SARBANES. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. I apologize for being late and missing all of your testimony and most of the questions. We have another hearing going on. The title of this hearing is the Condition of the U.S. Banking System. There have been times in the past 10, 20 years we could have said we are in some kind of crisis. There is another committee hearing going on today about the energy crisis in California and other parts of the country. And I apologize for not being here for this one. That seemed more of a crisis than we face in the areas that you oversee, so maybe that is good news.

Chairman Greenspan, welcome back. And to our other panelists, thank you for joining us today. My wife is from North Carolina. And every Easter, we go down to North Carolina and we literally camp out in the wilds of North Carolina with her family, siblings, and their children. We were sitting around the camp fire back around Easter and heard a chilling story of identity theft involving the children of one of my wife's siblings, and how this has plagued her in her life for much of the last year, actually more than a year.

Someone gave me a note here that said that a publication called the SAR (Suspicious Activities Reports) Activity Review reported some very large increase in the amount of reported identity theft and the impact that it has had on the lives of literally thousands of Americans. It seems to be a growing phenomenon. Having talked to someone who has lived through this for the past year or so, I am just wondering what can you do in your roles and what can we do in our roles to confront this growing concern?

Chairman SARBANES. Let me add to that, *The Washington Post* had an article just a few weeks ago—the Justice Department says that identity theft is one of the Nation's fastest-growing white collar crimes, just to underscore what Senator Carper is asking about.

Mr. HAWKE. I think that that is a very serious problem, Senator. We, and I believe the other agencies, just within the past few weeks, put out—I think it was quite a comprehensive advisory to banks on the need to have controls in place and to be alert to occasions when identity theft might be occurring. If financial institutions apply rigorous rules with respect to the access to information, it will help immeasurably, I think, in this regard.

Banking institutions cannot be a complete bulwark of protection against identity theft because, in some instances, it is beyond the ability of the bank to control. But they can be vigilant, and they can be rigorous in the way they verify the identity of people who are opening accounts. They can certainly be vigorous in avoiding the disclosure of account information and other confidential information to people without very solid identification of the person to whom they are giving the information.

Senator CARPER. Please.

Ms. TANOUE. I would just reiterate that all the agencies, including the FDIC, have issued guidance on identity theft.

Senator CARPER. Is this recent?

Ms. TANOUE. I think during the past 5 months, yes. And that guidance does include information on measures that institutions can take to protect against stolen information. We would be happy to provide you a copy.

Senator CARPER. Thank you.

Mr. Chairman.

Chairman GREENSPAN. Senator, I think that what we are observing is probably an inevitable consequence of the tremendous increase in information technology. The very technology, however, that is creating the availability of a lot of this information which had not been available before to be absconded with, is also likely to be where the problem is going to be solved because we have very rudimentary mechanisms now for identification—Social Security numbers, driver's licenses, a variety of things which are so simple essentially to copy.

We are invariably going to much more sophisticated means of identification. We already have them in a number of areas, obviously. And my impression is that until we move the technology into areas where it is very difficult to, for example, match eye prints or fingerprints or voice prints or a variety of things which are not simple things to copy, until we get to those levels, in my judgment, this is going to be an issue.

I must admit, I was surprised at how fast the issue came up. And I think we are going to be dealing with it for a while. But I do think that the very emergence of it is probably going to put in place a good deal more of quasi-cryptographic means by which one can identify oneself and that should, hopefully, make it far more difficult to essentially steal somebody's identity for purposes of obtaining, usually relatively small cash awards.

Senator CARPER. Thank you for that. We have seen it in our own family, just from a personal perspective, what it does to an individual in their life. Obviously, as this threat grows or this level of criminal activity grows, it poses an increasing threat to our financial institutions as you well know.

Chairman GREENSPAN. For example, we had the comparable issue in counterfeiting. It is not unrelated. We have made very significant advances in this area and I think much of the same type of approach is available to protect identities.

Senator CARPER. Mr. Chairman, I have one more question, if I could. And this is a short one. I was Governor when Congress was debating and adopting and the President was signing into law the Gramm–Leach–Bliley bill. But a number of folks predicted coming out of the adoption of that legislation that its enactment would lead to increased mergers between banks and insurers. So far, I do not think we have seen a great deal of that. And I would just like to know your thoughts about why, and if you expect to begin to see some increased merger activity that had been predicted.

Chairman GREENSPAN. I think it is too soon in the sense that the regulatory structure is not in place, that these are very major moves on the part of institutions, and we will see them as time moves on and as we begin to integrate the statute into regulation and into the history which will enable individual institutions to make judgments as to whether in fact the regulatory climate which is available to them is conducive to an effective merger.

Mr. HAWKE. I think there are a couple reasons, Senator. As I talk to bankers and ask that same question—why there has not been more interest, for example, in acquiring insurance underwriters—they basically tell me they are not really very familiar with that business. It is a strange business to them, and the returns are quite different from those that bankers are looking at. And, looking at that from the other end of the pipeline, the insurance underwriters who presently do not own depository institutions may have some reservations about subjecting themselves to the regulatory environment that would be required.

In the securities area, banks, as a result of rulings that the Federal Reserve made a number of years ago, have already been able to expand very significantly into a whole variety of securities activities. And again, looking at that from the other end of the pipeline, you have something of the same thing. Securities firms may

not be acquiring depository institutions because of concerns about taking on another type of regulation that they are not presently subject to.

The one area in which I think Gramm–Leach–Bliley has been particularly useful and successful is in expanding the opportunities for banks, large and small, all over the country to increse their insurance sales activities. If you talk to community bankers, that is one thing that they latch onto that was really important to them in Gramm–Leach–Bliley.

Senator CARPER. All right. Thank you all very, very much.

Mr. Chairman, thank you.

Chairman SARBANES. Thank you very much, Senator Carper. I have a few questions that I want to ask as we draw toward a close. And of course, Senator Corzine has been here. He may want another round as well.

First of all, Senator Corzine and I have both been very interested in this financial literacy and education issue. Actually, Chairman Greenspan, you gave a major speech on that. I think it would be helpful to us if we could get from each of the agencies, and this following a bit up on Senator Dodd as well, your view of how much of a need there is, how much of a shortfall there is with respect to financial literacy and education and what might be done about it. Both in a broader sense and even what your agencies might do in order to counter a problem of a lack of financial literacy and education, if in fact you perceive there to be one. I take it that most of you do. Would I be safe in saying that?

Mr. HAWKE. Mr. Chairman, I would say that basic financial literacy is certainly a concern. One element of that is the persistent resistance of many people to deal with commercial banks. This may not be an issue of financial literacy so much as something that is more sociological. But we see again and again in survey data that people are unwilling to deal with commercial banks for one reason or another. So, they use check cashers and fringe providers, payday lenders that are much more high-priced and do not have the ability to provide the same range of services. People will walk by a commercial bank to go to a payday lender right next door. One aspect of financial literacy that I think is very important is educating people and educating banks about how they can do a better job in reaching them.

Chairman SARBANES. We worked with Secretary Summers on that because he was quite interested in that issue and actually undertook some initiatives when he was Treasury Secretary in order to try to bank the unbanked, so to speak, or draw them into the financial mainstream. And they developed a number of programs at Treasury in order to try to do that. We are not certain yet whether this Treasury is going to continue down that path and seek to carry that through, but I think that is very important. All four of your agencies recently joined in issuing an advisory—I have the impression that the four agencies are working together in a more coordinated fashion than used to be the case. Is that an accurate impression or was it always the case?

Chairman GREENSPAN. No, it is been up and down, Mr. Chairman. I think we are in an up stage at this point. But even on the down side, it works well in the sense that the alternative, which

is basically to have a monopoly regulator, I do not think would serve this country well. So there are problems in the sense—I think Ellen Seidman mentioned it—we do not come to agreements immediately. We do not come to conclusions as quickly as some would like. So that there is friction and there is cost and there is probably excess conversation that goes on.

But having said that, I think it is a very small price to pay for what is an extraordinarily effective regulatory system in this country. And it is encumbent upon all four of us to make certain we endeavor to find a center we can coalesce around. The goodwill in the process has been really quite measurable and I think quite effective.

Chairman SARBANES. Well, you issued this advisory:

> High on or off balance sheet growth rates are a potential red flag that may indicate the need to take action to ensure the risks associated with brokered or other rate-sensitive funding sources are managed appropriately.

How serious is the problem. What actions are you taking, if any, other than issuing the advisory?

Ms. TANOUE. This relates to the funding and liquidity issues that I think we have all testified about. We are working very closely to issue guidance like that through the FFIEC.

In addition, we are watching the credit portfolios of the institutions very closely as they try to meet these funding and liquidity challenges.

Mr. HAWKE. Liquidity is a subject that we talk about with our banks all the time. We recently had a telephone seminar devoted entirely to liquidity. We had hundreds of banks around the country signed up, and it gave us the opportunity to address directly many of these concerns about liquidity.

Chairman SARBANES. I want to follow up on a question that Senator Bayh asked. And that is, we may look at our own system and say, well, it is in pretty good shape and it is pretty strong. But how severe is the risk to which we are exposed from a breakdown in the systems overseas? Japan has very serious problems right now from all reports. We had an Argentina scare. How exposed are we in this kind of world economy so that we must also have at the forefront of our worries the world context in which we are operating, no matter how much we may look at our own system here and say it is in pretty good shape. Something happens overseas, and the next thing we know, we have a major problem on our hands.

Chairman GREENSPAN. Mr. Chairman, we are very conscious of that. And indeed, more importantly, so are the banks because a goodly part of their risk-management systems focus on addressing precisely the types of risks which you allude to. That is not to say that you can eliminate these problems very readily because, obviously, you are not only dealing with credit risk and the other risks we see domestically, but, very often you are dealing with exchange rate risk as well. And so, there are lots of possibilities for difficulties to emerge. There are lots of threats to the capital of the banking system as a consequence.

But that is precisely what risk-management is all about. And what we endeavor to do in overseeing a number of our institutions, is to try to understand how they are addressing precisely this question. I am not saying that we can say with a great deal of certainty

that we are perfectly secure. I do not think we can ever be secure. Indeed, banking is by its very nature risk-taking. But I do think we are acutely aware of the types of problems that can emerge, especially having been through the East Asian crises of 1997 and the Russian default shortly thereafter. So that there is not a long history behind us of tranquility in the international financial system. I hesitate to say that it is in complete control. It never will be. But I know of nothing which suggests to me that there is not a very significant amount of effort involved in both the banking system and in our supervisory system to make sure as best we can that these areas are covered.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Just an observation, I guess, as much as a question. But I would love your comments back. We talked mostly about sort of the macroelements of the condition of the banking system today. We got off here in the latter stages on financial literacy, which is one of those issues that impacts the overall soundness of the system—predatory lending, community development lending, money-laundering, the privacy issues that Senator Carper talked about.

All of those issues tended not to be where you focused your testimony, but are issues and conditions. I wonder if there are things off of my list that I have left out. I would love to hear how all of you feel we are dealing with the issue, for instance, of money-laundering, which hasn't been talked about, which is a serious concern. I think some of the others we talked at least a little bit about—community development lending, whether there is enough attention to that and whether you think there is a commitment in the private sector to addressing these sort of microissues as opposed to the macrorisk-management issues that have been major focus of the condition of the banking system. And I would ask any of you.

Chairman GREENSPAN. Let me just start off, Senator, and say, the fact that you did not hear very much in our prepared remarks is indicative of the fact that we do not believe that those microissues are creating major safety and soundness problems with the commercial banks, which is important in and of itself. They are all very critical issues which all four of us spend perhaps almost an inordinate amount of time focusing on because they are quite difficult to deal with and difficult to come to the right conclusions on. None of them is simple. And in fact if they were, they probably wouldn't be problems.

Jerry.

Mr. HAWKE. I would concur with that. Money-laundering is obviously a tremendously important issue. Money-laundering lies at the heart of drug trafficking. We have very strong regulations in place that require banks to have systems and controls that are aimed at identifying instances of money-laundering.

I think our people have done a very good job in alerting banks to the risks that are presented in that respect. These are not only broad risks that relate to drug trafficking, but, risks that relate to the banks themselves. So banks have a strong interest in assuring that they are not unwittingly implicated in other people's illegal conduct, and that is something we bear down quite heavily on.

Ms. TANOUE. I would also add that within the time constraints, we only have a certain amount of space in our testimony and time to address the issues. Some of the issues that we are also addressing include the CRA regulatory review, for example, and I think the Committee would be interested probably in an update at some point soon in the status of that work.

Senator CORZINE. I am sorry?

Ms. TANOUE. The CRA.

Senator CORZINE. The CRA, community development.

Ms. TANOUE. Mr. Chairman, I did want to follow up on the question you had regarding financial literacy. I would mention that the FDIC has undertaken a very significant nationwide program on that front, called "Money Smart," in conjunction with the Department of Labor, to offer education on financial programs to people outside the mainstream.

Chairman SARBANES. Can you submit us materials about that?

Ms. TANOUE. Absolutely.

Chairman SARBANES. We would be very happy to have that.

Senator CORZINE. Thank you.

Chairman SARBANES. All right. Let me say it is my intention that at some point this year, the Committee will turn its attention to the money-laundering issue, which is a very important issue.

Senator Carper, do you have anything else?

Senator CARPER. No. Thank you, Mr. Chairman.

Chairman SARBANES. Well, this has been a very good panel. We are most appreciative to you. Let me again underscore the fact that the written statements have obviously been prepared with a great deal of care and work and we appreciate having that, as well as your presence here today before us.

Chairman Greenspan, we will be seeing you again next month when we do the monetary policy hearing and, as always, we look forward to that occasion.

And we thank all of you for this contribution. We will continue to maintain this close relationship as we concern ourselves with the safety and soundness of our financial system.

Thank you all very much.

The hearing is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional materials supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

I am pleased to welcome this distinguished panel of witnesses before the Banking Committee this morning: Alan Greenspan, Chairman, Federal Reserve Board; Jerry Hawke, Comptroller of the Currency; Ellen Seidman, Director, Office of Thrift Supervision; and Donna Tanoue, Chair, FDIC.

The purpose of today's hearing is to review the condition of the banking system of the United States. This hearing is not prompted by any triggering event or problem. Rather, the intention is to return to a prior practice of this Committee of holding periodic oversight hearings on the state of the banking system. By making this a regular event we would hope to elevate scrutiny of the system when times appear good and there may be a tendency toward complacency, as well as to defuse potential alarm when a hearing is held at a time that problems may exist. We would hope the regular scheduling of this hearing would be a useful discipline on the system and perhaps itself serve as a stabilizing influence.

It appears that the past decade of economic growth has significantly strengthened the condition of the U.S. banking system. In my view the enactment by Congress of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 in response to the thrift crisis, and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 in response to the commercial banking problems of the late 1980's and early 1990's, contributed to that improved condition. The capital and regulatory standards put in place by those statutes helped the system to take advantage of the growing economy of the 1990's. Improved coordination of supervision by the regulators also made a contribution.

This morning we will hear from the regulators that the banking industry is better situated today to withstand a softening of the economy than it has been in the past. Banks have a greater variety of products and more geographic diversification in their assets. They have higher earnings, more capital, better risk-management techniques, and higher asset quality than in the past.

Nevertheless they will also point out that asset quality problems have worsened for the past 2 years and loan loss provisions have increased substantially. Non-interest income of banks has been affected by a less robust economy and weaker stock market. Net interest margins declined for the sixth consecutive quarter to their lowest level since the first quarter of 1987. Loan losses continued to rise, with commercial and industrial loans accounting for more than half of the increase. The deterioration was concentrated among larger banks.

The manufacturing sector has also been slowing down, which affects commercial loan quality. Increasing numbers of employees are being laid off, which is adversely affecting the quality of consumer loans. Sectors such as telecommunications, technology, and agriculture, and the banks that service them, are facing serious economic challenges. And consumers are more highly leveraged today than at any other measured point.

The Committee will want to review all of these issues with the regulators this morning. Most fundamentally we will want to get an assessment from the regulators not only of how the system looks today, but how it may look 6 months or a year from now. The consensus forecast is that economic growth will pick up in the third and fourth quarters of this year and resume at a faster pace next year. If that is true, it will obviously have a beneficial impact on the banking system.

However, that outcome is far from assured. If the economy remains weak for the rest of this year, what impact will that have on the banking system? How well equipped is the system to cope with a weak economy as well as a growing economy? These are some of the threshold questions we will want to explore with the bank regulators today. I look forward to hearing their testimony.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 20, 2001

Mr. Chairman and Members of the Committee, I am pleased to be here this morning to discuss the condition of the U.S. banking system. In my presentation today, I would like to raise just a few issues. I have attached an appendix in which the Federal Reserve Board staff provides far more detail relevant to the purpose of these hearings.

There are, I believe, two salient points to be made about the current state of the banking system. First, many of the traditional quantitative and qualitative indicators suggest that bank asset quality is deteriorating and that supervisors therefore

need to be more sensitive to problems at individual banks, both currently and in the months ahead. Some of the credits that were made in earlier periods of optimism—especially syndicated loans—are now under pressure and scrutiny. The softening economy and/or special circumstances have especially affected borrowers in the retail, manufacturing, health care, and telecommunications industries. California utilities, as you know, have also been under particular pressure. All of these, and no doubt other problem areas that are not now foreseeable, require that both bank management and supervisors remain particularly alert to developments.

Second, we are fortunate that our banking system entered this period of weak economic performance in a strong position. After rebuilding capital and liquidity in the early 1990's, followed by several years of post-World War II record profits and very strong loan growth, our banks now have prudent capital and reserve positions. In addition, asset quality was quite good by historical standards before the deterioration began. Moreover, in the last decade, as I will discuss more fully in a moment, banks have improved their risk-management and control systems, which we believe may have both strengthened the resultant asset quality and shortened banks' response time to changing economic events. This potential for an improved reaction to cyclical weakness, and better risk-management, is being tested by the events of recent quarters and may well be tested further in coming quarters.

We can generalize from these recent events to understand a bit better some relevant patterns in banking, patterns that appear to be changing for the better. The recent weakening in loan quality bears some characteristics typical of traditional relationships of loans to the business cycle. The rapid increase in loans, though typical of a normal expansion of the economy, was unusual in that it was associated with more than a decade of uninterrupted economic growth. As our economy expanded, business and household financing needs increased and projections of future outcomes turned increasingly optimistic. In such a context, the loan officers whose experience counsels that the vast majority of bad loans are made in the latter stages of a business expansion, have had the choice of restraining lending, and presumably losing market share or hoping for repayment of new loans before conditions turn adverse. Given the limited ability to foresee turning points, the competitive pressures led, as has usually been the case, to a deterioration of underlying loan quality as the peak in the economy approached.

Supervisors have had comparable problems. In a rising economy buffeted by competitive banking markets, it is difficult to evaluate the embedded risks in new loans or to be sure that adequate capital is being held. Even if correctly diagnosed, making that supervisory case to bank management can be difficult because, regrettably, incentives for loan officers and managers traditionally have rewarded loan growth, market share, and the profits that derive from booking interest income with, in retrospect, inadequate provisions for possible default. Moreover, credit-risk specialists at banks historically have had difficulty making their case about risk because of their inability to measure and quantify it. At the same time, with debt service current and market risk premiums cyclically low, coupled with the same inability to quantify and measure risk, supervisory criticisms of standards traditionally have been difficult to justify.

When the economy begins to slow and the quality of booked loans deteriorates, as in the current cycle, loan standards belatedly tighten. New loan applications that earlier would have been judged creditworthy, especially since the applications are now being based on a more cautious economic outlook, are nonetheless rejected, when in retrospect it will doubtless be those loans that would have been the most profitable to the bank.

Such policies are demonstrably not in the best interests of banks' shareholders or the economy. They lead to an unnecessary degree of cyclical volatility in earnings and, as such, to a reduced long-term capitalized value of the bank. More importantly, such policies contribute to increased economic instability.

The last few years have had some of the traditional characteristics I have just described: the substantial easing of terms as the economy improved, the rapid expansion of the loan book, the deterioration of loan quality as the economy slowed, and the cumulative tightening of loan standards.

But this interval has had some interesting characteristics not observed in earlier expansions. First, in the mid-1990's, examiners began to focus on banks' risk-management systems and processes; at the same time, supervisors' observations about softening loan standards came both unusually early in the expansion and were taken more seriously than had often been the case. The turmoil in financial markets in 1998, associated with both the East Asian crisis and the Russian default, also focused bankers' attention on loan quality during the continued expansion in this country. And there was a further induced tightening of standards last year in re-

sponse to early indications of deteriorating loan quality, months before aggregate growth slowed.

All of this might have been the result of idiosyncratic events from which generalizations should not be made. Perhaps. But at the same time another, more profound development of critical importance had begun, the creation at the larger, more sophisticated banks of an operational loan process with a more or less formal procedure for recognizing, pricing, and managing risk. In these emerging systems, loans are classified by risk, internal profit centers are charged for equity allocations by risk category, and risk adjustments are explicitly made.

In short, the formal measurement and quantification of risk has begun to occur and to be integrated into the loan-making process. This is a sea change—or at least the beginning of one. Formal risk-management systems are designed to reduce the potential for the unintended acceptance of risk and hence should reduce the procyclical behavior that has characterized banking history. But, again, the process has just begun.

The Federal banking agencies are trying to generalize and institutionalize this process in the current efforts to reform the Basel Capital Accord. When operational, near the middle of this decade, the revised accord, Basel II, promises to promote not only better risk-management over a wider group of banks but also less-intrusive supervision once the risk-management system is validated. It also promises less variability in loan policies over the cycle because of both bank and supervisory focus on formal techniques for managing risk.

In recent years, we have incorporated innovative ideas and accommodated significant change in banking and supervision. Institutions have more ways than ever to compete in providing financial services. Financial innovation has improved the measurement and management of risk and holds substantial promise for much greater gains ahead.

Building on bank practice, we are in the process of improving both lending and supervisory policies that we trust will foster better risk-management; but these policies could also reduce the procyclical pattern of easing and tightening of bank lending and accordingly increase bank shareholder values and economic stability. It is not an easy road, but it seems that we are well along it.

Appendix: Condition of the Banking Industry

PREPARED BY: STAFF, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 20, 2001

The U.S. banking industry is well capitalized and highly profitable by historical standards and in reasonably good shape, although there are signs of erosion as problem loans have risen, especially in larger syndicated credits. Moreover, some further erosion is likely as borrowers who have taken on heavy debt burdens experience less robust increases in profits and income than might have been anticipated not too long ago. In many cases, problem loans are a hangover from loans made in the mid-1990's when lenders evidently failed to exercise sufficient discipline. After about 1998, banks took a number of steps to tighten lending standards and terms, which should help to limit further deterioration. Nevertheless, with a weakening economy, problems could well worsen for some banks and some market segments, requiring vigilance by banks and their regulators. As always, the underlying issue is how to adopt and price realistic assessments of likely credit risks under alternative scenarios, keeping credit flowing to worthy borrowers at reasonable prices.

Today, banking organizations and their supervisors are taking a number of steps that will be necessary to ensure that our financial system continues to flourish and support long-term economic growth well into the future. Key elements of such actions are referenced in the last two sections of this appendix.

Earnings

Although banking profitability has risen to historically high levels in terms of return on assets and return on equity over the past decade, in recent periods higher loan loss provision expenses and narrowing net interest margins have placed pressures on bank profitability. Despite those emerging weaknesses, downside risks likely have been limited by the increasing diversity of noninterest and interest sources of revenues. The continued push by banks to diversify their revenues by expanding business lines devoted to asset management, servicing, securitization, investment banking, and other fee-based activities should help stabilize earnings streams. In addition, in the wake of consolidation and interstate banking, many larger firms are less vulnerable to downturns in particular regions or specialized business lines.

Nonetheless, in the past few quarters, emerging earnings weaknesses have been pronounced at some of the larger banking organizations, which have experienced

sharp increases in loan loss provision expenses, narrowing interest margins, and significant declines in venture capital revenues. During the first quarter of this year, those negative developments at large firms were somewhat offset by record trading profits and better overhead cost efficiency. While the net effect was a decline in profits at many larger banking organizations, the underlying strength in the profitability of regional and community banks, coupled with nonrecurring securities gains, helped the industry as a whole achieve record first quarter earnings of nearly $20 billion.

Asset Quality

The rise in nonperforming assets at banking organizations has been pronounced over the past year, especially at larger banking organizations. Despite that rise, these problems generally remain moderate in historical terms relative to earnings, assets and capital. Assets classified as substandard, doubtful or loss have also risen rapidly in recent periods, though again from a modest base. Much of that increase is attributable to larger syndicated credits, though there are some indications of softening in the credit quality of middle-market borrowers. In response to this rise, banks have written down assets to estimated net realizable values and replenished reserves for expected problems through loan loss provision expenses.

A common theme for many of the problem credits has been significant leverage employed to expand businesses during times of ebullient economic and market conditions. Many of these credits were originated during a period of relaxed lending standards that did not adequately account for the susceptibility of the borrower to weakening sectoral or economic conditions. After the reminders in 1998 from the Asian disruptions and the Russian default, lending standards were tightened. But, with the advent of a softening economy, the embedded risks of weaker or more vulnerable borrowers are becoming well recognized. Particularly hard hit have been certain borrowers in the retail, manufacturing, health care and telecommunications industries. In addition, unexpected developments in asbestos litigation as well as the difficulties faced by the California utilities have also added considerably to the stock of classifications.

The rapid deterioration of credit quality in certain segments of bank loan portfolios reflects the significant share of the growth in bank lending in recent years to borrowers on the borderline between investment and noninvestment grade creditworthiness. With the presence of active money and capital markets in the United States, and their ease of access by the best quality borrowers, these credit grades reflect the quality of those with which our banks now normally deal. They represent the types of borrowers that tend to require the more customized analysis, underwriting and structuring offered by banks that may not be as readily available or as cost-effective through the bond market. The higher magnitude and volatility of default rates in these types of borrowers is well documented from decades of experience in the below-investment grade segment of the bond market. Consequently, as conditions have weakened and defaults have risen sharply in noninvestment grade bonds, a parallel increase has occurred in troubled and nonperforming loans of bank portfolios. Forecasts for a continued rise in defaults for lower rated bonds by Moody's suggest that bank corporate asset quality is also likely to deteriorate further before it improves.

Although part of the deterioration may be a natural consequence of taking normal business risk in a weaker economy, part also reflects a lack of discipline by some banks, particularly in the 1995–1997 interval. As banking organizations relaxed their standards and the rigor of their credit risk analysis in this period, banking supervisors responded by issuing cautionary guidance and stepped up the intensity of reviews of lending operations at many banking firms. In particular, supervisors pointed out the need for lenders to avoid the use of overly optimistic assumptions that presumed strong conditions would prevail indefinitely. In addition, supervisors also noted the lack of downside risk analysis or stress testing as a weakness in risk-management practices at many banks.

Recent credit losses have highlighted the importance of following those sound lending and evaluation fundamentals and have clearly differentiated strong credit risk-management systems from weak ones, prompting many organizations to take remedial action. For the past several years, the banking agencies have shifted their supervisory approach to focus on risk-management processes at banking organizations as a more effective means for promoting sound banking practices. While bank risk-management practices have improved, in part because of supervisory efforts, recent experience has shown that more work needs to be done. More recently, to help facilitate improvements underway at banks in response to current credit difficulties, the banking agencies issued guidance earlier this year clarifying their expectations regarding sound practices for managing leveraged finance exposures.

Even before recent weaknesses, banks had begun to reevaluate their strategic direction and, with the encouragement of supervisors, had become more deliberate about the need to implement formal procedures for recognizing, pricing, and managing risk. Without these reforms, the recent deteriorating trends would likely have been considerably worse. In these emerging systems, loans are classified by risk, internal profit centers are charged for equity allocations by risk category, and risk adjustments are explicitly made. In addition, more advanced systems provide the metrics that are necessary to support active portfolio management, including decisions on whether certain loans exhibiting emerging weaknesses should be sold and at what price. The active sale of troubled syndicated credits has been an emerging trend among larger organizations. In particular, the increasing appetite for these loans by nonbank investors has helped deepen and liquefy the market, providing an outlet for banks with adequate capital and reserves to sell loans at a discount to par value and to rebalance their portfolios.

Today risk-management systems have also helped rationalize the pricing of risk through stricter terms and conditions for more vulnerable borrowers. Sophisticated risk-management systems are also helping banks to reevaluate the profitability of bank lending by benchmarking loans against corporate hurdle rates. In many circumstances, banks are recognizing that without the ancillary cash management or other revenue opportunities attached to the lending relationship, it is difficult to find stand-alone lending opportunities that meet these hurdle rates. By using these sophisticated quantitative risk-management tools to support their decisionmaking, banks are better able to distinguish profitable versus unprofitable relationships and determine if a particular customer is compatible with the bank's appetite for risk.

At present, the tightening of terms and standards at banks and the bond market has not inhibited the flow of funding to sound borrowers, though borrowers appear to be increasingly tapping the bond market, and lenders and the bond market also are requiring higher spreads for marginal credits. While tightening can be over done, so far banks seem to be making balanced decisions on the tradeoff between risk and returns. This is a favorable outcome, because it assists in directing capital flows to their highest and best use in the economy.

Much focus has been placed on the dynamics within the corporate loan book, which is currently experiencing the majority of problems, but banks and supervisors should continue to be vigilant for other potential risks. In particular, though retail credit quality has been fairly stable in recent years, consumers, like corporations, have also increased leverage, making their ability to perform under stressful circumstances less reliable. In recent years, buoyant economic conditions raised expectations for continued growth in income and employment for consumers, which along with rising levels of wealth, has led to growth in household debt that has outstripped growth in disposable personal income over the past 5 years. That expansion of debt has pushed consumer debt service burdens to new highs.

With the recent slowdown in the economy, rising personal bankruptcies, an increasing unemployment rate, and a modest deterioration in loan quality, lenders have tempered their outlook, tightening their standards somewhat for credit cards and installment loans. At the same time, while consumer spending has leveled as the economy has weakened, demand for credit has strengthened in recent periods.

Over the past decade, banking organizations have taken advantage of scoring models and other techniques for efficiently advancing credit to a broader spectrum of consumers and small businesses than ever before. In doing so, they have made credit available to segments of borrowers that are more highly leveraged and that have less experience in managing their finances through difficult periods. For the most part, banks appear to have tailored their pricing and underwriting practices to various segments of their consumer portfolios to account for the unique risks related to each. Some institutions have also tailored lending toward segments with troubled credit histories, the so-called subprime market. Such lending can be favorable both to borrowers and lenders. Subprime borrowers benefit by gaining access to credit and the opportunity to build a sound credit history that may eventually allow them to achieve prime status. For lenders, subprime lending affords the opportunity for higher returns provided the necessary infrastructure is in place to closely track and monitor the risk related to individual borrowers, which can be labor intensive and costly. Lenders must also recognize the additional capital and reserve needs to support such lending, particularly if they have concentrations in subprime loans.

Banks that have not understood the subprime market have had significant difficulties. To ensure that banks entering this business properly understand these risks, the agencies have encouraged banks to adopt strong risk-management systems tailored to the challenges posed by these loan segments. Beyond poor risk-management, there have also been instances in which certain lenders have charged

fees and structured loans designed not to protect against risk, but rather to deceptively extract a borrower's net worth. Such predatory lending practices, though rare, are a cause for concern and examiners are watchful for programs that would violate the law in this regard.

Another area of supervisory focus, of course, is commercial real estate. The exceptional demand for office and other commercial real estate in recent years has led to a rebound in the volumes of loans secured by these properties. This time, however, as demand has grown, larger banking organizations have managed to keep their holdings modest relative to their asset bases either through securitizations, sales or by avoiding originations altogether. In contrast, many smaller commercial banks have raised their commercial real estate concentrations relative to assets and capital. While underwriting practices appear to be much healthier today than they were in the 1980's and standards have tightened somewhat recently, supervisors are paying particular attention to community banks with concentrations that make them materially vulnerable to a downturn in this market.

While for the past several years there have been few real estate markets with material imbalances in supply and demand, emerging signs of weakness make the need for vigilance more pressing. In the first quarter of this year, there has been a pronounced increase in nationwide vacancies that has resulted in a negative net absorption of office space in the United States. That poor performance, the worst in 20 years, has been attributed by some market observers to the abrupt return of office space to the market by technology firms and to delays by prospective tenants hoping that softening conditions will lower rents further. In this environment, noncurrent commercial real estate loans have edged up somewhat in the first quarter. Whether the first quarter represents a temporary phenomenon or the beginning of a longer term trend remains to be seen, but the need for institutions to continue a realistic assessment of conditions and stress test their portfolios is paramount.

In addition to real estate, agricultural lending is also facing challenges. Commodity price weakness, coupled with changes in the Federal price support programs, has placed pressures on the ability of farmers to service their debt. This in turn has led to a rise in noncurrent farm loans. Banks are continuing to identify ways to work with their borrowers to navigate through this difficult period.

Funding

For banks to remain in sound condition, they must not only pay attention to the quality of their assets, but also to the nature and quality of their funding. In recent years, large and small banks alike have come to rely increasingly on large wholesale deposits and nontraditional sources of funds. They have done so in part as the demand for loans and their own growth objectives have outstripped the growth in insured core deposits. It is true that retail core deposit growth has been quite meager over the past decade with higher returns in mutual funds and the stock market luring customers away from banking deposits. On the other hand, banks have also made the calculated decision to pay relatively low-interest rates on some types of retail accounts and rely on higher-priced jumbo deposits or wholesale borrowing to fund incremental asset growth.

Despite competition for household funds, community banks have been relatively successful at maintaining their core deposit bases. For example, a decade ago banks with less than $50 million in assets funded around 80 percent of their assets with core deposits. Over the course of the past decade, that figure eroded by 7 percentage points, but remains a fairly strong 73 percent of assets. That compares to core deposit holdings of only 39 percent for banks with more than $10 billion in assets.

While community banks have experienced moderate erosion in the share of core deposits funding assets, when that trend is coupled with rapid loan growth, pressures on bank liquidity have intensified. To replace core deposits, community banks have been fairly successful at attracting jumbo deposits and have made use of Federal Home Loan Bank advances. Community banks have also funded the gap between loan and deposit growth by liquidating securities holdings and accordingly raising the quantity of loans relative to assets. The combined deposit and loan trends have pushed liquidity benchmark ratios such as loans-to-deposits to historic peaks. On the other hand, there are some signs of relief for bank liquidity. For one, the demand for loans by businesses and consumers appears to be moderating, and there are some early indications that consumers are returning to bank retail deposits in the wake of disappointing stock and mutual fund results.

Still, many of these liquidity pressures are likely to remain in one form or in another, and banks are likely to continue to explore nondeposit alternatives for managing their balance sheets. While the use of nondeposit liabilities to fund growth is not new to banks, the growing volume, variety and complexity of these funds creates new issues. To meet this challenge, banks must strive to fully understand the

implication of relying on these types of funds both from a liquidity and earnings perspective. The Federal Reserve recently issued guidance on the use of complex wholesale borrowings and the banking agencies recently issued guidance on rate sensitive deposits to highlight the importance of adequate management techniques for ensuring stable and consistent funding.

Capital and Supervisory Initiatives

The most stable funding source for bank balance sheets is shareholder equity. More significantly, shareholder equity's key feature is its ability to absorb losses. The need for banks to hold capital commensurate with the risk they undertake is highlighted by recent weaknesses in bank asset quality and the uncertain economic environment. Today, by virtue of market pressures following the difficulties of the late 1980's, minimum regulatory capital requirements and the ability of many banking organizations to measure and recognize their own needs for a cushion against more difficult times, the industry capital base appears adequate to meet emerging challenges. From a regulatory capital perspective, the vast majority of all banks meet the definition for well capitalized.

The original Basel Accord that was adopted in 1988 has served supervisors and the industry fairly well over the past decade as one of the primary tools for maintaining a sound banking system. More recently, the nature and complexity of risk undertaken by many larger organizations have made the blunt traditional measures of capital adequacy, whether equity-to-assets, leverage, or current risk-based capital ratios, less meaningful. In considering the likely continuation of innovations over the next decade, supervisors must develop ways to improve their tools while reinforcing incentives for sound risk-management.

The new Basel risk-based proposal seeks to achieve the twin objectives of a more meaningful capital adequacy measure and promoting sound risk-management practices. The proposal by the Basel Committee that was announced in January of this year calls for an international capital accord that is based on three pillars: a minimum capital requirement that is more sensitive to risk, a supervisory review process, and market discipline. It is important to note that the Basel Committee is in the process of reviewing the public's comments on the proposal and there are still a myriad of important issues and details to address and work out before it can be implemented.

The proposal offers a menu of alternative frameworks for establishing minimum capital requirements so that institutions can be matched with the approach that fits their particular degree of sophistication, risk profile and risk-management capabilities. On one end of the spectrum, the proposed advanced approach, designed for the most sophisticated and complex entities, relies on a bank's internal risk rating and loss estimates in the establishment of the minimum requirements for credit exposures. At the other end of the spectrum, the proposed standardized approach modifies the current framework to be somewhat more risk sensitive but retains many of the simple features of the current accord.

The second pillar, the supervisory review process, requires supervisors to ensure that each bank has sound risk-management processes in place. The emphasis in that review is both on the integrity of the process that produces the metrics used in calculating the supervisory minimum, as well as the adequacy of a bank's own analysis of its capital needs.

The second pillar fits very well with the Federal Reserve's efforts in recent years to encourage larger, more complex banks to improve their internal risk rating systems while placing more emphasis on their own internal analysis of capital adequacy. The new accord is much more than an effort to improve the meaningfulness of minimum regulatory capital ratios, although that clearly is an important aspect of the proposal. Embodied in the proposal are some important risk-management principles and sound practices that supervisors would expect all of the very largest and most complex U.S. banks to be following or aspiring to, even those not electing to use one of the more advanced approaches. As proposed, the capital standards should provide banking organizations in the United States and abroad with strong incentives to accelerate their development and implementation of improved risk-management systems in order to qualify for a more risk sensitive regulatory capital treatment. Moreover, the review necessary to ensure that bank risk measures are sound maintains the focus of supervisors on the key elements of control and risk-management that govern safe and sound banking.

The third pillar complements the first two by bolstering market discipline through enhanced disclosures by banks. By their very nature, many banking risks are opaque. However, innovations in recent years that have helped improve the management of risk have also led to the development of various summary statistics to meaningfully describe risks that were qualitatively described in the past. While

challenges remain in making such measures comparable or differences across institutions well understood, such disclosures are a necessary complement to the other two pillars for the overall approach to retain the necessary level of rigor and integrity. Disclosure of information that helps stakeholders determine risk profiles is designed, of course, to increase, when necessary, the market pressure and costs on bank lenders that they would otherwise receive as a matter of course if they were not beneficiaries of the safety net. Market discipline can also provide useful signals to supervisors.

Significantly, the opportunity for enhanced market discipline through disclosure is substantial given that larger organizations fund about two thirds of their assets with uninsured funds. However, supplemental information will be irrelevant unless uninsured creditors believe that they are, in fact, at risk. Uninsured creditors have little reason to engage in risk analysis, let alone act on such analysis, if they believe that they will always be made whole under a de facto too-big-to-fail policy. Recognizing that dilemma, in 1991 the Congress placed in the Federal Deposit Insurance Corporation Improvement Act a requirement for a least-cost resolution of financial institutions. Although an exception clause exists, it does not require that all uninsured creditors be made whole. Conceptually, there are rare situations where events may require that the FDIC and other governmental resources be used temporarily to sustain a failing institution pending its managed liquidation. But indefinitely propping up insolvent intermediaries is the road to stagnation and substantial resource misallocation, as recent history attests.

Indeed, if the Government protects all creditors, or is generally believed to protect all creditors, the other efforts to reduce the costs of the safety net will be of little benefit. The implications are similar if the public does not, or cannot, distinguish a bank from its affiliates. As financial consolidation continues, and as banking organizations take advantage of a wider range of activities, the perception that all creditors of large banks, let alone of their affiliates, are protected by the safety net is a recipe for a vast misallocation of resources and increasingly intrusive supervision.

Financial Holding Companies and Umbrella Supervision

Mindful of the potential for the Federal safety net to extend beyond what Congress intended in its enactment of the Gramm–Leach–Bliley Act ("GLB Act"), the Federal Reserve has been careful to distinguish between insured depositories and uninsured holding company affiliates and parent organizations in the supervision of financial holding companies ("FHC's"). Consequently, the Federal Reserve's focus in FHC supervision has been to identify and evaluate, on a consolidated group-wide basis, the significant risks that exist in a diversified holding company with a view to evaluating how such risks might affect the safety and soundness of insured depository institution subsidiaries. Such supervision is not intended to impose bank-like supervision on FHC's, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, it seeks, on the one hand, to balance the objective of protecting the depository institution subsidiaries of increasingly complex organizations with significant interrelated activities and risks, against, on the other, the objective of not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization.

To accomplish that objective we have relied on our long-standing relationships with primary bank, thrift, securities, and foreign supervisors while forging new relationships with the functional regulators that oversee activities that are newly permitted under the Act. These relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but at the same time, allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden. The Federal Reserve places substantial reliance on internal management information maintained by FHC's and on reports filed with, or prepared by, bank, thrift, and functional regulators, as well as on publicly available information for both regulated and nonregulated subsidiaries.

Since enactment of the GLB Act, over 500 FHC's have been formed. The vast majority of those are small community holding companies that converted largely in an effort to take advantage of the insurance agency provisions of the GLB Act or to be well positioned should opportunities for exercising new powers present themselves. Most of the larger holding companies have also converted to FHC's, and appear to be taking advantage of the securities, merchant banking, and to a lesser extent, the insurance provisions of the Act. In addition to the conversion of existing bank holding companies, there have been a few nonbank financial service companies that have applied for and received FHC's status in connection with their acquisition of banking organizations.

In general, banking organizations appear to be taking a cautious and incremental approach to exercising new powers under the GLB Act. In addition, the number of new, truly diversified financial holding companies across securities, insurance and banking has been few enough to let organizations and supervisors gradually gain experience and comfort in their operations.

PREPARED STATEMENT JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

JUNE 20, 2001

Introduction

Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate this opportunity to discuss the condition of the banking system. I am pleased to report that the last decade has been a period of economic prosperity and strong growth in the banking sector. Commercial bank credit grew by over 5 percent per annum during the 1990's. During this period of prosperity, most banks strengthened their financial positions and improved their risk-management practices.

As a result, the national banking system is in a much better position to bear the stresses of any economic slowdown. National banks are reporting strong earnings with a return on equity (ROE) for the first quarter of this year of 15.2 percent—a level considerably higher than the ROE of 11.5 percent prior to the last economic slowdown in 1990–1991. Fifty-five percent of banks reported earnings gains from a year ago. Asset quality for the national banking system is better. The ratio of noncurrent loans (for example, 90+ days past due and nonaccrual) to total loans is 1.3 percent, compared to 3.3 percent in the first quarter of 1990, the year marking the start of the last slowdown. And capital levels are at historical highs. As of the first quarter of 2001, the ratio of equity capital to assets was 8.9 percent, compared to 6.0 percent in the first quarter of 1990.

As we move into the next decade, banks and bank supervisors face two major challenges. The first is cyclical: how to identify and manage the risks associated with a slowing economy in the United States and internationally. Many nonbank companies are experiencing a slowdown in demand for their products and services. This in turn is prompting a scaling back of expansion plans and staff reductions, which invariably will have regional and local economic repercussions for a variety of bank lending and servicing activities.

The second challenge is structural: how to adapt bank operations and supervision to the fundamental long-term changes in the banking industry. The rapid changes in technology, the increased competition in the market for financial services providers, and the globalization of financial markets are all presenting significant strategic and operational challenges for bank management and regulators.

My remarks today will cover four main topics. First, I will discuss the current state of the national banking system. Second, I will describe how the national banking system today compares with 1990, just before the last economic slowdown. I will then highlight the emerging risks and trends, and I will end with a discussion of the steps that the OCC has taken and will continue to take to address those risks.

The Current State of the National Banking System

The 1990's were a period of extraordinary earnings for the banking industry. National banks reported record earnings for 8 consecutive years as net income rose from $17.3 billion in 1992 to $42.6 billion in 1999. During this period, the annual return on equity averaged 15.2 percent, peaking in 1993 at 16.4 percent [see Figure 1].

Greater diversification of income sources improved the quality of bank earnings during the 1990's. This diversification trend should improve the capacity of banks to weather difficult economic times and better manage the risks embedded in their operations. For example, the share of banks' revenues coming from noninterest income sources such as fee income, asset management and trust services, brokerage and trading activities and fiduciary income increased over the last 10 years from 34 percent to over 45 percent [see Figure 2]. The trend away from reliance on traditional interest income is in part an active effort by banks to better manage risk. As a supervisor, we strongly support the efforts of national banks to diversify their revenue streams through financially related activities.

The search for new sources of revenue also reflects an effort to offset the effects of increased competition in traditional lending activities from nonbank competitors. Interest income grew at the modest rate of 5 to 6 percent during this period, largely

as a consequence of loan growth. During most of the 1990's, banks' net interest margins (the spread between what a bank earns on loans and investments and what it pays for funds) declined, a trend that is unlikely to be reversed. Because they expect continuing margin declines and slowing growth, banks have turned to alternative sources of revenue.

Slow revenue growth may become an issue for banks in 2001 if slower economic growth and weakening equity markets continue. Noninterest income is likely to be subdued and bank lending is likely to be sluggish. The most recent Federal Reserve Beige Book published last week reported declining loan demand in many of the Federal Reserve Districts as firms in a variety of industries have cancelled or postponed plans to expand and in some cases are laying off employees.

Another key determinant of the profitability of the banking system is the quality and performance of its loans. One useful measure of asset quality is the level of noncurrent loans—those loans with payments past due at least 90 days or in nonaccrual status, when any payments received by the bank are used first to pay down principal. The ratio of noncurrent loans to total loans, which was 4.1 percent in 1991, fell steadily to less than 1 percent in the late 1990's [see Figure 3]. The low level of noncurrent loans meant that banks were able to divert a relatively small amount of their revenue each year to loan loss reserves, which in turn boosted earnings.

The deterioration in credit quality, particularly in the commercial and industrial (C&I) loan portfolio, began 3 years ago and picked up steam in 2000. The noncurrent ratio for C&I loans for large banks increased by 56 basis points last year. While overall credit quality deterioration was more modest for smaller banks, rising only 3 basis points in 2000, these nationwide aggregate ratios understate the impact that the slowdown in economic growth is having on small bank credit quality in some geographic areas.

Spurred by the slippage in asset quality in 2000, particularly for C&I loans at large banks, the dollar value of loss provisions (the additions to loan loss reserves) rose 32 percent over the previous year. The ratio of provisions to loans rose to 0.95 percent, its highest rate since 1993. The rise in provisioning was most pronounced at the large banks and credit card banks, but provisioning at smaller banks also increased to its highest rate since 1993. Nonetheless, provisioning remains below the rates experienced during the banking turmoil of the 1980's and early 1990's.

The weakening in credit quality indicators and slowing of the economy increases the likelihood that banks will increase the level of provisioning in coming quarters to cover inherent loan losses. Prior to the 1990–1991 recession, loan loss reserves, as a percentage of total loans at national banks, were 2.5 percent, rising to a peak of 2.8 percent in 1992. During the current expansion, by contrast, the industry-wide loss reserve ratio for national banks declined to 1.8 percent. While loan loss reserves as a percentage of loans have remained fairly stable at 1.8 percent for the last 2 years, the coverage ratio of reserves to noncurrent loans has fallen from 184 percent to 138 percent. If the economy continues to slow, causing a further deterioration in credit quality, banks will be expected to increase their level of reserves.

The record earnings of the 1990's and good asset quality enabled national banks to build their capital. The ratio of equity capital to assets for all national banks rose to 8.9 percent at the end of the first quarter of 2001, the highest level in nearly four decades [see Figure 4]. Nearly 98 percent of all national banks met the regulatory definition of well capitalized by maintaining a ratio of equity capital to assets above 5 percent and a total capital to risk-based assets above 10 percent.

Comparison With Prior Economic Slowdown

With the slowing of economic activity in the United States and the potential for increased financial stress on banking institutions, it is worthwhile comparing the current condition of national banks to conditions that existed just prior to the recession of the early 1990's. Indeed, mindful of the stresses that many commercial banks experienced in the late 1980's, that point is a constant frame of reference for us as we approach today's supervisory challenges.

For the national banking system as a whole, profitability, asset quality and capitalization are significantly stronger today than in 1990 [see figure 5]. For example, median income as a percentage of assets (return on assets, or ROA) was 14 basis points higher in the first quarter of 2001 than in the same period in 1990. The median ratio of noncurrent loans to total loans was 92 basis points lower and the median capital ratio was 160 basis points higher.

The proportion of the banking industry facing the economic slowdown from a position of weak performance is substantially less than in 1990 just prior to the last recession. For example, less than 1.5 percent of the banks currently have an equity capital ratio under 6 percent. In 1990, 17 percent of banks had an equity capital ratio under 6 percent.

Banks have also made gains during these years in diversifying risks. Loan securitization has become a significant funding tool, enabling banks to generate revenues from loan origination while shifting credit and interest rate risk off of their balance sheets. Banks have also broadened the geographic scope of their operations and increased the range of financial services they offer, providing them with a greater capacity to weather adverse economic developments. Advances in information technology have provided bank managers with advanced risk-management tools that were unavailable a decade ago.

Emerging Risks

While the national banking system is in a stronger position relative to the last economic slowdown, banks cannot be complacent about the risks that will continue to surface in the current economic environment, particularly in the areas of credit and liquidity.

Credit Quality

While the level of loan losses is still relatively low, since 1997 the OCC has been concerned about a lowering of underwriting standards at many banks. This relaxation of standards stems from the competitive pressure to maintain earnings in the face of greater competition for high-quality credits, particularly from nonbank lenders. In some cases, banks' credit risk-management practices did not keep pace with changes in standards. We now are beginning to see the consequences of those market and operational strategies in the rising number of problem loans.

The deterioration in credit quality indicators that began 3 years ago has to date been largely concentrated in the C&I loan portfolios of the larger banks [see Figure 6]. The Asian financial crisis and the turmoil in the capital markets in the fall of 1998 also put pressure on large banks' loan portfolios. As capital markets contracted and the cost of debt became more expensive, corporations turned to the banking sector for an increasing share of their financing needs. This shift accounts, in part, for the substantial growth rates that banks have experienced in C&I lending, leveraged financing, and commercial real estate and construction financing. While such lending resulted in strong growth in the banking sector, competition to book these loans also put pressure on banks' underwriting and risk-management controls.

Emerging credit risk is not just an issue for large banks. As corporate earnings have weakened, the spillover effects on credit portfolios are beginning to show up in the smaller institutions. Community banks (defined as banks with assets under $1 billion) in 33 States and the District of Columbia have experienced an increase in their noncurrent loans over the last year [see Figure 7]. Particularly vulnerable to a downturn are banks in manufacturing areas that are highly dependent on energy production and distribution systems. Areas that rely heavily on manufacturing are experiencing falling earnings and slowing or negative employment trends.

We expect credit quality to be an issue for banks throughout 2001, as the financial positions of some businesses and households weaken due to slow economic growth. This deterioration in credit quality will be an added drag on bank earnings.

Liquidity Risks

Funding (or liquidity) risk at banks is also increasing as households and small businesses reduce their holdings of commercial bank deposits. Banks have traditionally relied on consumers and small businesses in their communities as a major source of funding. These so-called core deposits, most of which are covered by Federal deposit insurance, have provided a stable and generally nonrate sensitive source of funding. With the rapid run up in the stock market in the 1990's, however, and the widespread popularity of money market mutual funds, households and small businesses have increasingly shifted their savings and transaction accounts into pension funds, equities, and mutual funds. Deposits in banks and thrifts accounted for 10.5 percent of household financial assets in 2000, down substantially from 19 percent in 1990 and 22 percent in 1980.

Between 1993 and 2000, while annual asset growth in the banking system averaged 7 percent, core deposits at banks grew at a rate of less than 4 percent per year. This lagging growth in core deposits relative to asset growth is likely to continue.

In response to the long-run, secular trend of slower deposit growth, banks have turned increasingly to higher interest rate wholesale funding. Both large and small banks have increased their reliance on wholesale (noncore deposit) funding sources to finance their incremental loan and asset growth. While large banks are accustomed to accessing the capital markets for funding, this is a new activity for many smaller banks. Because of costs and information constraints, small banks find it more difficult than large banks to raise funds through public debt offerings, securitizations, and other capital market instruments. Thus, we see that small banks are increasingly relying on wholesale providers such as the Federal Home

Loan Banks as well as deposits obtained through the Internet or CD listing services. Although these sources can provide community banks with cost-effective funding, their use requires banks to have more rigorous management systems to monitor and control funding concentrations and maturity concentrations.

Consequently, traditional measures of bank liquidity, such as the ratio of core deposits to assets, reflect increased liquidity risk for both small and large banks. For example, core deposits as a percentage of assets for small banks (those with less than $1 billion in assets) declined from 79.8 percent in 1992, the first year of recovery from the last recession, to 69.6 percent in 2000. For the larger banks, the core deposits to assets ratio declined from 56.6 percent in 1992 to 43.9 percent in 2000.

How a bank funds itself is important because when a bank experiences deteriorating credit quality, it faces the risk of pressure on its funding and liquidity. Wholesale funds are far more risk- and price-sensitive than federally insured core deposits. Prudent management of this type of funding, therefore, is increasingly important. In particular, community banks that engage in business lending and have high levels of wholesale funding need to have effective internal controls and realistic contingency funding plans.

OCC's Approach to Growing Risk in the Banking System

A dynamic and healthy banking system is vital to the functioning of the overall economy. Our job as bank supervisors is to maintain a sound banking system by encouraging banks to address problems early so that they can better weather economic downturns and are in a position to contribute to economic recovery. As we have seen in the past, banks whose financial condition is seriously weakened by credit quality problems are less capable of extending credit because their attention is necessarily devoted to problem resolution and capital preservation.

By acting early, in a measured and intelligent way, bank supervisors can moderate the severity of problems in the banking system that will inevitably arise when the economy weakens. By responding when we first detect weak banking practices, supervisors can avoid the need to take more stringent actions during times of economic weakness. Supervisors are most effective when they take early and carefully calibrated steps that target potential industry excesses and failures in risk-management. This approach will help us maintain a healthy banking system that can continue to extend needed credit to sound borrowers during difficult economic times.

Since 1997, the OCC has implemented a series of increasingly firm regulatory responses to rising credit risk and weak lending and risk-management practices. These efforts, which started with industry reminders and advisories about the dangers of weakening lending standards and poor credit risk-management, grew into more focused examination and policy responses as risks increased.

- In 1997, in response to a sharp increase in the incidence of weakening underwriting standards reported by our examiners, we required examiners to discuss the results of the 1997 Survey of Credit Underwriting Practices with their banks' CEO's. We also instructed examiners to discuss any examples of weak underwriting disclosed in examinations directly with the bank CEO.
- In 1998, in response to further weakening of bank underwriting and risk selection standards, we implemented the Loans With Structural Weaknesses initiative to ensure that poorly underwritten and other higher risk credits were brought directly to the attention of bank management and boards. We instructed our examiners to identify such loans in all reports of examination, to criticize and classify such loans where appropriate, and to incorporate the amount and severity of weaknesses found into their conclusions about credit quality and portfolio management, and the overall condition of the bank. Simultaneously, we formed a team of our best credit experts to review loans from across the population of our largest banks to identify examples of the types of weaknesses our examiners were reporting. Based on this review, which came to be called the Ugly Loan Project, we developed and delivered a focused training program. The goals of that program were to advance the credit risk evaluation and classification skills of our examiners and to clarify our expectations about how structural and other credit weaknesses should be incorporated into their judgments about credit risk in individual loans and portfolios. We issued a comprehensive guidebook and examination procedures on Loan Portfolio Management to bankers and examiners to clearly communicate our expectations for sound portfolio credit risk-management processes. This guidance covers underwriting, loan review and approval, exception reporting pricing and portfolio stress testing.
- In 1999, we issued an industry advisory about the growing risks associated with higher-risk leveraged and enterprise value-dependent credits. We initiated an effort to improve the consistency of credit classifications among the banking agen-

cies, and led the development and issuance of interagency policies on higher risk subprime and high loan-to-value lending activities.

- In 2000, we continued training efforts designed to sharpen our examiners' risk recognition and credit classification skills, and led the development of Interagency Risk Management Standards for Leveraged Loans. This guidance, issued in 2001, establishes consistent criteria among the agencies for evaluating and classifying troubled leveraged and enterprise value dependent loans. We also led the development of Interagency Guidance on Accounting for Loans Held for Sale, which was issued this year, to improve public disclosures of credit losses being taken by banks that are selling problem and other loans in the secondary markets.

Throughout this process we have maintained an open and candid dialogue with the banking industry and our examiners about rising credit risk in the system and the need for improved risk-management by bankers. Through regular meetings with individual bank CEO's and periodic meetings with groups of CEO's and Chief Credit Officers, we have discussed the risks involved with some of the weaker credit-granting practices that seeped back into the system during the mid-to-late 1990's. We have worked with bankers to identify and mitigate their higher risk, more vulnerable credits at a time when their capital accounts and income statements are most capable of absorbing the risk. We have also insisted on accurate risk identification and disclosure so market forces are capable of affecting change where appropriate.

National banks have responded positively to these initiatives. Bankers are adjusting both their risk selection and underwriting practices. Credit spreads are wider, recent credit transactions are better underwritten than they were as little as 12 months ago, and speculative grade and highly leveraged financing activity has slowed in both the bank and public credit markets.

The widening of credit spreads and tightening of risk selection and underwriting standards reflect a reassessment of risk tolerance by all credit providers, not just banks. Bankers are working diligently to shore up previously weak risk selection and underwriting practices, improve deficiencies in credit risk identification and risk-management, and strengthen reserves as appropriate. Our recent examining activities are confirming these positive responses.

We recognize that we need to ensure a balanced approach as economic and credit conditions weaken. We have implemented, and will continue to follow, a careful but firm approach to addressing weak credit practices and conditions. In this regard, we are constantly mindful that the alternative approach of silent forbearance can allow problems to fester and deepen to the point where sound remedial action is no longer possible—a lesson that all bank supervisors learned painfully in the late 1980's and early 1990's.

The OCC has also taken a number of steps to address our concerns about increasing liquidity and funding risk.

- Over the past 2 years, we have provided OCC examiners with specialized liquidity risk-management training. That training focuses on current funding trends and issues and the importance of appropriate liquidity management, including bank contingency funding planning.
- In February, we issued a Liquidity Handbook, which outlines the OCC's expectations with respect to bank's liquidity risk-management practices. It highlights a number of elements necessary for successful liquidity management, including a consolidated liquidity strategy, effective risk-management tools, strong internal controls, sound contingency funding plans, and reliable management information systems.
- We have held a number of outreach activities and training programs. Included among them was a telephone seminar, The Challenges of Sound Liquidity Risk Management. OCC's Expectations and Policy for Community Banks, held on May 15 and 16, 2001. The seminar focused specifically on key aspects of managing community bank liquidity. Staff from over 300 community banks participated in the seminar.
- The OCC authored a Joint Advisory on Brokered and Rate-Sensitive Deposits, which the bank and thrift regulatory agencies published in May of this year. The Advisory highlights for banks the risk-management challenges posed by interest rate and credit-sensitive sources of funds.

The growing complexity of the banking industry requires us to develop new and modern tools to help detect emerging weaknesses more quickly. The OCC has been strengthening our early warning systems, which now include a set of tools—we call it "Project Canary"—designed to enhance our identification of and supervisory responses to banks that may be more vulnerable to emerging risks. We have created financial measures based on Call Report data, and we look at changes in those measures in assessing movement to higher risk position levels, particularly in the

area of credit, interest rate, and liquidity risks. For each measure, we have established benchmarks to assist in the identification of those banks with the highest financial risk positions. While risk taking is necessary in the normal course of banking, the paramount issue is whether high levels of risk taking are balanced with commensurate levels of risk-management. Bank managers, bank directors, and OCC examiners can use this information to look for high levels of risk and determine if risk-management and mitigants are appropriate for the given level of risk.

Our early warning system also provides assessments of a bank's vulnerability to changes in economic conditions. We have developed several internal models, which we combine with existing external models, to better define those banks that may be at higher risk of adverse macroeconomic or regional economic developments. For example, we can review the potential earnings impact of layoffs in a particular industry or community for banks in that area.

This early warning system is providing us with information to better calibrate our supervisory efforts and target the application of examination resources to the area of highest potential risk. Our supervisory managers use this information in planning examinations, allocating resources, and targeting key risks. These early warning tools also provide a useful, consistent method for identifying potential risk areas and performing comparative analysis. As such, they enable examiners and managers to better allocate resources through more focused examinations and offsite reviews. Supervisory offices use these measures as an oversight tool, by comparing the early warning reports to current risk assessments and supervisory plans, so that inconsistencies can be identified and resolved. And these tools also help us in assessing and tracking systemic risk.

Conclusion

In conclusion, we believe the condition of the banking industry today is strong. The vast majority of banks have strong capital and earnings, improved risk-management processes, and more diversified revenue streams. As a result, we believe the banking industry today is better able to withstand adverse economic developments than it was going into the recession of the early 1990's.

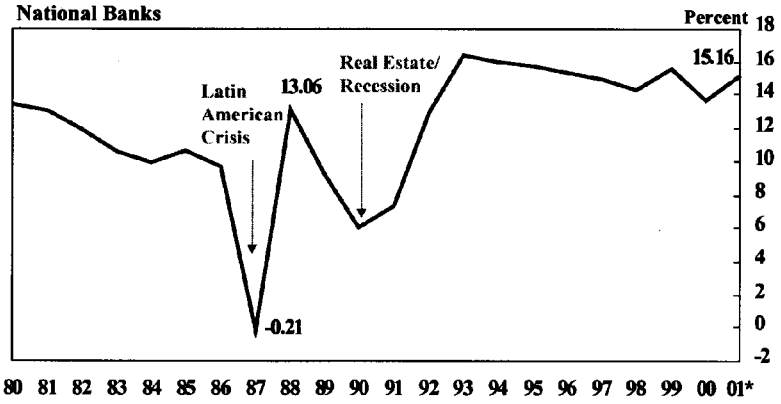
We are, however, in a period of heightened uncertainty concerning the domestic and global economic outlook. Credit problems are rising in our banks and we project continued pressure on bank earnings, at least over the near term. If the U.S. slowdown becomes deeper and persists, the effects on the banking industry will be much more serious. Declining earnings would heighten concerns about the safety and soundness of certain banks.

As supervisors, we have the important responsibility to neither discourage nor encourage lending but to ensure the soundness of the banking system. In good times, this is easy. It is more difficult to do when economic conditions are deteriorating and we are challenged to ensure that our standards for safety and soundness are neither too harsh nor too lax. We have experience with the difficult long-term problems created when bank supervisors failed to act in a timely and measured fashion and they tried to play catch up after the damage is done.

If we have learned anything from past economic crises both in the United States and overseas, we know that a sound banking system is essential to continued economic growth. I can assure you that the OCC will remain vigilant in our efforts to continually improve the risk-management of national banks and thereby maintain a viable, healthy industry to support our economy.

Figure 1

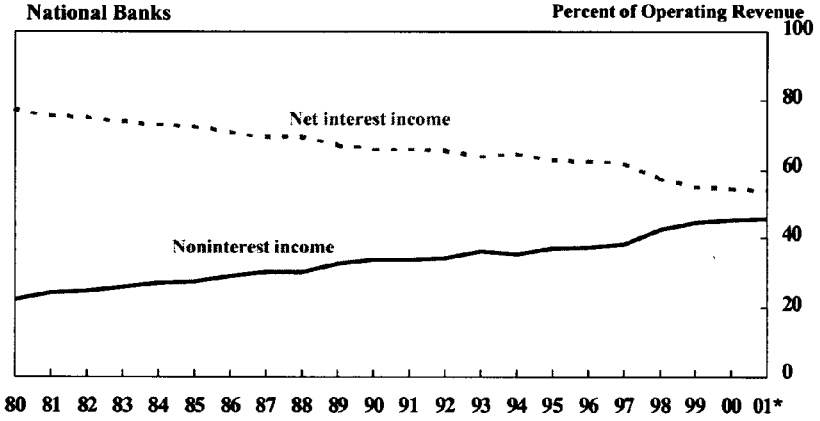
The return on equity has remained quite strong since 1992



* 2001 data as of March 31, 2001. All other data as of year-end.
Source: Integrated Banking Information System

Figure 2

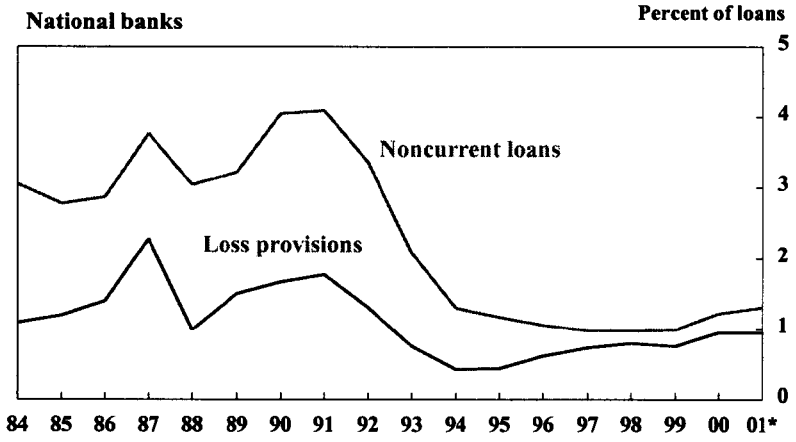
Banks are increasingly relying on noninterest income



* 2001 data as of March 31, 2001. All other data as of year-end.
Source: Integrated Banking Information System

Figure 3

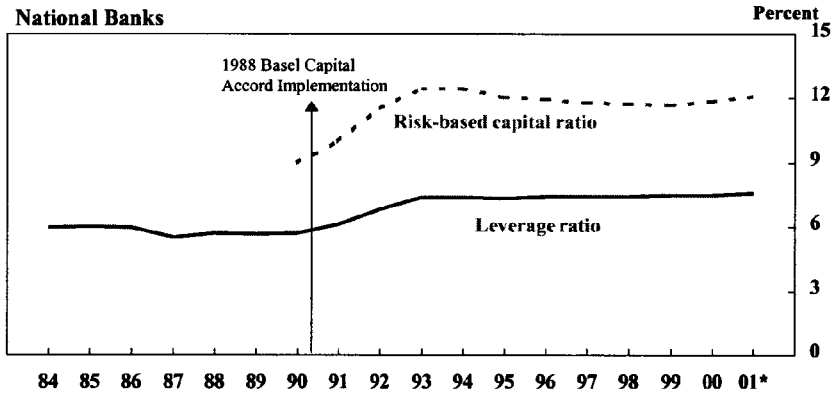
Problem loans and provisioning were historically low in 1990s



* 2001 data as of March 31, 2001. All other data as of year-end.
Source: Integrated Banking Information System

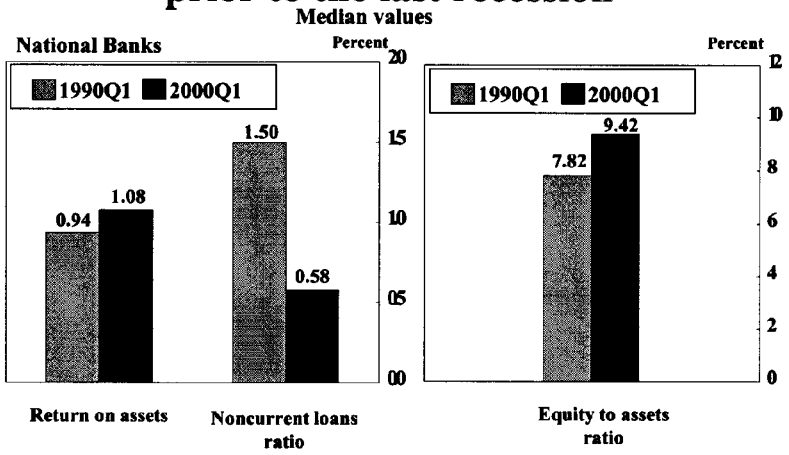
Figure 4

Capital levels are high



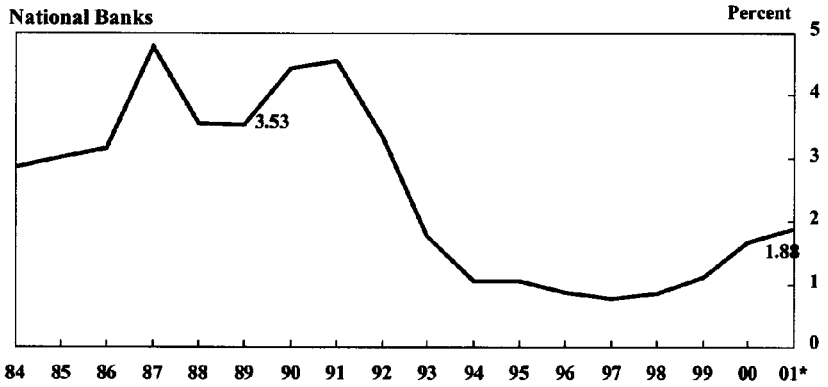
* 2001 data as of March 31, 2001. All other data as of year-end.
Source: Integrated Banking Information System.

Figure 5
Key condition indicators much improved from prior to the last recession



Source: Integrated Banking Information System. Excludes specialty banks that have credit card loans (or securitized credit card credits) in excess of 25% of assets or loans less than 10% of assets.

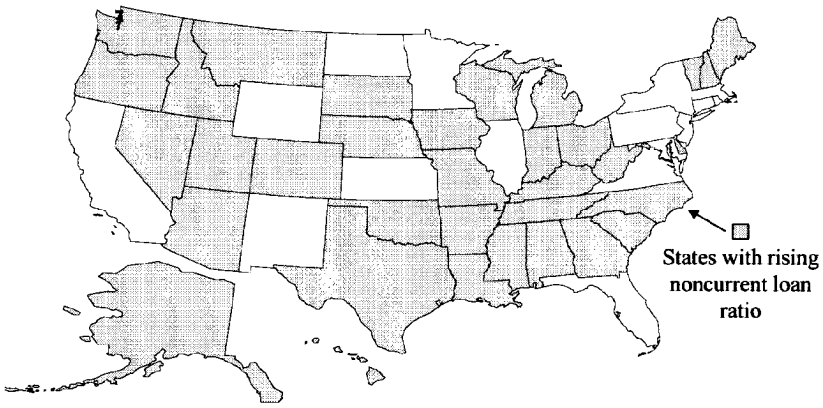
Figure 6
Noncurrent C&I loans ratio rising



* 2001 data as of March 31, 2001. All other data as of year-end.
Source: Integrated Banking Information System.

Figure 7

Small banks in most states now showing deterioration in loan quality



Source: Integrated Banking Information System. Bank with assets under $1 billion, excluding specialty banks that have credit card loans (or securitized credit card credits) in excess of 25% of assets or loans less than 10% of assets. Increase in noncurrent loans ratio of at least 5 basis points between 2000Q1 and 2001Q1.

PREPARED STATEMENT OF DONNA TANOUE

CHAIR, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 20, 2001

Mr. Chairman, Senator Gramm, and Members of the Committee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the condition of the bank and thrift industries and the deposit insurance funds.

I am pleased to report that the banking and thrift industries continue to exhibit strong financial results. However, we are seeing signs of stress that indicate that this continued strong performance will be more difficult to maintain in the future. I will highlight three of these warning signs in my testimony today—subprime lending, vulnerabilities in the agricultural sector, and funding and liquidity challenges.

Perhaps the most important message that I will leave with you today is that there are flaws in the current deposit insurance system and the best time for constructive debate on changes to deposit insurance is now, during a period of financial health for the banking and thrift industries, rather than in the charged atmosphere of a crisis. Today, depository institutions are strong and profitable. The deposit insurance funds also are in good financial condition and the FDIC stands fully prepared to fulfill its commitment to depositors. We should not, however, assume that these good times will last another decade. As you know, depositors in all walks of life have come to rely on FDIC insurance to guarantee that their insured deposits are absolutely safe. The financial strength of the FDIC and its ability and commitment to honor its responsibility to depositors are beyond question. Therefore, I urge this Committee to take advantage of this timely juncture and to move forward on reform to ensure that the strength and stability of our deposit insurance system remains unquestioned.

Condition of the Industry

The banking sector continues to experience strong financial performance. Commercial banks recently completed their eighth consecutive year with an industry return on assets above 1 percent. A return on assets (ROA) of 1 percent or higher has traditionally been a benchmark of superior earnings performance. Prior to 1993, the commercial banking industry never had an annual ROA as high as 1 percent. Almost 60 percent of all insured commercial banks reported an ROA of 1 percent or higher last year.

Three main sources of strength drove bank earnings during this period of prosperity. First, the improvement in asset quality following the last recession has meant that expenses for credit losses have been less of a drain on banks' revenues. Second, noninterest revenues have been growing rapidly, as the industry has diversified its sources of income. Third, banks have had strong growth in assets, particularly in loans, as they have provided necessary credit to a record-breaking economic expansion.

Many indicators of trouble—unprofitable banks, "problem" banks, undercapitalized banks, bank failures—all remain near their cyclical lows. Banks' capital has kept pace with the industry's growth. Today, more than 95 percent of all banks are in the highest regulatory capital group. The number of "problem" banks—78 banks, with $17 billion in assets at the end of last quarter—is near its cyclical low point.

Our most recent earnings data, which we released earlier this month, show that net income of commercial banks set a new record in the first quarter of 2001. However, this record was made possible by nonrecurring gains on sales of securities. The industry's net operating income, which more closely reflects the strength of banks' ongoing core business, was $565 million below the level of a year earlier.

Sustaining these very high levels of profitability has become increasingly difficult for the banking industry. There is evidence that many banks have taken on more risk as they have sought to maintain profitability. At the same time, some of the most important factors that have contributed to the industry's relative prosperity are becoming less favorable.

Net interest margins—the difference between what banks earn on their loans and other investments and what they pay for deposits and other liabilities—reached a 14 year low in the first quarter. The margin decline stemmed from increased competition, which has put downward pressure on loan pricing and upward pressure on funding costs, and a relatively flat yield curve.

The volume of problem loans has been growing for almost 2 years, mostly in loans to commercial and industrial (C&I) borrowers at large banks. Only one-third of all banks are showing deterioration in their C&I portfolios, but together they account for more than two-thirds of all C&I loans held by commercial banks. Moreover, most of the deterioration is centered in larger banks, particularly those with large and

middle market corporate loan portfolios. This deterioration is reflected in the interagency Shared National Credit review program, which has reported two straight years of significant increases—albeit from a very low base—in classified and criticized credit volumes, a 53 percent increase in 1999 and another 44 percent increase in 2000. The 2001 Shared National Credit review is currently in progress and results will be available later this year, but indications are of a continuing trend.

Credit card loans, which the FDIC identified as a potential concern in our 1997 testimony on industry condition, have shown an improved trend in loan losses since 1998. Up until the first quarter of this year, this improvement has paralleled an improving trend in personal bankruptcy filings through the end of 2000. However, personal bankruptcies in the first quarter of this year were up 18 percent over the previous year, raising the possibility of higher write-offs of credit card loans later this year.

As the percentage of troubled loans has risen from cyclical lows, banks have had to apply an increasing share of their revenues to provisioning for loan losses. Last year, loss provisions absorbed 8.2 percent of banks' net operating revenues, the highest proportion since 1992. In the first quarter of this year, loss provisions were 36.1 percent higher than a year ago.

Concentrations of traditionally higher risk loans as a percent of capital also have been on the rise. The forthcoming issue of the FDIC Regional Outlook, which we will release shortly, shows that the percent of insured institutions with moderately high concentrations—that is, commercial and construction loans totaling between 400 and 700 percent of capital—has increased by more than half since 1995. A greater percentage of insured institutions, 17.1 percent, has concentrations in this 400 to 700 percent range now than at any time since at least 1984. This fact is troubling as history shows that banks with concentrations such as these consistently tend to fail more often than banks with lower concentrations—as much as 2 to 3 times as often by some measures. It is important to recognize that the higher capital levels we see are accompanied in many cases by higher portfolio risks.

The FDIC is addressing the increase in credit risk in several different ways. The FDIC employs a risk focused examination approach that enables examiners to prioritize risk and allocate staff to those areas of the bank that represent the most risk. Enhanced examination software tools give our examiners the ability to perform more sophisticated loan reviews with special emphasis on the higher risk C&I and construction/development loans. In addition, the FDIC recently instituted a large bank supervision program that provides more on-going supervision throughout the year for many of our largest institutions. Our offsite monitoring programs provide current data on loan growth and performance trends that are closely reviewed by staff assigned to monitor each insured bank. We also monitor the industry and local real estate markets through other vehicles such as the Report on Underwriting Practices and the Survey of Real Estate Trends. We continue to work closely with other regulators to improve the information exchanges and interagency cooperation that are necessary in today's rapidly evolving banking system. An example is the recently issued additional guidance to banks on risk-management practices for leveraged financing.

As we contemplate further weakening in asset quality and slowing revenue growth in the near term, we should recognize that the banking industry today is far stronger than when it entered the last economic downturn more than 10 years ago. Banks now have more opportunities for geographic diversification and new sources of income. Banks also have been able to control growth in their overhead expenses, and to steadily improve efficiency.

Many of the observations made about commercial banks apply to insured savings institutions as well. While the profitability of insured savings institutions has been somewhat lower than the profitability of commercial banks, the past few years have brought strong earnings and growth for the thrift industry as well. Reflecting their historical role as providers of financing for homeownership, more than two-thirds of all loans held by insured savings institutions are home mortgage loans. At commercial banks, home mortgages account for less than one quarter of all loans. The large share of home mortgages in their loan portfolios means that most thrifts have lower net interest margins and lower credit risk than commercial banks. However, thrifts are subject to the same competitive pressures, and exhibit many of the same trends in performance and condition that we see at commercial banks.

Condition of the Insurance Funds

The two deposit insurance funds managed by the FDIC reflect the favorable condition of the bank and thrift industries. The Bank Insurance Fund (BIF) reported a balance of $31.4 billion (unaudited) as of March 31, 2001, compared to $31 billion at year-end 2000. One BIF-member institution failed in the first quarter of 2001,

and there have been just 22 BIF-member failures over the preceding 5 years. The BIF balance has grown in each of the last five quarters, but these increases failed to keep pace with strong growth in BIF insured deposits. As a result, the BIF reserve ratio[1] has drifted downward, from 1.36 percent of estimated insured deposits at the end of 1999 to 1.32 percent as of March 31, 2001. From March 2000 to March 2001, BIF insured deposits increased by $180 billion. Nearly one-third of this amount ($57 billion) can be attributed to two organizations that have been sweeping brokerage-originated cash management funds into insured-deposit accounts at BIF-member bank affiliates. The insured deposit growth at these two organizations—without additional contributions to the insurance fund—has been enough to account for a 3 basis point decline in the BIF reserve ratio.

The Savings Association Insurance Fund (SAIF) also has reported steady growth, resulting in a balance of $11 billion as of March 31. No SAIF members have failed thus far in 2001, and only three SAIF members failed in the preceding 5 years. Recent insured deposit growth has been relatively strong for the SAIF, although less so than for the BIF. SAIF insured deposits grew 1.7 percent during the first quarter of 2001 and 5.8 percent during 2000, compared to average annual growth of 0.6 percent in the preceding 5 years. The SAIF reserve ratio stood at 1.43 percent on March 31, which was unchanged from year-end 2000 and down slightly from 1.45 percent at the end of 1999. Brokerage account sweeps added an estimated $2 billion to SAIF insured deposits, accounting for a one-half basis point decline in the SAIF reserve ratio.

Challenges to Continued Strong Performance

A transition from a decade of rapid economic growth to the slower growth the U.S. economy is now experiencing will, to some degree, adversely affect bank earnings. The impact is likely to be greatest on institutions that have been most aggressive in their selection of risks. In this regard, as they develop risk-management strategies, insured institutions need to allow for the potential for economic conditions to be less favorable than prevailed during the 1990's.

Experience suggests that a weakening economy takes some time to affect banks. I would like to devote some attention to two issues that are more immediately before us, namely those posed by subprime lenders and lenders dependent on the agricultural economy. I also will discuss an issue that is extremely important to many banks today, that of funding and liquidity.

Subprime Lending

The FDIC continues to have concerns regarding subprime consumer and mortgage lending. We are closely watching approximately 150 institutions that have subprime lending programs, for example, programs that purposely target subprime markets, in volumes that equal or exceed 25 percent of capital.

Subprime lending can be—and indeed, has been—beneficial to borrowers with blemished or limited credit histories and is an acceptable activity for insured institutions, provided that the institution has proper safeguards in place. Without these safeguards, mistakes can be costly, as evidenced by the role subprime lending has played in recent failures. Subprime lending figured prominently in 6 of the 20 bank and thrift failures in the past 3½ years. Further, since most subprime lenders in the bank and thrift industry have not been tested in an economic downturn, it is realistic to expect additional problems for institutions with concentrations of subprime loans should economic conditions deteriorate further.

Several factors that are very often associated with subprime lending can create problems for the lenders, their regulators, and for the FDIC as receiver for failed institutions. One factor is the nature of the assets created as a by-product of loan securitization. In a securitization, the subprime lender sells packages of loans to another party or institution, but often retains the right to receive a portion of the cashflows expected from the loans. The expected value of these cashflows is generally referred to as the retained interest, or residual.

The residual holder's right to receive cashflows is generally a deeply subordinated position relative to the rights of the other security holders (as such, they serve as a credit enhancement to the other securities). To determine the value of this residual, the tender must make a variety of assumptions about the underlying loans, which would include delinquency rates, charge-off rates, and discount rates. As a result, and particularly with subprime loans, the accurate valuation of the residuals can be extremely difficult, making the residuals a highly illiquid and very volatile asset. In institutions with excessive concentrations of residuals, the safety and

[1] The reserve ratio is the fund balance divided by the dollar volume of the estimated insured deposits.

soundness of a bank or thrift may be threatened if the valuations turn out to be overly optimistic.

The complexity of subprime loan securitizations also means that accounting deficiencies are more likely. In some of the failures involving subprime lenders that securitized loans, accounting statements were deemed inadequate or inappropriate by bank supervisors.

Finally, subprime lending programs may use third parties for loan origination, servicing or other activities. The use of third-party originators and servicers is a standard business practice that can reduce bank costs and enhance efficiency. However, poor analysis and monitoring of loans purchased from third parties have contributed to the failure or near-failure of a few institutions due to misrepresentation, and even apparent fraud, on the part of the originator.

We have intensified our supervisory attention to the roughly 150 banks and thrifts with subprime lending programs. The banking agencies released the March 1999 Interagency Guidance on Subprime Lending. In January 2001, the agencies distributed the Expanded Guidance for Subprime Lending Programs. The focus of our supervisory attention is on the need for more intensified risk-management procedures and internal controls for such higher risk lending programs, as well as the need for appropriate levels of reserves and capital.

Vulnerabilities in the Agriculture Sector

Farm banks remain in a vulnerable position as their profitability is linked so strongly to the uncertain economics of farming and the continuance of Government support payments. Without Government payments, many farmers would have significantly more difficulty meeting loan payments.

Today, more than 1,900 banks hold more than 25 percent of their loans in farm loans. While these farm banks constitute some 23 percent of all commercial banks, these banks tend to be smaller, rural community institutions, and hold less than 2 percent of all bank assets. Farm banks are highly sensitive to local economic conditions, being less diversified in their lending and sources of income. For instance, noninterest income contributes less than 15 percent of farm banks' revenue compared to over 43 percent for other commercial banks.

The FDIC is not predicting serious near-term problems in the farm bank sector. In spite of the well-publicized stress in the agriculture sector, the performance of farm banks, on average, remains quite steady with loan quality and capital positions remaining relatively strong. Only 2 percent of farm banks lost money in 2000. Most farm banks are currently well capitalized and well managed and generally are in much better financial condition than they were before the 1980's farm crisis.

Over the longer term, farm banks face the difficult issue of rural depopulation. U.S. Census data indicate that the Midwest has most of the counties in the United States that have lost population since 1970. Farms have been consolidating for decades, resulting in larger farms and lower populated rural areas.

To date, two sources of income have helped farmers, and thereby farm banks, avert a more serious financial crisis. In aggregate, farm households have come to depend more on off-farm income, mostly wages and salaries, for their livelihood. In addition, Federal assistance remains significant, providing 49 cents of every dollar farmers earned in 2000.

However, the FDIC must remain vigilant for further declines in the agricultural economy. The U.S. Department of Agriculture currently forecasts a decline in net cash farm income in 2001 to under $51 billion, down from $56.4 billion last year (assuming no supplemental assistance for the 2001 crops). Higher energy costs also play a role in the forecasted decline.

Funding and Liquidity

During this record economic expansion, loan growth in the commercial banking industry has been exceptionally strong while deposit growth has failed to keep pace. This raises questions of decreased liquidity and continued credit availability, especially at community banks.

Since 1992, loans held on bank balance sheets have increased by $1.8 trillion or at an 8.3 percent compounded growth rate. In contrast, core deposits grew by only $709 billion, which translates to a 3.6 percent compounded growth rate. As a result, the share of commercial banks' assets funded by core deposits has declined steadily from its peak level of 62 percent at year-end 1992, to 46 percent at the end of 2000. During that same period, the percent of banks' assets that consists of loans increased from 56 percent to 60 percent.

Pressures stemming from the need to fund rapid loan growth are particularly evident at community banks, which traditionally have relied almost exclusively on core deposits to fund balance sheet growth. In this environment of strong loan demand,

the balance sheets of banks with less than $1 billion in assets have undergone shifts in the composition of their assets and liabilities that have increased many community banks' exposure to interest rate risk, credit risk, and liquidity risk.

Many small banks appear to be liquidating securities to fund loan growth, and increasing the proportion of higher yielding, higher-risk loans in their portfolios in order to offset the increased cost of funding. This has helped to limit the erosion in community bank profitability in recent years. But these changes have left many small banks more vulnerable to rising interest rates and a slowing economy.

The ongoing loss of liquidity in banks' balance sheets is evidenced by the industry's historically high and rising loans-to-assets ratio. Loans are less liquid, that is, they are harder to convert into cash than assets such as U.S. Treasury securities or other marketable securities. Similarly, core deposits are important because they are not as volatile as many alternative sources of funds. They do not reprice quickly when interest rates rise, and because they tend to be fully insured, they do not flow out of banks when concerns about an institution's health arise. The loss of liquidity is also shown by the declining ratio of core deposits to assets, as banks have increased the share of loans in their asset portfolios and funded a growing share of their assets with nondeposit liabilities.

Increased reliance on liabilities other than core deposits implies potentially higher and more volatile funding costs for banks. Banks' inability to fund asset growth exclusively with core deposits has led to a growing dependence on large certificates of deposit and Federal Home Loan Bank (FHLB) advances. At the end of 1992, only 4.6 percent of commercial banks had any FHLB borrowings; these advances provided only 0.2 percent of commercial banks' funding. By the first quarter of this year, 45 percent of commercial banks had FHLB advances, which supplied 2.9 percent of the industry's funding.

There is no question that FHLB advances and other nondeposit funding sources play an important role in depository institutions' liquidity and funds management strategies. New Call Report data showed that, at the end of March, 52 percent of banks' FHLB advances had maturities in excess of 3 years. This suggests that many banks are attempting to use these advances to hedge interest-rate exposures of their longer-term assets. However, FDIC examiners have raised supervisory concerns in certain cases when a large concentration of an institution's funding needs were being met by FHLB advances or other wholesale funds and management did not fully understand the risks associated with those funding sources. Late last year, the FDIC issued guidance to our examiners for reviewing FHLB advances. Finally, on May 11, 2001, the FDIC and the other Federal bank and thrift regulatory agencies issued a joint advisory on the risks of brokered and other rate-sensitive deposits that outlined prudent risk identification and management practices for deposits.

There is some evidence that liquidity pressures are easing. The past two quarters have seen a pickup in growth in core deposits, led by increases in money market deposit accounts. These savings accounts, which offer access to funds while paying interest on balances, can represent "safe havens" for investors seeking risk-free, short-term investments. Growth in banks' domestic deposits has surpassed growth in loans for two consecutive quarters. But, two quarters is not a trend, and it is much too early to determine if recent strong deposit growth is credible.

Deposit Insurance Reform

Last year, the FDIC initiated a comprehensive review of the deposit insurance system. Our review identified some important flaws in the system, which we described in an Options Paper issued last August. I will describe the flaws and our recommendations for fixing them. A consensus appears to be emerging in support of several of the FDIC's recommendations, but some important implementation issues remain. I urge the Committee to take up these issues with my successor as soon as practicable, to ensure that we take advantage of the opportunity to enhance the deposit insurance system in good times, when the industry is strong.

The Case for Reform

One of the key flaws in today's system is that deposit insurance premiums do not reflect the risk that individual institutions pose to the system. Although the FDIC Improvement Act (FDICIA) mandates a risk-based deposit insurance premium system, other provisions of law prohibit the FDIC from charging premiums to institutions that are both well capitalized, as defined by regulation, and well managed (generally those with the two best examination ratings) when a fund's reserve ratio is at or above the Designated Reserve Ratio (DRR) of 1.25 percent. As a result, over 92 percent of insured institutions are in the FDIC's best-risk category and currently pay no deposit insurance assessment. All institutions pose some risk, and there are significant and identifiable differences in risk exposure among the institutions in

the best-rated premium category. Indeed, even institutions with different CAMELS ratings (CAMELS "1" or "2") pay the same amount for insurance—zero. Having institutions with different risk characteristics all paying nothing for insurance renders the risk-based premium system ineffective, reduces the incentive for banks to avoid risk and forces safer institutions to subsidize riskier institutions.

The inability to price risk appropriately has had a number of other negative effects. Since very little in premiums has been collected since 1996, the deposit insurance system is financed almost entirely by those institutions that paid premiums in the past. There are currently over 900 newly chartered institutions, with over $60 billion in insured deposits, that have never paid premiums.

In addition, deposit insurance that is underpriced creates an incentive for institutions to grow rapidly. Financial institutions outside the realm of traditional banking recently began to make greater use of FDIC insured deposits in their product mix. Large dollar volumes of investment firm brokerage accounts were swept into deposit accounts in their FDIC insured subsidiaries. To the extent that these institutions are in the best-rated premium category, they pay no insurance premiums for this rapid growth. Since they are not paying for insurance, new institutions and fast-growing institutions are benefiting at the expense of their older competitors and slower-growing competitors. Rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in a rapid increase in premiums for all institutions.

The second flaw in the current deposit insurance system identified by the FDIC study is that premiums are volatile and are likely to rise substantially during an economic downturn when financial institutions can least afford to pay higher premiums. By law, when a deposit insurance fund's reserve ratio falls below the DRR, the FDIC must raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within 1 year, or charge all institutions at least 23 basis points until the reserve ratio meets the DRR. However, during a period of heightened insurance losses, both the economy and depository institutions in general are more likely to be distressed. A 23 basis point premium at such a point in the business cycle would be a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery.

In addition to these two key flaws in the deposit insurance system, our review addressed two other important issues. The first is the existence of two separate deposit insurance funds. As long as the FDIC maintains two funds, whose assessment rates are determined independently, the prospect of a premium differential with its attendant inefficiencies and inequities exists. Separate funds also are not as strong as a combined deposit insurance fund would be. Moreover, because each insurance fund now insures both banks and thrifts, there is little justification for maintaining separate funds.

The second issue is the erosion in the real value of deposit insurance over time. Deposit insurance coverage is an important component of the Federal Government's program to promote financial stability, yet there is no mechanism for regular adjustments to maintain its real value as the price level rises.

The FDIC's Recommendations

The FDIC published the following recommendations for reforming our deposit insurance system on April 5, 2001.

- The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge premiums on the basis of risk, independent of the level of the fund.
- Sharp premium swings triggered by deviations from the designated reserve ratio should be eliminated. If the fund falls below a target level, premiums should increase gradually. If the fund grows above a target level, funds should be rebated gradually.
- Rebates should be determined on the basis of past contributions to the fund, not on the current assessment base.
- The Bank Insurance Fund and the Savings Association Insurance Fund should be merged.
- The deposit insurance coverage level should be indexed to maintain its real value.

Collectively, these recommendations will result in a deposit insurance system that will allocate the assessment burden more smoothly over time and more fairly across institutions. They are not designed to increase the long-term assessment revenue to the FDIC.

These reforms are designed to be implemented as a package. Picking and choosing among the parts of the proposal without focusing on the interaction between the various recommendations could weaken the deposit insurance system, magnify macroeconomic instability, and distort economic incentives.

At a general level, a consensus appears to be emerging in support of several of our conceptual recommendations. There is broadening agreement that:

- The deposit insurance system must be less procyclical. That is, premiums should not rise sharply during an economic downturn taking funds out of the banking system when they are needed most to help fuel a recovery.
- The FDIC must be able to charge appropriately for risk, both because the current system creates perverse incentives and because riskier institutions should shoulder more of the assessment burden for deposit insurance.
- Reform must address the issue of deposit growth, to lessen the impact of rapid growers on the rest of the industry and to bring a measure of fairness to the funding of the deposit insurance program.

Some important implementation issues remain to be resolved. These are the issues on which the FDIC will need to focus its discussions and build consensus going forward. One is how to set the target level for the fund. It is important to note, however, that a target level, be it a point or a range, should probably not be fixed permanently. It would be wise to revisit the performance of the fund and general economic conditions every few years and adjust accordingly. Another issue is how to differentiate among institutions on the basis of risk and charge premiums accordingly. A third issue is how to determine the size and allocation of rebates.

The FDIC's reform proposals were accompanied by various illustrative examples of ways of addressing these issues. These issues require policymakers to weigh and balance important policy goals. For example, in determining how to price risk across banks, actuarial judgments must be balanced against public policy goals. On an actuarial basis, banks with substantial loan concentrations pose a greater risk to the insurance fund, other things being equal. From a public policy point of view, however, it may not be desirable to over-penalize lenders in communities that happen to be dependent upon particular industries. As the examples illustrate, none of these issues are insurmountable, and working together we can implement meaningful deposit insurance reform.

Conclusion

I appreciate the opportunity to testify regarding the overall strength and prosperity of the banking industry. Today's strong economy and banking system also provide a window of opportunity to improve the deposit insurance system. It would be a missed opportunity to wait until the economy and the banking industry are suffering and the results of the weaknesses in the deposit insurance system have become all too evident. The FDIC's recommendations will strengthen the deposit insurance system, promote economic stability, enhance safety and soundness, and make the system more equitable.

These reforms will work best if implemented as a package. In particular, the ability to price for risk is essential to an effective deposit insurance system. Picking and choosing among the parts of the proposal could weaken the deposit insurance system, magnify macroeconomic instability, and distort economic incentives. Trying to address other issues without addressing risk pricing does not solve one of the most fundamental flaws in the current system.

I would like to thank Chairman Sarbanes, Senator Gramm, and Members of the Committee once again for the Committee's interest in this important issue and for the opportunity to present the FDIC's reform proposals. I hope that this Committee and the Congress, working with my successor, will be able to bring about these much needed reforms.

In closing, I also would like to thank my colleagues at the FDIC who produced the reform recommendations I have discussed and who work so hard at insuring a safe and sound financial system for the American people. It has been a pleasure and a privilege to work with them.

PREPARED STATEMENT OF ELLEN SEIDMAN

DIRECTOR, OFFICE OF THRIFT SUPERVISION, U.S. DEPARTMENT OF THE TREASURY

JUNE 20, 2001

I. Introduction

Mr. Chairman, thank you for the opportunity to appear before the Committee to discuss the financial condition and performance of the thrift industry. As the Director of OTS, I have come to appreciate how difficult it is to change perceptions. We often hear that perception is reality. Sometimes perception is reality, but not always. The thrift industry is a case in point. Today, many of those who do not follow

the industry closely still perceive the industry as being deeply troubled. The memory of the thrift crisis lingers in the Nation's collective consciousness. In 1988, one in five thrifts was insolvent. Equity-to-assets ratios averaged 3.5 percent. In that year alone the industry reported losses of $13.3 billion.

Working together, President Bush and Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to address the crisis, and clean-up problem thrifts. By 1991, the thrift industry had returned to profitability and began a long process of restoration, stabilization, and strengthening.

Where Is the Industry Today?

Today's thrift industry is strong and growing. Profitability, asset quality, and other key measures of financial health are at or near record levels. The average equity-to-assets ratio is over 8 percent, and 98 percent of thrifts are well capitalized. Problem thrifts and loan loss rates are very low. Mortgage loan originations are at or near record levels. And only three thrifts have failed in the past 5 years.

Many factors are responsible for the current health of the thrift industry. Obviously, the Nation's long-running economic prosperity and the quality of thrift management are two critical factors. We must also recognize the contribution of critical statutory and regulatory reforms that have been initiated over the last twelve years to strengthen the banking system. The reforms of FIRREA, and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which mandated new capital standards, uniform standards for lending, operations and asset growth, and prompt corrective action, played a large role in strengthening the system. New supervisory tools and enforcement powers, such as the Examination Parity and Year 2000 Readiness for Financial Institutions Act, have given us the ability to intercede more quickly and forcefully if problems develop at an institution. At OTS we have worked hard, through recruiting, training, our new accreditation and professional development programs, and other new supervisory tools, to make certain our staff is equipped to deal with the challenges of an ever more complex industry.

II. Condition of the Thrift Industry

As of March 31, 2001, there were 1,059 OTS-regulated thrifts, holding assets of $953 billion. Though consolidation continues to reduce the number of thrifts, asset growth has been strong, and assets are at the highest level since March 1991.

While there are some large thrifts that operate nationwide, most thrifts are small, community-based financial service providers. As of the first quarter of 2001, 71 percent of thrifts had assets less than $250 million. Mutual thrifts comprise 39 percent of the industry, but have only about 7 percent of the industry's assets. The industry employs 182,000 people, maintains over 61 million insured deposit accounts, and holds over $668 billion in housing related-loans and securities, including $458 billion in whole single-family loans, representing over 48 percent of thrift assets.

A. Earnings and Profitability

In recent years, the earnings and profitability of the thrift industry have been strong—a trend that continued into the first quarter of this year. First quarter earnings were $2.16 billion—the third best quarterly earnings on record. For the year 2000, the industry reported earnings of $8.0 billion, just shy of the record earnings of $8.2 billion posted in 1999.

The industry's return on average assets, a key measure of profitability, was a healthy 0.92 percent in the first quarter of this year and 0.91 percent in the year 2000. The industry posted yearly returns on assets above 0.90 percent for the last 3 years—a feat last achieved in the late 1950's.

In large part, the strength and stability of the industry's earnings can be attributed to diversification of income sources, and strong asset quality.

The industry's success over the past decade in expanding its line of products and services, such as mutual fund and annuity sales, trust activities, and transaction accounts, has enabled the industry to diversify its income stream and generate more stable earnings. Higher proportions of noninterest income helped stabilize thrift income and provided better insulation against interest rate fluctuations. Noninterest income as a percent of thrifts' gross income more than doubled over the past 10 years to 12.4 percent for 2000 from 5.1 percent in 1990.

Smaller thrifts, as a whole, did not fully participate in the overall industry earnings expansion. While remaining stable, smaller thrift earnings have lagged overall industry earnings for the last 3 years. Part of the reason for smaller thrifts' lag in earnings is that they hold higher than average proportions of lower yielding assets—cash, U.S. Treasury securities, and nonmortgage related investment securities. As of the first quarter, thrifts with assets under $100 million held 16.8 percent of their total assets in lower yielding assets compared to the industry average of

7.4 percent. In addition, the majority (56 percent) of mutual thrifts had first quarter assets under $100 million. Mutual thrifts are not under shareholder pressure to maximize profits and pay dividends. However, mutual thrifts often "share" profitability with their owners—depositors—through higher interest rates and lower fees on deposit accounts. Mutuals are also active participants in the economic development of their communities. This sharing of profitability lowers net earnings.

B. Asset Quality

The overall quality of thrift asset portfolios is strong and key measures of problem loans are at or near historic lows. Troubled assets (loans 90 or more days past due, loans in nonaccrual status, and repossessed assets) were 0.62 percent of assets in the first quarter, slightly above the recent low of 0.58 percent at September 30, 2000. The ratio of troubled assets-to-total assets has remained below 1 percent since September 1997.

As might be expected in the current economic environment, the level of delinquent loans has been increasing. The industry's noncurrent loan ratio increased in the three most recent quarters, albeit from a record low level. However, less seriously delinquent loans—those 30–89 days past due—were 0.70 percent of assets in the first quarter, down from 0.74 percent at the end of 2000.

The majority of the overall increase in thrift noncurrent loans was due to arise in delinquent business-related loans, namely, commercial loans, nonresidential mortgages, and construction loans. Although the dollar amount of the typical business-related loan is larger than the typical consumer-related loan, the industry's total investment in business-related loans is small—less than 10 percent of all thrift assets. Thus, the overall increase in noncurrent loans reflects the delinquency of a small number of loans at a few thrifts.

Loan charge-off rates have also remained at low levels. Net charge-offs as a percent of total assets were 0.19 percent (annualized) in the first quarter, down slightly from 0.20 percent in 2000. The low charge-off rates reflect the high quality of thrift loan portfolios, which are heavily concentrated in single-family mortgages. Charge-off rates for single-family mortgages are generally very low compared to other types of loans. The loan charge-off rate was 0.05 percent of all single-family mortgages in the first quarter (annualized), or $50 per $100,000 of loans.

Thrifts' loan loss reserves have remained relatively constant at approximately 1 percent of total loans since 1999, reflecting the low levels of troubled assets and charge-off rates. The industry's reserve ratio is somewhat lower than that of the commercial banking industry. Again, this is due to thrifts' higher percentage of assets held in mortgage loans, which have lower loss rates than commercial loans.

C. Capital

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. Equity capital was 8.1 percent of assets in the first quarter, with 98 percent of the industry exceeding well-capitalized standards.[1] Only four thrifts were less than adequately capitalized at the end of the first quarter, and each is operating under an OTS-approved capital restoration plan.

D. Funding Sources

While capital ratios remain strong, the industry has become somewhat more dependent on wholesale funding as deposit growth has slowed due to changing savings and investment patterns and the strong competition from mutual funds. Although deposits remain the primary source of funding for the industry, the ratio of total deposits-to-total assets has declined steadily over the past decade. In 1990, deposits funded 77.0 percent of thrift assets. By the end of first quarter of 2001, the ratio had declined to 57.0 percent.

Though the dollar volume of deposit growth has slowed, the number of deposits has increased since 1998, from 50.4 million in 1998, to 61.2 million as of the first quarter of 2001. The average size of small denomination deposits (those under $100,000) was $6,900 as of the first quarter of 2001, compared to $8,000 in 1998, reflecting the industry's increase in noninterest bearing checking accounts that typically carry relatively small balances. Such deposits increased by 28 percent to $36.8 billion in the first quarter, from $28.7 billion at the end of 1998.

With deposits declining as a source of funding, the thrift industry has become more dependent on wholesale funding, primarily in the form of Federal Home Loan

[1] On November 3, 2000, OTS and the other Federal banking agencies requested public comment on an advance notice of proposed rulemaking that considers establishment of a simplified regulatory capital framework for noncomplex institutions. And on September 27, 2000, OTS and the other Federal banking agencies requested public comment on proposed revisions to capital rules for residual interests in asset securitizations or other transfers of financial assets.

Bank (FHLB) advances. At the end of the first quarter, FHLB advances funded 22.8 percent of total thrift assets, up from 7.4 percent in 1991. In addition, other types of borrowings, such as repurchase agreements, subordinated debt, and Federal funds purchased, funded 8.9 percent of assets, up from 5.5 percent in 1991.

E. Interest Rate Risk

Interest rate risk remains a key concern in the thrift industry. Interest rate risk is a natural by-product of the industry's basic business of making long-term mortgages, which are generally funded with shorter-term deposits and other borrowings.

Interest rate risk was at the forefront of supervisory concern during 1999 and early 2000 as rising interest rates and a sharply inverted yield curve combined to put downward pressure on the industry's profit margins. Interest rate risk in the industry, however, has eased considerably since then. Interest rates have fallen dramatically and the yield curve has returned to a more normal shape. Thrift management also took steps to change their asset mix to reduce interest rate risk. Thrifts are now reporting wider net interest margins and generally lower levels of interest rate risk exposure.

OTS, alone among the Federal bank regulators, has implemented a stress-test based supervisory strategy for evaluating the interest rate risk of the institutions we regulate. As a result, both we and the institutions are able to effectively assess and deal with any increase in interest rate risk sensitivity arising from changing interest rates or funding through noncore deposit sources, including FHLB advances with embedded options. As of the first quarter, 73 percent of all thrifts were classified as having low levels of interest rate risk, 18 percent as having medium levels, and 9 percent as having higher levels. Those in the higher risk level category are given close supervisory scrutiny.[2]

F. Problem Thrifts

The number of problem thrifts—those with composite safety and soundness examination ratings of 4 or 5—remains low. There were 14 problem thrifts at the end of the first quarter, up from 10 in September 1999—the lowest level since OTS's inception. Assets of problem thrifts have also remained low and stood at 0.5 percent of industry assets as of the first quarter. Thrifts categorized as being in "problem status" are subject to increasingly strong supervisory action to ensure that management and the board of directors move to resolve the institution's problems.

Thrifts that are rated composite "3", while not considered problem institutions, warrant more than the normal level of supervisory attention. The number of institutions with 3 ratings rose from a recent low of 67 in 1998, to 98 by the end of 2000. (The commercial banking industry had a similar increase in 3-rated institutions during this period.) By the end of the first quarter, the number had declined to 90. Of these, 91 percent were "well-capitalized," and thus have a capital cushion that increases their ability to work through their difficulties in an orderly manner.[3]

Supervisory attention is also focused on thrifts identified in other types of examinations, such as compliance, Community Reinvestment Act (CRA), and information technology (IT), as needing improvement. As of the first quarter, there were 67 thrifts rated 3 or below in compliance, including 6 thrifts rated 4 or 5. Sixteen thrifts were rated less than satisfactory in their CRA examination. Reflecting the rapid changes in technology, focus on privacy and security concerns, and increased demand for technologically savvy managers, 35 thrifts were rated 4 or 5 on their IT exam, and 24 were rated 3. In all cases, we work with these institutions to help them return to strong ratings.

G. Continuing Role of the Thrift Industry

1. Community Lenders with Residential Focus

Although thrifts can make consumer and, in limited quantities, commercial loans, they remain primarily focused on residential mortgage lending. Thrifts originated over 21 percent of all single-family mortgages made in the United States in the first quarter. Moreover, thrifts are the dominant originator of adjustable rate mortgages

[2] On April 12, 2001, the OTS issued a new Regulatory Handbook section on Derivative Instruments and Hedging that included an expanded discussion of risks of using derivatives, a discussion of OTS's policy on derivatives that incorporates sensitivity analysis or stress testing from TB13a, and a discussion of FASB's SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities.

[3] On April 30, 2001, the OTS proposed amendments to its assessment rule that would more accurately reflect the increased costs of supervising 3-, 4-, and 5-rated institutions.

(ARM's). In the first quarter, roughly 69 percent of all new ARM originations were made by thrifts.[4]

The industry originated $74.3 billion in single-family mortgages in the first quarter, the second highest quarterly volume on record. Since the end of 1995, the industry has originated over $1 trillion in single-family home loans.

Single-family mortgage loans and related securities comprised almost two-thirds of thrift assets in the first quarter. In addition, 4.7 percent of thrift assets were held in multifamily mortgages, bringing the percentage of assets held in residential-related loans and securities to 70.1 percent.

While thrifts are primarily residential mortgage lenders, they have become more active in consumer and commercial business lending. The industry's ratio of consumer loans-to-assets was 6.3 percent in the first quarter, up from 4.5 percent at the end of 1990. Utilizing the expanded small business lending authority granted by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the industry's ratio of commercial loans-to-assets stood at 3.0 percent in the first quarter, up from 1.5 percent at the end of 1997.

Thrifts also help their communities by making mortgages on hospitals, nursing homes, farms, churches, stores, and other commercial properties. Such loans comprised 4.0 percent of thrifts' assets in the first quarter.

2. Full Range of Financial Services

Besides loans and deposits, thrifts provide a wide range of savings and investment products to their communities. The industry's sales of mutual funds and annuities, and trust assets administered, have risen dramatically over the past 5 years. Total sales of mutual funds and annuities were $2.9 billion in the first quarter of 2001, and $12.8 billion for the year 2000, compared to $6.4 billion in 1995. Trust assets administered totaled $427.4 billion as of the first quarter versus $13.6 billion at the end of 1995.

III. Risks Facing the Industry

A. Credit Risk

While the overall financial condition of the thrift industry is strong, the current economic slowdown suggests that rising levels of delinquent loans are a distinct possibility. In terms of credit risk, the industry's largest exposure is in residential mortgage loans. Fortunately, however, the housing market is very strong in most areas of the country and delinquencies on single-family residential loans have remained at very low levels. Barring a serious downturn in the economy, which seems unlikely, the credit quality of residential mortgage portfolios should remain healthy.

The slowdown in economic activity, however, is bound to have a bad effect on marginal credits, particularly overextended consumers and commercial borrowers.

Thrifts are not immune to weakness in the business sector since 3.0 percent of thrift assets are held in commercial loans. Nor is the industry immune to problems in the consumer sector. In recent years, debt service burdens of consumers have generally grown more rapidly than their incomes, and the rate of consumer savings of disposable income has been disturbingly low.

Not surprisingly, banks and thrifts have been tightening credit standards, building loss reserves, and otherwise fortifying their balance sheets. As we have learned from experience, it is not sufficient to rely solely on bank and thrift managers to ensure the safety and soundness of the system. Vigilant supervision is important, particularly in a banking system such as ours where deposit insurance, together with ever-tougher competition, can blunt market discipline and encourage undue risk-taking by some institutions.

Given the current economic environment, we are placing increased emphasis on credit review in our examination process. OTS examiners are focusing on thrifts' credit quality, reserve policies, and capital adequacy. The loan monitoring, loan collection, and work out procedures of thrifts are being given increased scrutiny. Particular attention is being given to business-related loans originated during the height of the economic expansion.

B. Liquidity Risk/Funding Changes

We are also closely monitoring thrifts' liquidity, although it should be stressed that liquidity problems are rare in the industry, and when they do occur, are invari-

[4] Mortgage origination market share estimates based on data from the Mortgage Bankers Association of America and the Federal Housing Finance Board.

ably triggered by weaknesses such as problem loans.[5] While an insured depository institution is solvent and has eligible collateral, liquidity is available. Nevertheless, the thrift industry as a whole has become decidedly more dependent on wholesale funding in recent years, and loan-to-deposit ratios have been increasing. These trends reflect the recent slow pace of deposit growth as well as our very competitive financial markets in which banks and thrifts must carefully balance the trade-off between liquidity and profitability.[6]

C. Operational Risk

Operational risk, which includes the risk of loss due to technical failures and human error, seems to be an ever-present and growing concern in the financial services industry. The growth of internet banking, the outsourcing of core banking functions, and the rapid pace of technological and financial innovation has created new challenges and concerns.

Advances in technology have also created opportunities for thrifts, especially in the areas of marketing and broadening customer services. Thrifts also utilize technology to increase their understanding of certain credits, enabling better product pricing. The use of technology for these purposes is encouraged but must be done so responsibly.

Our IT examiners, and increasingly, technology-trained safety and soundness examiners, focus on how well thrifts' use of technology are designed and monitored to minimize operational risk and ensure thrift and customer security and privacy.

Given the recent financial difficulties experienced by many "high-tech" companies, thrifts' contingency planning is receiving increased supervisory attention.[7]

D. Increasingly Competitive Environment

The increasingly competitive environment in the financial services industry has forced thrift executives to search not only for ways to cut costs but also for new business opportunities, which often have a more extreme risk/return profile than the traditional thrift business. Subprime lending, whether home equity or credit cards, is one such business. Well-managed subprime lending, with responsible marketing, pricing and terms, is an important element in expanding credit access. But the business is fraught with danger for consumers, institutions, and the deposit insurance funds when an excess of zeal for short-term profitability overcomes responsible management and monitoring, including adequate reserving and capitalization.[8]

Guiding an institution through these shoals successfully is, of course, the responsibility of each institution's management and board of directors. The willingness of management and directors to understand and manage risk is one of the primary underpinnings of a safe and sound operation. A key part of OTS's supervisory strategy is to hold regular meetings with senior thrift managers. OTS's regional supervisory staffs meet regularly with thrift senior managers during onsite examinations and to discuss items of supervisory interest. OTS also holds meetings and conferences with senior managers from multiple thrifts to share ideas and discuss trends affecting the industry. During the past 18 months, OTS held 24 town meetings involving 240 thrifts; 20 Financial Management Seminars with 740 attendees; five Directors' Forums that attracted 1,275 attendees; and a Leadership Conference attended by over 400 thrift CEO's and directors from about 250 institutions.

Thrift senior managers at these meetings voiced several common issues. First and foremost was that thrifts operate in a very competitive environment, especially in the conforming single-family mortgage market. This means thrifts need to think and plan strategically, especially given the country's changing economy and demographics. To ensure long-term profitability and earnings growth, many thrift man-

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[5] On March 15, 2001, OTS issued an interim rule to implement the recent repeal of the statutory liquidity requirement. The rule removes the regulation that requires savings associations to maintain an average daily balance of liquid assets of at least 4 percent of its liquidity base.

[6] On May 11, 2001, OTS and the other Federal banking agencies issued an advisory on the risks of brokered and other rate sensitive deposits. On June 8, 2001, OTS issued Examiner Guidance on wholesale borrowings. On June 19, we issued a Thrift Bulletin that outlines sound principles for liquidity management. That bulletin stresses the importance of liquidity policies and procedures, management oversight, contingency planning, and scenario analysis.

[7] On June 11, 2001, OTS published a request for comment pursuant to section 729 of the Gramm–Leach–Bliley Act. OTS and the other Federal banking agencies are studying their regulations on the delivery of financial services. The purpose of the study is to report findings and conclusions to Congress, together with recommendations for appropriate legislative or regulatory action to adapt existing requirements to online banking and lending.

[8] On January 31, 2001, OTS and the other Federal banking agencies issued expanded guidance intended to strengthen the examination and supervision of institutions with significant subprime lending programs. The guidance supplements previous subprime lending guidance issued March 1, 1999.

agers are focused on finding new markets to serve and analyzing new business lines. These managers strongly feel that niche markets, emerging markets, and markets neglected or forgotten after "mega mergers" reduced local banking presence offer good opportunities for profitable expansion.

Each thrift must adopt its own strategy to compete in an increasingly competitive environment. Our examination focus is to ensure that thrifts have the requisite managerial expertise, sound policies and procedures, and adequate systems before entering new lines of business. We also follow up to ensure that institutions effectively manage and monitor these business lines once entered.

IV. OTS Focus During the Next Twelve Months

A. Ensure Problem Thrifts Have Capable Management

Onsite examinations and regular offsite financial monitoring are two of the tools we use to keep on top of issues and institutions, and ensure thrift management and boards of directors are adequately addressing weaknesses. Two other supervisory tools that we use to monitor problem institutions are the Regional Managers Group meetings, which happen 10 times a year, and high-risk videoconferences, which happen 3 times a year for each region—a total of 15 3- to 5-hour meetings to discuss high risk or high profile institutions each year. These tools enable us to learn from each other, enhance consistency across the country, and stay on top of problem institutions, while retaining primary responsibility for supervision in our regions.

B. Functional Regulation

OTS has made a considerable effort in the last several years to reach out to other State and Federal functional regulators to coordinate and streamline the potential overlapping regulatory interests. These activities involve meetings, regular communications, and joint activities and programs, often through various supervisory coordinating entities such as the National Association of Insurance Commissioners (NAIC), the National Association of Securities Dealers (NASD), and the North American Securities Administrators Association (NASAA).

We have worked extensively over the last several years with the NAIC to coordinate the regulatory overlap that has developed with increased insurance company acquisitions of thrift institutions. As a result of this coordination, OTS has in place information sharing agreements with 45 State insurance regulators. These efforts include frequent appearances by OTS and NAIC officials at programs sponsored by OTS and by the NAIC or by individual NAIC State members. We have also sponsored several joint programs. OTS's senior managers have attended NAIC training sessions on the State insurance regulatory system. Likewise, the State insurance commissioners, their staff, and NAIC's staff attended an OTS-sponsored training program about the thrift regulatory system.[9] Our Regional Directors have working relationships with insurance commissioners in States in their region where insurance companies that own thrifts are domiciled.

OTS's regional staff also coordinate closely with their regional counterparts at the NASD on issues of common interest involving securities activities by thrift service corporations engaged in securities brokerage activities. Similarly, we have developed a good working relationship with staff of the NASAA that enables us to coordinate and leverage our resources to achieve success in areas of mutual interest. We continue to work with the SEC on policy matters (such as the privacy regulations required under the Gramm–Leach–Bliley Act) and, occasionally, on matters involving specific institutions.

C. Coordination With Other Federal Banking Agencies (FBA's) and State Banking Regulators

OTS also works closely with other FBA's and State bank regulators, both through the Federal Financial Institutions Examination Council (FFIEC) and individually, where appropriate, to identify emerging issues in the financial institutions industry and to coordinate supervisory activities. This activity occurs both in Washington and at the regional level, directly with other regulators and through the Conference of State Bank Supervisors (CSBS). Topics of mutual interest include emerging risks, adverse trends, and other supervisory matters. This is a mutually beneficial relationship that keeps all parties apprised of potential problems, emerging issues, and possible overlaps of regulatory authority that may pose potential regulatory burdens

[9] OTS and the other Federal banking agencies issued final consumer protection rules for the sale of insurance products by depository institutions on December 4, 2000. The final rule implements section 305 of the Gramm–Leach–Bliley Act. As required by the statute, the agencies consulted with the NAIC.

or gaps in regulatory coverage.[10] For example, in connection with proposed OTS regulations on mutual savings associations and mutual holding companies, we have met with seven State banking commissioners. CSBS was very helpful in arranging these meetings.

In matters involving preemption, we notify the appropriate State regulator to obtain their views when an institution asks us to opine that HOLA preempts a particular State regulatory action. If we issue an opinion we send a copy to the State regulator and CSBS.

D. Keep Supervisory Staff Well Trained and Informed

Another aspect of our regulatory oversight is OTS's focus on dynamic, needs-based employee training. We have inventoried the skill sets possessed by all of our examiners and, utilizing that information, are able to identify needed areas of training. This typically involves a periodic assessment by regional supervisors of upcoming and emerging issues at institutions in the region, an assessment of the strength of regional examiners in the skills required to address these needs, and training targeted to address areas of need. Our new Professional Development Program, geared to enhancing individual competencies and skills; specialty examiner tracks; accreditation programs; and a soon-to-be-piloted management development program, keep employee skills at top levels.

OTS examiners typically receive training several times annually. Our training is designed for maximum impact with minimum disruption to the day-to-day operations of the agency. Training is delivered in various forms, including computer-based programs, videoconferencing, outside programs, and by pooling specialized examiner resources so individuals can share their expertise nationally within the agency. Both our trust and IT examiners, although regionally based, work across the country, and the agency's credit card specialists are always on call to deal with this specialized set of risks. During 2000, examiners worked cross-regionally for a total of almost 800 days, and we had 19 details to Washington. These exchanges enhance the skills and perspective of both the sending and recipient offices.

In addition to our internal training activities, we work closely with the other FFIEC agencies to identify areas that warrant more extensive and coordinated training initiatives. This past year, the FFIEC piloted the concept of just-in-time training on CD to get training on hot issues such as subprime lending and privacy out quickly to a wide audience. We hold staff conferences and teleconferences to promote sharing of ideas and experiences among supervisory staff. We are also improving our information systems to simplify and expedite access to internal and publicly available thrift and market information.

E. Early Warning Systems

We are increasing our use of offsite early warning systems to help pinpoint potential problem areas. In addition to our Net Portfolio (NPV) Model, OTS examiners and analysts utilize our Risk Assessment Model (RAM) and our recently implemented Risk Monitoring System (RMS) to assist offsite financial analysis. Both risk identification models utilize financial "triggers and hits" to quickly identify areas that need special attention and analyses. The RMS also provides our examiners and analysts with direct links to thrift web sites, thrift stock price data, SEC filings, and general economic information, all used to closely monitor and analyze thrift operations between onsite exams.

V. Items for Legislative Consideration

We are developing a list of legislative proposals for your consideration that would reduce regulatory burden on the thrift industry, streamline and improve OTS supervisory authority, and make technical corrections. The items we are studying include:

- Statutory authority for a Deputy Director of OTS. This would avoid the potential for gaps in OTS regulatory and enforcement authority if there is a vacancy in the office of the Director. This is particularly important because of the delay inherent in filling vacancies for Presidential appointments.
- Permitting Federal thrifts to merge and consolidate with their nonthrift subsidiaries directly. Today, a Federal thrift may only merge with another depository institution. We have recently learned of a situation where current law will cost the

[10] OTS supervises 148 State-chartered savings associations and 32 thrift holding company structures whose thrifts subsidiaries are all State-chartered. This role, which is similar to that of the FDIC and the Federal Reserve with respect to State-chartered commercial banks and savings banks, requires significant coordination with State bank regulators on a day-to-day basis in our regions.

institution an estimated $11 million to structure a merger in a way that is consistent with existing law.

- Modernizing thrift community development investment authority to permit investments to promote the public welfare and remove obsolete provisions based on HUD programs that have been off the books for 20 years.
- Eliminating the requirement that a service company subsidiary of a thrift must be organized under the laws of the State where the home office of the thrift is located. This geographic restriction was imposed before interstate branching, the Internet, and telephone banking, and today simply serves no useful purpose.
- Enhanced small business and consumer lending authority to enable thrifts to better serve the credit needs of their communities.
- An exception from broker-dealer registration by thrifts equivalent to the exception that banks have under the Securities Exchange Act of 1934. The SEC has issued an interim rule accomplishing this result, but it may be appropriate to confirm the change by statute.
- An exception from investment adviser registration by thrifts equivalent to the exception that banks have under the Investment Advisers Act of 1940. The SEC has announced it is considering rulemaking to address this issue, but, as with the broker-dealer exception, a confirming statutory amendment appears appropriate.

After our final policy reviews and consultation with other affected agencies, we plan to submit a package of legislative proposals with a recommendation for their enactment.

VI. Conclusion

Over the past several years, the thrift industry has expanded and diversified while achieving strong financial results. At OTS, we have used this time to ensure that our staff and technology is poised to deal with new risks and to assist the institutions we supervise as they move into new areas, so they are properly focused on long-term profitability and responsible service to their customers and communities. The challenges continue, but both the industry and the agency are well-positioned to meet them.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM ALAN GREENPAN

Q.1. What do you think is the single greatest potential problem facing the U.S. financial system today?

A.1. Considering the challenging economic environment of recent months, our financial system remains in remarkably good shape. Certainly an important concern facing the U.S. banking system is the deterioration in credit quality. Much of the erosion is the result of a weakening in underwriting standards, especially in the 1996–1998 period. To date, financial institutions have shown the capacity to absorb emerging problems in severely affected segments of their loan portfolios. Problems have been for textiles, health care, media, agriculture, computer, telecommunications and other technology segments. More broadly, other segments of bank loan portfolios, including corporate, real estate, and consumer portfolios, have shown only moderate weakness to date. Should the domestic economy slow further or contract, the performance of these portfolios could deteriorate placing pressure on the earnings and, if the downturn were severe, potentially the capital bases of financial institutions.

At the present time, the U.S. financial system is better prepared to enter a period of economic weakness than in the past by virtue of stronger capital bases, loan loss reserves and more active risk-management techniques. Despite the increase in problem credits, financial institutions have also continued to provide credit to sound borrowers. Still, financial institution managers, regulators and policy makers must remain vigilant for deteriorating conditions and take necessary actions to address emerging problems so that these institutions are able to continue to perform their essential intermediation function for the U.S. economy even under weaker conditions.

Q.2. While many analysts predict a recovery from the current economic slowdown in the second half of the year, there is still a chance that the downturn could be worse than expected. If the economy were to underperform, what consequences would that have for the safety and soundness of the banking system?

Specifically, I would like to ask about the banking system's risk exposure in the following areas:

- Noncurrent Loans
- Credit Card and Consumer Loans
- Mortgage Delinquencies
- Telecommunications Sector

A.2.

Noncurrent Loans

Please see the answer to question 3.

Credit Card and Consumer Loans

With regard to the risk exposure from credit card and consumer loans, these loans amount to about 10 percent of bank balance sheet assets, though another 5 percentage points is also held indirectly through credit card securitizations. Over the past decade, banking organizations have taken advantage of scoring models and other techniques for efficiently advancing credit to a broader spectrum of consumers and small businesses than ever before. In doing

so, they have made credit available to segments of borrowers that are more highly leveraged and that have less experience in managing their finances through difficult periods. In recent years, intense competition for customers and the expansion of credit to weaker or more highly leveraged segments resulted in record net charge-off levels for credit card portfolios. In the last 2 years, net charge-offs have declined to a lower level but are still moderately above average. Nevertheless, this particular business line remains highly profitable for most banks as higher interest rates on credit card loans are offsetting higher credit costs. In addition, with the recent slowdown in the economy, rising personal bankruptcies, an increasing unemployment rate, and a modest deterioration in loan quality, lenders have tempered their outlook, tightening their standards somewhat for credit cards and other consumer loans.

Should the economy weaken further, credit card net charge-offs would likely rise, possibly fairly rapidly. The effect on individual banks would depend largely upon the portion of leveraged consumers in their credit card portfolios. Banks would feel earnings pressure both directly from credit cards funded on balance sheets and from lower noninterest income on securitized credit cards. In extreme cases, high charge-off rates could trigger early amortization clauses of securitized credit card pools, causing a rapid return of credit card receivables to bank balance sheets, resulting in both credit and liquidity pressures. At present, given current capital levels, strong earnings, and adequate reserves, deterioration in the consumer portfolio is most likely to be more of an earnings issue than a capital concern.

Mortgage Delinquencies

Credit quality for mortgage loans has eroded somewhat in recent periods, but remains historically in line with the healthy quality of the past several years. During the first quarter, noncurrent mortgage loans totaled 0.95 percent of the portfolio at insured commercial banks, compared to 0.90 percent at year end and were roughly equal with the level at year end 1997. Since the collateral for the vast majority of mortgage loans is the borrower's residence, borrowers tend to attempt to remain current on their mortgages even during difficult times. Consequently, mortgage loans tend to perform better during tougher economic times than other consumer loans. Moreover, though certain residential housing markets have experienced price weaknesses during downturns, the loss experience on mortgage loans has generally been modest. For example, in 1991 the proportion of mortgage loans that were noncurrent totaled 1.64 percent, with total portfolio net charge-offs a modest 17 basis points.

Telecommunications Sector

Please see the answer to question 6.

Q.3. After 5 very good years, the rate of nonperforming commercial, industrial, and personal loans increased by 26.6% in 2000. Can you please tell me what stress, if any, this places on the banking system, and whether or not you expect a similar rate of increase for this current year?

A.3. At present, the banking system is better prepared for a potential further softening in the economy than in past decades. For ex-

ample, just prior to the last recession, the overhang of effects from problem developing country loans and mounting commercial real estate problems at insured commercial banks resulted in noncurrent[1] loans totaling 3.7 percent of total loans; that compares to just 1.2 percent today. Moreover, in 1990 noncurrent loans amounted to nearly 30 percent of tier 1 capital and reserves, compared to 8.6 percent at the end of the first quarter of 2001. In addition, bank earnings relative to assets were just 48 basis points in 1990 compared to the 120 achieved in 2000 and 128 in the first quarter of 2001, despite higher provisions from weakening asset quality. In addition, 1990 earnings were much more dependent on loan quality, while earnings today are more diversified.

During 2000, noncurrent loans at insured commercial bank rose by 30 percent, and in the first quarter of 2001 were up by an annualized 33 percent. It is likely that noncurrent loans will continue to rise throughout the course of 2001 and perhaps into early 2002 as well before peaking. However, at that rate of growth such deterioration would generally place pressure on bank earnings, but not on capital adequacy.

Q.4. Though the delinquency rates for credit cards and consumer loans are well below the high levels experienced during the last economic downturn, they have risen back to levels comparable to 1993. What do you think the effects of this increase in delinquency rates will be, with regard to both consumers and the financial institutions that you regulate?

A.4. Delinquency rates on a variety of consumer loans have returned to high levels in recent periods and do suggest increased strain on the finances of some U.S. households. As indicated in the response to question 7, these pressures also appear in historically high levels of debt service burden and personal bankruptcies are at an elevated level. Although measures of household net worth continue to be benefitted from higher home prices, important questions remain about the willingness and ability of consumers to sustain recent trends. Through the first quarter, the deterioration in consumer loan portfolios remains within the range of what would normally be expected during a period of economic weakness and does not appear particularly threatening either to U.S. households or their lending institutions. Continued slippage, however, could cause heightened concern. Through 2000 and for the first quarter of this year, credit card net charge-off rates for insured commercial banks were only modestly above the average loss rate for the decade of the 1990's and were below the peak rates of 1997 and 1998. Loss rates on installment loans have been at moderately high levels since 1997 (around 1.04 percent) without notably disruptive effects, but have increased in the first quarter of 2001, to 1.20 percent.

Overall, consumer lending (including securitized credit card receivables that are managed, but off-balance sheet) represents about 15 percent of commercial bank assets, with most exposures relating to credit cards. Although most credit card exposures, in turn, are held by roughly 30 so-called "credit card banks," those institutions remain both highly profitable and are typically owned by larger, well-diversified banking organizations. The earnings and capital

[1] Loans 90 days or more delinquent or nonaccruing.

bases and increasingly sophisticated risk-management practices of both the credit card banks and their parent institutions mitigate supervisory concerns related to the consumer sector. Recent Federal Reserve surveys of bank lending practices and other supervisory indicators also suggest that lenders are closely monitoring their exposures and are tightening standards and terms on consumer loans in response to declining quality. As noted in response to question 2, any deterioration in the strength of consumer loan portfolios will most likely be limited to the banks' reported earnings rather than their capital.

Q.5. According to a Mortgage Bankers Association survey, 10% of mortgages backed by the Federal Housing Administration are now 30 or more days delinquent. An article in the June 12 *New York Times* stated that, "The mortgage problems underscore one main reason many policymakers and economists are so concerned about whether the United States will enter a recession this year." Can you please tell the Committee your thoughts and concerns about the high level of mortgage delinquency?

A.5. While delinquencies by FHA mortgage holders jumped several quarters ago, mortgage delinquencies by holders of conventional mortgages, by far the larger share of the market, have risen only slightly during this time. That said, one must still be concerned about the recent sharp increase in FHA delinquencies because many FHA borrowers would likely be among the first households adversely affected by an economic slowdown, and the situation bears close watching to see if mortgage delinquency becomes more prevalent among conventional mortgage holders.

Q.6. I have heard from varying persons that the banking industry has significant exposure in the telecommunications sector. What is the direct and indirect exposure of banks to the fall-out in the telecommunications sector?

A.6. The banking industry has been active in underwriting bonds and originating large credit facilities for the telecommunications sector. During the recent telecommunication expansion, the banking industry has worked to syndicate credits to a diverse array of investors, thus spreading and diversifying risk within and outside of the U.S. banking industry. In practice, the originating agent bank retains only a small portion of the underlying credit by participating out the vast majority of the commitment to other U.S. and foreign banking organizations, asset managers, and insurance companies. In addition, bank loans are generally more senior to bond holders in bankruptcy so that the severity of losses upon default tends to be less severe than for other creditors. In addition, these loans are generally structured with covenants that can limit further draws on the outstanding commitment if the borrower's condition deteriorates.

In particular, based on data from the interagency Shared National Credit program for 2001, the 10 largest U.S. bank holding companies had outstanding telecommunication balances relative to tier 1 and reserves ranging from as little as 1.8 percent to as high as 18.1 percent. Including commitments to lend, which some telecommunication companies may be unable to draw, exposures ranged from 5.7 percent to 43 percent of tier 1 capital and reserves.

It should be noted that the telecommunications industry has a number of different segments not all of which are experiencing difficulties. In addition, much of the credit is to borrowers with investment grade credit ratings.

That said, signs of weakness in the telecommunications and other high technology sectors are troubling and could place pressure more broadly on the U.S. economy should layoffs in this sector continue and should the effects of a pull back in technology investment spillover into other sectors. In particular, in the first quarter of this year, there has been a pronounced increase in nationwide office vacancies that has resulted in a negative net absorption of office space in the United States. That poor performance, the worst in 20 years, has been attributed by some market observers to the abrupt return of office space to the market by technology firms and to delays by prospective tenants hoping that softening conditions will lower rents further. Whether the first quarter represents a temporary phenomenon or the beginning of a longer-term trend remains to be seen, but the need for institutions to continue a realistic assessment of conditions and stress test their portfolios is paramount.

As emphasized earlier, the banking industry is well positioned to meet emerging asset quality weaknesses. As telecommunication and other technology firms reassess their business strategies to better reflect current market conditions, creditors will be challenged to ensure that they make appropriate risk-return tradeoffs while continuing to provide credit to sound borrowers.

Q.7. According to the OCC, consumers are more highly leveraged now than at any measured point in history. Not only are debt service payments at historic highs, but the increase in debt has been financed through instruments other than mortgages. Credit card debt is rising very rapidly; the *Chicago Sun-Times* reported that the average credit card debt per household is $8,123 and has grown threefold over the past decade. Debt service payments constitute over 14% of disposable income. What do you believe the effects of this high level of personal debt will be with regard to consumers, the banking sector, and the economy as a whole? If the economic downturn is worse than expected, what would be the effect of having so many people so highly leveraged?

A.7. Over the past 2 years, mortgages and other types of consumer debt have increased substantially more rapidly than disposable income. As a result, the debt service burden, defined as the ratio of required payments on mortgages and other types of consumer loans to disposable income, is close to 14½ percent—the top of the range seen in the 20 year history of this series. However, even with these large increases in household debt, the dramatic gains in household assets in recent years have pushed household net worth (assets minus liabilities) to a high level by historical standards. According to the latest published data, household net worth at the end of the first quarter of this year was about five and a half times disposable personal income, up from about five times disposable personal income at the beginning of 1996.

That said, there are signs that the economic slowdown has put some households under increased financial strain. For example, bankruptcy filings have run at an elevated rate this year, and some

measures of delinquencies on loans to households—including, for example, those on mortgages described in the answer to question 5—have increased recently. If this strain were to worsen or become more widespread, households might curtail the growth of their spending further, which would dampen increases in overall output. As a result, the Federal Reserve continues to monitor carefully household financial positions.

Q.8. Remittances are a large and growing economic reality that affect millions of people both in America and south of the border. It has recently come to my attention that this industry, which recent estimates have put at more than $20 billion annually, often charges high fees and that many of the leading companies have been challenged in court for having hidden fees. In a *New York Times* article it is stated that "the fees have run from about 10 percent to 25 percent or more." Do you believe that there are problems in the manner in which the bulk of remittances are made today? What steps has your agency taken to analyze possible solutions including fostering or creating alternative transfer mechanisms?

A.8. Both banks and nonbanks in the United States currently provide cross-border money transfer services to residents of the United States. These services include traditional electronic wire transfers between a U.S. bank and its overseas correspondent using telecommunications networks such as SWIFT; electronic money transfer services provided by nonbanks such as MoneyGram or Western Union; ATM withdrawals overseas using international EFT networks to debit the cardholders' U.S. bank accounts; and other emerging networks.

The fees associated with cross-border remittances by individuals may include charges for initiating the transfer itself, charges to convert U.S. dollars to a foreign currency, and sometimes, fees for the receipt of funds by beneficiaries. Fees may vary by service provider, service, point of origin, point of destination, amount of money sent, and the method of funding the payment. Based on a quick, informal survey of a few nonbank money transmitters, we found the quoted fees ranged from $6 to $15 for transfer amounts of $100 and from $15 to $68 for transfer amounts of $1,000, depending on the destination country and the service used. Currency exchange charges are additional if delivery is to be made in the local currency. Receivers are not charged any fees according to the surveyed institutions.

By comparison several large U.S. banks have said they charge between $35 and $45 to send a consumer international wire transfer and typically add foreign exchange charges if the money is to be delivered in the local currency. Additional charges also may be imposed on beneficiaries by the receiving bank for delivery of funds. In the cross-border context, bank charges for consumer wire transfers can frequently be higher than the fees charged by nonbank money transmitters due to lower volumes of activity, additional handling costs, and correspondent banking fees.

At the present time, the market appears to provide consumers with several accessible, rapid, and efficient cross-border transfer services. As a result of increasing competition and growing volumes of remittances, fees for making cross-border consumer transfers also appear to be decreasing, although costs still vary significantly

across companies and countries. Looking ahead, the technological change and the projected strong growth of overseas remittances may well continue to increase competition, decrease processing costs, lower fees, and increase the number of alternatives for making cross-border transfers.

For its part, the Federal Reserve continues to analyze issues related to cross-border payments, including alternatives to promote greater efficiency. For example, the Federal Reserve has been exploring whether general improvements could be made in handling cross-border funds transfers using the automated clearing house (ACH), a system by which many U.S. consumers receive electronic payroll deposits and Government benefits. The Federal Reserve recently launched a service for sending cross-border payments to Canada through the ACH and, later this year, will be investigating the feasibility of crossborder ACH payments with Mexico and other countries. In addition, the Federal Reserve is working closely with industry groups on potential improvements to cross-border payments. One such industry effort, lead by the National Automated Clearing House Association, an industry group, is a global effort to improve cross-border ACH payments, known as WATCH (Worldwide Automated Transaction Clearing House). The Federal Reserve has also been in discussion about the cost, timing, and transparency of cross-border transfers with other central banks, most recently through the G–10 central banks' Committee on Payment and Settlement Systems.

Financial Literacy and Education

Q.9. Former Treasury Secretary Summers has stated that "all high school students should receive a financial education," and that "though personal financial education must begin in the home, it must continue in the schools." Can you please comment on the state of financial literacy and education among Americans, including any deficiency in this area that should be addressed? If you see any deficiencies, what do you believe can and should be done with regard to these deficiencies in both a broad sense and with regard to your agency? At the hearing I asked for information regarding any initiatives that your agency has taken, including the Money Smart program. Could you please provide this information in your submission to the record?

A.9. Recent studies by the Jump$tart Coalition and the Consumer Federation of America confirm that gaps in financial literacy levels exist among both youth and adults. The Jump$tart Coalition found that, on average, students in a 2000 financial literacy exam answered only about 52 percent of the questions correctly. The Consumer Federation of America administered a consumer literacy quiz to 1,700 adults nationwide; the average score was 75 percent correct.

Our sense is that programs and resources for dealing with these gaps in financial literacy are plentiful. For example, surveys by the Woodstock Institute and the Fannie Mae Foundation indicate that numerous school and community-based programs focus on financial literacy (see *Tools for Survival: An Analysis of Financial Literacy Programs for Lower-Income Families* [2000], Woodstock Institute;

and *Personal Finance and the Rush to Competence: Financial Literacy Education in the U.S.* [2001], Fannie Mae Foundation).

The major difficulty seems to be in bringing people, programs, and resources together in a timely and meaningful way. Partnerships among organizations and groups are one approach to addressing this difficulty. The Federal Reserve is participating in financial literacy partnerships at several levels. The Board is represented on the Board of Directors of the Jump$tart Coalition, and a majority of the Federal Reserve Banks are members of the State coalitions of Jump$tart. For example, staff at the Federal Reserve Bank of New York led a public/private network to encourage the New York State Department of Education to incorporate personal financial literacy into the mandated high school economics curriculum for the State of New York.

Board staff have been engaged over the past year in discussions with colleagues in the National Partnership for Financial Empowerment, a nonpartisan coalition initiated by Treasury, and serve on two work groups on minority outreach and working with Native Americans.

Across the System, Federal Reserve staff based in our Community Affairs and Public Information programs work with community development organizations and school systems to provide financial and economic education resources to the community.

Initiatives such as the Federal Reserve System's Project Money Smart (developed by the Federal Reserve Bank of Chicago) and Building Wealth (developed by the Federal Reserve Bank of Dallas) are designed to provide information in printed brochures and through their web sites, with links to a wide variety of financial literacy resources. On the Project Money Smart web site, for example, consumers are linked to information on budgeting, savings, credit, mortgages, and financial institutions. On the Building Wealth web site, consumers can compare different savings and investment choices and calculate the future value of their savings.

Q.10. What steps has the Federal Reserve taken to promote technology and innovation in the payments system, and what steps should it take? As well, are you concerned that the initiation of payments on the Internet, or through another electronic means, could affect the safe operation of the payment systems?

A.10. The Federal Reserve has taken a number of steps to promote technology and innovation in the payment system. With respect to its own systems, the Federal Reserve has consolidated the number of its computer centers and centralized software over the past decade to reduce costs and increase the efficiency of its electronic payment systems. These initiatives have enabled the Federal Reserve to cut the prices for its electronic payment services by more than half since the mid-1990's.

The Federal Reserve is also adapting services to use Internet protocols and web technology internally and for communicating with customers. In addition, the Reserve Banks are using web technology to make some low-risk services (for example, cash ordering, savings bond purchases, and check information) available via the

Internet.[2] In the future, the Reserve Banks may consider offering higher risk services (for example, Fedwire funds transfers) through the Internet or an extranet if sufficient security and quality of service could be guaranteed.

Given the large number of checks that continue to be written in this country (roughly 70 billion a year), the Federal Reserve has also focused significant attention to using technology to improve the efficiency of the check system. The Federal Reserve has played a leadership role for many years in the development of the technology and associated standards for capturing, exchanging, and storing check images. More recently, the Federal Reserve Banks have been participating in a multiyear project to create a standard for their check processing operations and to enhance electronic check services, such as the delivery of check data and images to its bank customers.

The Federal Reserve is also taking additional steps to promote the use of electronics in payments services in the belief that such payments can be less costly and more efficient than paper-based payments. Earlier this year, for instance, Board staff revised its commentary to Regulation E, which implements the Electronic Fund Transfer Act, to clarify requirements for authorizing electronic fund transfers and for using the Internet to enroll customers in electronic bill payment arrangements, as well as how the regulation applies to certain electronic transactions.

The Board has also asked the Payments System Development Committee (co-chaired by Vice Chairman Roger Ferguson and Federal Reserve Bank of Boston President Cathy Minehan) to work collaboratively with the private sector to explore opportunities for improving the payments system. The Committee has focused on several issues and has taken a market-oriented approach toward payment system innovation. As part of its efforts, the Committee and Federal Reserve staff are working with a number of standards-setting organizations to facilitate increased interoperability in the payments system.

This Committee has also sought information from the private sector on other barriers to innovation and takes steps to address these barriers when appropriate. One such effort involves promoting the use of standard message formats when transmitting electronic files of check information for presentment. Another ongoing effort involves cooperation with banking industry and consumer representatives to determine how to address some of the legal impediments to the expanded use of truncation in check processing to reduce the cost of transporting and processing paper checks. Removing these impediments would require Congressional action.

As noted earlier, the large-value U.S. payment systems cannot currently be accessed over the Internet. Security concerns and other technical issues, such as the inability to ensure service quality, limit the desirability of using the Internet for such systems. Most core clearing and settlement systems for retail payments similarly do not use the Internet for interbank clearing and settlement operations at this time.

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[2] The Reserve Banks are also conducting a pilot to enable banks to originate off-line book-entry securities transactions over the Internet.

To conduct business over the Internet with the general public, many firms permit credit cards and some firms also permit automated clearing house transactions created from the information on a paper check (frequently referred to as a "electronic check" or an "e-check") to be used to pay for goods and services ordered over the Internet. The various firms and clearing organizations involved in these transactions are experimenting with different arrangements for security and liability. At this stage, the Federal Reserve is continuing to monitor the rapidly changing developments in this area and to discuss these developments with the private sector. The Federal Reserve has not expressed public concerns about specific systems. To the extent payments are initiated through banks, bank supervisory policies pertaining to banking over the Internet would be relevant.

Q.11. Over the last decade, core deposits have declined as a percentage of bank and thrift assets, as individuals have taken advantage of new investment options. Declining deposits have forced banks to look elsewhere for sources of liquidity. Small community banks, which may have limited access to alternative funding sources, are increasingly relying on advances from the Federal Home Loan Banks as a way to meet their liquidity needs. Do you have any comments on this development and its implications, if any, for the financial services industry?

A.11. At smaller banks (those with assets less than $500 million), the proportion of assets funded by FHLB advances rose from 3.8 percent to 6.3 percent between year-end 1995 and year-end 2000. Larger banks showed a similar increase—from 3.4 percent to 6.7 percent—suggesting that the banking system as a whole—and not just community banks—has been increasing its use of FHLB advances. This relatively limited usage by banks of FHLB advances to fund assets suggests that, to date, the subsidy provided by the FHLB's is not so substantial as to greatly limit banks' use of private sector sources of funding. With less than 15 percent of FHLB advances flowing to community banks, and with the use of advances by community banks being similar to that of larger institutions, neither the FHLB System nor the community banks appear, in general, to be uniquely dependent on each other. Of course, as I have noted in other forums, it is not clear that the FHLB System is either an efficient or cost effective way to subsidize housing or community development because the bulk of its subsidy goes to larger institutions and is not targeted toward the disadvantaged groups. It is appropriate that Congress occasionally review the role of FHLB's, just as it should periodically review all forms of subsidized credit and credit allocation mechanisms it has created, to determine if the role played by these organizations is still needed and justified.

Q.12. According to the Japanese banking industry's own publicly disclosed numbers, about 30 percent of bank assets are classified by examiners as having problems. Experience in the United States and other industrialized countries indicates that if a bank has classified assets of 10 percent to 15 percent of total assets, it is in danger of becoming insolvent and needs immediate supervisory action. The Finance Minister of Japan is reported to have said a few months ago that "Japan's fiscal situation is at the verge of col-

lapse." Data from various official and academic sources indicate Japan's government debt is well over 100 percent of GDP and growing rapidly, and some experts believe Japan is reaching its financing limits.

Q.12.a. What is your assessment of the Japanese banking system?

Q.12.b. What risk, if any, does the situation in Japan pose to both U.S. financial institutions and to the U.S. economy?

Q.12.c. What actions should be taken to improve it?

A.12.a. A combination of bad loans left over from the "bubble economy" and new bad loans from a weak economy have left Japanese banks with sizable asset quality problems. Sizable portfolios of problem loans suppress bank earnings, create uncertainty about bank asset values, and distract bank management from the business of making new loans.

A.12.b. U.S. banks and bank supervisory authorities are aware of the asset quality problems at Japanese banks and are alert to the risks they may pose. U.S. banks manage their exposures to Japanese banks with these risks in mind. In addition, U.S. bank supervisory authorities pay careful attention to the activities of the U.S. operations of Japanese banks.

A.12.c. A key step to improve the situation is to reduce the problem loans of Japanese banks. The Japanese government has recently announced a plan that aims to do so. In addition, the plan aims to lower the exposure of Japanese banks to swings in equity prices. This plan has the potential to improve the condition of the banks and hence, the soundness of Japanese financial system. How aggressively the plan is implemented will be critical in determining its success.

Q.13. There have been reports that Argentina is facing serious economic peril. What can you tell us on the situation in Argentina? What effect, if any, do you see on the U.S. economy as a whole, and specifically on the financial sector?

A.13. Argentina is in the midst of a recession that began in mid-1998. This prolonged downturn, in combination with traditionally poor tax collection, has generated shortfalls in fiscal revenues and contributed to the Federal government's sizable budget deficits. In addition, Argentina's external position is characterized by significant vulnerability, as the country has at times struggled to service its heavy external debt.

In December 2000, as financial market anxiety about the outlook for Argentina's economy became acute, the country was granted a 3 year financial assistance package, including $14 billion in loans from the IMF, as well as financing from various other official and private sources. To qualify for these funds, Argentina has been required to implement policies designed to strengthen its fiscal performance and stimulate growth. In addition, the Government has moved to reduce its debt-servicing burden in the short run with a $30 billion debt exchange, which was completed in early June. However, none of these efforts has proved sufficient to restore confidence among investors, and Argentine financial markets are currently experiencing a severe degree of pressure.

U.S. trade with Argentina is minimal, accounting for less than 1 percent of our exports and imports. Accordingly, the direct impact

through trade channels of disruptions in Argentina should be limited. On the financial side, the linkages are somewhat greater but, even so, the vulnerability of the U.S. financial system does not seem to be substantial. The exposure of U.S. institutions to Argentina is small relative to their combined capital. Argentina is a sizable presence in the market for developing-country debt, but the prolonged nature of Argentina's economic problems has presumably allowed investors time to adjust their portfolios in response to the increasing level of risk. However, other emerging market economies are experiencing some spillover effects. The managing director of the IMF has announced a proposed extension of Brazil's support program to strengthen Brazil's financial resources.

Q.14. In a speech before the American Bankers Association, Federal Reserve Board of Governors Member Edward Gramlich said that, "Higher rates of national savings are among the unsung heroes of the good U.S. economic performance in the late 1990's." However, the most recent data from the White House shows a substantial decline in personal savings, from over 5 percent in 1996 to minus 0.9 percent today. Do you think that this is a serious problem, and if so, what can we do to ameliorate it? What position does this place Americans in if the economic slowdown worsens? Finally, what are the effects of this decline with respect to national investment levels and GDP growth?

A.14. The general decline in the personal saving rate over the past two decades has been a source of concern for policymakers. The recent precipitous decline of the personal saving rate into negative territory has heightened these concerns but needs to be evaluated with respect to other developments in households' financial situations. While personal saving as a percentage of personal disposable income declined from 1996 to today, households' net worth—measured in the Federal Reserve Board's Flow of Fund accounts—rose from about five times personal disposable income at the beginning of 1996 to more than five and a half times personal disposable income today. Households have reacted to this increase in wealth by boosting their spending relative to their current income. Because saving is measured in the national income accounts as the difference between current income (not including capital gains) and spending, the additional spending supported by wealth increases has resulted in lower measured personal saving. That said, there are still valid concerns about whether households are saving enough to help fund investment in the economy, and whether households are adequately prepared for retirement.

Recent research by economists at the Federal Reserve Board using data from our Flow of Funds Accounts and Surveys of Consumer Finances suggests that the latest decline in personal saving rates is primarily a consequence of a plummeting saving rate for high-income households, which are generally the type of households most able to weather an economic slowdown. Lower-income households are generally more susceptible to problems during less robust economic times, but these are not the households whose saving rates have been declining in recent years. While it is certainly appropriate for policymakers to be concerned about the financial situations of households during an economic slowdown, the personal saving rate is not necessarily the best indicator of potential trouble.

The level of investment in the U.S. economy has played a very important part in increasing productivity and real GDP growth in recent years. As Governor Gramlich indicated in his recent speech before the American Bankers Association, national saving is an important determinant of national investment. National saving comprises personal saving, business saving, and Government saving, and thus a decline in personal saving would lead to a decrease in national saving if all other sources of saving remained the same. In recent years national saving has been rising primarily because the increase in Government saving and, to a lesser degree, the increase in business saving have more than offset the decline in personal saving. Moreover, these divergent trends are not necessarily unrelated. For example, strong corporate profits bolstered business saving and helped spur the significant capital gains in corporate stocks. Tax payments on realized capital gains boosted Government saving while at the same time contributing to the decline in personal saving. Thus, all sources of saving must be considered when looking at the funds available for investment.

Q.15.a. What forms, if any, of bank surveillance are done through automated technology and/or the Internet?

Q.15.b. Does your agency have any plans to augment the role of automated technology in gathering and disseminating information?

A.15.a. To supplement on-site examination activities, the Federal Reserve routinely monitors the financial condition and performance of banks and bank holding companies using automated screening systems. These surveillance systems utilize financial data reported on quarterly regulatory reports and focus heavily on identifying banking organizations that are exhibiting problems or deteriorating so that examination resources can be directed to troubled companies. Further, surveillance screens are used to flag companies engaged in new or complex activities to assist examiners in planning on-site examinations. Currently, specialized surveillance programs are run quarterly for State member banks, small shell bank holding companies, and the remaining larger and more complex banking holding companies. The Federal Reserve also uses an automated screening system to monitor compliance by financial holding companies with the requirements of the Gramm–Leach–Bliley Act.

In addition, the Federal Reserve utilizes an automated system to produce Uniform Bank Holding Company Performance Reports, which include detailed current and historical financial and peer group information for individual banking organizations. These reports are primary analytical tools for examiners and are also provided to management at bank holding companies. With the exception of a small number of confidential items, these reports are also made available to the public. Recent surveillance initiatives have focused on achieving timely electronic delivery of surveillance information. For example, the Federal Reserve has included a number of surveillance notifications in its Banking Organization National Desktop (BOND) application. These notifications push screening results and data directly to the e-mailbox of analysts and examiners responsible for supervising complex banking organizations. The Federal Reserve also maintains other computer applications that facilitate access to financial data from regulatory reports and to surveillance program results for all banks and BHC's. For instance,

using the Performance Report Information and Surveillance Monitoring (PRISM) application, examiners and analysts can readily access the Board's extensive database of financial and surveillance data and perform customized analyses of trends and developments at supervised institutions. Examiners and supervisory staff can also generate electronic reports that summarize surveillance program results for individual banking organizations.

A.15.b. Regarding the augmentation of the role of technology in the gathering of information, beginning in September 2001 the Federal Reserve will implement a web based system that will allow financial and bank holding companies to file their FR Y10–Report of Changes in Organizational Structure via the Internet. This system will assist the institutions in the completion of the form and will allow them to provide the data electronically. On a trial basis, the system is being made available to a small set of holding companies in September and, gradually, the population of holding companies will be expanded over the coming months. Approximately 6 months later, we plan to expand the population further to include foreign banking organizations that operate in the United States and are required to file the FR Y10f. We hope to expand this capability to other regulatory reports in the near future. We have also established a capability to receive automated downloads of loan data from State member banks to assist in the preparation of examinations, and we receive shared national credit data electronically from respondent institutions. Last, we participate with the FFIEC agencies in the automated collection of Call Reports and HMDA and CRA data from banks. We are working with the FFIEC Reports Task Force to examine the possibility of using Extensible Markup Language (XML) as an alternative for the Call Report and potentially other regulatory reports in the future.

Regarding further automation in the dissemination of information, the Federal Reserve places much of its publicly available regulatory information on the Board of Governor's web site (*www.federalreserve.gov*). The public can also access several educational and training tools, as well as studies and reports related to community and economic development. We disseminate public regulatory report information through our National Information Center web site (*www.ffiec.gov/nic*), and HMDA and CRA information, data, and reports through the FFIEC HMDA (*www.ffiec.gov/hmd*) and CRA (*www.ffiec.gov/cra*) web sites. In addition, through the FFIEC web site (*www.ffiec.gov/info-services.htm*), we provide access to a mapping tool, geocoding tool, and the census data that the FFIEC uses to create HMDA and CRA reports.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENSIGN FROM ALAN GREENSPAN

Q.1. What is your insight regarding the status of the pending regulation by the Federal Reserve Board and the Treasury Department that would redefine real estate brokerage and management as financial activities?

A.1. The Board received more than 46,000 comments from the public in response to the invitation by the Board and the Secretary of the Treasury for comment on whether real estate brokerage and management activities are financial in nature or incidental to a fi-

nancial activity. We believe that it is important to consider the public comments and other relevant information carefully.

The Staff of the Board and the Treasury Department are in the process of reviewing and analyzing the information that the public has provided. Because of the volume of comments and information provided, that process will take some time.

Q.2 What are your views regarding the impact the proposed rule could have on the real estate brokerage industry and the financial services industry?

A.2. I do not have any firm views regarding the appropriate resolution of the proposal or the impact that various outcomes might have on the real estate industry or the financial services industry. The Board will consider these matters, along with the other standards enumerated in the Gramm–Leach–Bliley Act, as part of its review of the comments and the proposal.

Q.3. Real estate brokerage was not specifically addressed in the Gramm–Leach–Bliley legislation that was enacted into law at the end of the 106th Congress. Can you discuss your views of the Congressional intent of Gramm–Leach–Bliley regarding real estate brokerage's definition as a financial activity?

A.3. The Gramm–Leach–Bliley Act expanded the authority of companies that qualify as financial holding companies to engage in new activities and affiliate with other companies. The Act specifically listed a number of activities that Congress determined to be financial in nature and, therefore, permissible by statute for FHC's and their affiliates to conduct. These activities include broad securities underwriting activities, insurance underwriting and agency activities, merchant banking activities, activities previously determined by the Board to be closely related to banking, and activities that the Board has previously found by rule to be usual in connection with the conduct of banking abroad.

In addition to this list of specific activities, Congress specifically included in the Gramm–Leach–Bliley Act a provision that allows financial holding companies to engage in any activity that the Board, in consultation with the Secretary of the Treasury, determines to be "financial in nature or incidental to a financial activity." This provision was included in order to grant the Board and the Secretary flexibility to address and permit activities that were not addressed by Congress.

In determining whether an activity is financial in nature or incidental to a financial activity, the Act requires the Board and the Secretary to consider a number of factors including whether the activity is necessary or appropriate to allow a financial holding company "to compete effectively with any company seeking to provide financial services in the United States." In addition, the Act requires the Board and the Secretary to consider the purposes of the Bank Holding Company Act and the Gramm–Leach–Bliley Act, changes or reasonably expected changes in the marketplace in which financial holding companies compete and in the technology for delivering financial services, as well as other factors. While Congress included a provision allowing the agencies flexibility in defining permissible activities, Congress determined not to include a provision in the Gramm–Leach–Bliley Act that would have al-

lowed the general mixing of banking and commerce within financial holding companies. At the heart of the debate regarding real estate brokerage activities is the question whether real estate brokerage activities involve activities that are financial in nature or commercial in nature. The commenters focus on this issue and the Board will carefully consider this matter as it reviews the comments and consults with the Secretary of the Treasury.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM JOHN D. HAWKE JR.

Q.1. What do you think is the greatest potential problem facing the U.S. financial system today?

A.1. The main issues are credit risk and liquidity risk. The costs of managing these risks will likely cause earnings to decline in future quarters. The degree of the decline is contingent on the length and depth of the economic slowdown in the United States and overseas. The slowdown in the manufacturing sector is causing deterioration in asset quality not only in the large banks' commercial & industrial (C&I) loan category but also for C&I loans in some smaller banks across the country.

Banks also are reporting a steady decline in their deposit base resulting in increasing liquidity risk. The decline can be attributed in part to the strong gains in the equity markets in the 1990's, which has encouraged households to move their funds to higher yielding assets. For banks, this means that they must seek alternative sources of funding, which can be more rate and market sensitive. Managing the more rate-sensitive and potentially volatile sources of funding is a challenge for both large and small banks.

Q.2. While many analysts predict a recovery from the current economic slowdown in the second half of the year, there is still a chance that the downturn could be worse than expected. If the economy were to perform below expectations, what consequences would that have for the safety and the soundness of the banking system?

Specifically, I would like to ask about the banking system's risk exposure in the following areas:

- Noncurrent Loans
- Credit Card and Consumer Loans
- Mortgage Delinquencies
- Telecommunications Sector

A.2. Bank earnings will remain under pressure if the slowdown in economic growth continues. Noncurrent loans in the banking system are expected to increase for at least the remainder of 2001. If the banking system is subjected to long-term and deep economic weaknesses, some bank failures may occur. As I noted in my testimony, the national banking system is in a stronger position today to bear the stresses of an economic slowdown than a decade ago—it is better capitalized, earnings are stronger, bank balance sheets and revenue streams are generally more diversified, banks' risk-management systems have improved, and the asset quality of the national banking system is certainly better.

Even with their profitability under pressure, banks strengthened their capital ratios over the last year. The level of capital in the

national banking system remains at a historical high and provides an additional cushion against unexpected losses—the risk-based capital ratio was 12.1 percent at the end of first quarter 2001, compared to 9.0 percent at the end of first quarter 1990. Moreover, the portion of the banking industry facing the economic slowdown from a position of weak performance is substantially less than a decade ago. Nearly 98 percent of all national banks met the regulatory definition of well-capitalized by maintaining a ratio of equity capital to assets above 5 percent and a total capital to risk-based assets ratio above 10 percent.

The bulleted topics of this question are addressed separately in the responses to questions 3 through 6.

Q.3. After 5 very good years, the rate of nonperforming commercial, industrial, and personal loans increased by 26.5 percent in 2000. Can you please tell me what stress, if any, this places on the banking system and whether or not you expect a similar rate of increase for this current year?

A.3. The deterioration in asset quality has affected bank earnings through higher loan loss provisioning to increase loan loss reserves. While the coverage ratio of loss reserves to noncurrent loans declined at the end of first quarter 2001 to its lowest level since 1993, it still remains high at 138 percent and well exceeds the 68 percent coverage level at year end 1990. As noted above, the national banking system remains well capitalized, and even with their profitability under pressure, banks strengthened their capital ratios over the last year.

There are signs of increasing credit risk in the banking system, as the financial positions of some businesses and households are weakening due to slow economic growth. The greatest deterioration in credit quality has been in the Commercial & Industrial (C&I) loans category. The noncurrent C&I loan ratio rose by 22 basis points from 1.66 percent at year end 2000 to 1.88 percent at the end of first quarter 2001. While the deterioration has been more pronounced for large national banks, there were signs it has begun to spread to smaller banks. The concentration of the problem in business lending tracks developments in the overall economy with corporate profits declining and bond default rates rising. Therefore, banks' C&I loan quality is expected to continue to deteriorate if the economy continues to weaken.

Q.4. Though the delinquency rates for credit cards and consumer loans are well below the levels experienced during the last economic slowdown, they have risen back to levels comparable to 1993. What do you think the effects of this increase in delinquency rates will be, with regard to both consumers and the financial institutions you regulate?

A.4. Consumer lending remains a concern given the high consumer debt levels and the potential reliance of the consumer on more variable sources of income to service that debt. Consumers' indebtedness today relative to their income is at an all time high. If there is a prolonged slowdown and localized areas see sharp increases in layoffs, consumer defaults on loans may increase. As a result, banks may experience rising noncurrent ratios and charge-offs.

Q.5. According to a Mortgage Bankers Association survey, 10 percent of mortgages backed by the Federal Housing Administration are now 30 or more days delinquent. An article in the June 12 *New York Times* stated, "The mortgage problems underscore one main reason many policymakers and economists are so concerned about whether the United States will enter a recession this year." Can you please tell the Committee your thoughts and concerns about the high level of mortgage delinquency?

A.5. The national banking system had $457.3 billion of loans secured by 1–4 family residential mortgages as of the end of first quarter 2001. These accounted for 20.3 percent of total national bank loans, and included a wide variety of residential mortgage loans, including FHA loans. The noncurrent loan ratio for loans secured by 1 to 4 family residential mortgages in the national banking system has remained less than 1.2 percent since year end 1994. This level of delinquency is manageable relative to banks' capital and loan allowances. The ratio of charge-offs for 1 to 4 family residential mortgages was 0.14 percent at the end of first quarter 2001, and for the last 10 years has remained under the .27 percent peak experienced in 1992. The housing market has been fairly resilient to the most recent economic developments, but is vulnerable to a more protracted slowdown.

Q.6. I have heard from varying persons that the banking industry has significant exposure in the telecommunications sector. What is the direct and indirect exposure to the fallout in the telecommunications sector?

A.6. The primary source of data for industry exposures is the Shared National Credit[1] (SNC) data. The processing of the SNC data for 2001 is still underway, but preliminary data indicate telecom commitments of $130 billion with outstandings of $49 billion. Because many nonbanks banks (that is loan funds, insurance companies, and mutual funds) hold the majority of the lower tranches of these credits, the exposure to the banking industry will be significantly lower than the reported SNC totals. By the same token, banks have direct and indirect exposure to the telecommunications industry that are not captured in the SNC data.

Telecommunication credits are primarily held by a few of the largest banks, but they generally do not constitute significant concentrations for these institutions. These institutions typically have appropriate risk-management processes and reserving methodologies. Their problem loan identification has improved in the past year and their loan loss provisions have kept pace with charge-offs.

Q.7. According to the OCC, consumers are more highly leveraged now than at any measured point in history. Not only are debt service payments at historical highs, but also the increase in debt has been financed through instruments other than mortgages. Credit card debt is rising very rapidly; the *Chicago Sun-Times* reported that the average credit card debt per household is $8,123 and has grown threefold over the past decade. Debt service payments constitute over 14 percent of disposable income. What do you believe

[1] Shared national credits are loans extended to a borrower of $20 million or greater that are shared by three or more unaffiliated, supervised institutions. They are reviewed annually in May and June by teams of interagency examiners.

the effects of this high level of personal debt will be with regard to consumers, the banking sector, and the economy as a whole. If the economic downturn is worse than expected, what would be the effect of having many people so highly leveraged?

A.7. Although the credit quality of loans to individuals has generally not shown signs of stress comparable to that for business lending, pressure is also increasing on the consumer. During the period 1986 to 1992, consumer debt obligations declined because of the refinancing boom that enabled consumers to pay down some of their higher cost debt with income available from refinancing. Today, both mortgage debt and other consumer debt are rising. Despite the refinancing boom over the last 6 months, some consumers have reloaded their credit card and installment debt. These individuals will have a difficult time servicing their higher debt levels if they are faced with adverse circumstances such as rising energy costs, or less favorable income levels in the event of job changes, and/or layoffs in a slowing economy.

The recent sharp increases in personal bankruptcies are in part linked to high consumer debt burdens coupled with a slowing economy. Many analysts project bankruptcy filings to continue to be high throughout 2001. The volume of personal bankruptcies has a direct impact on the level of losses in consumer loan portfolios, particularly for unsecured loans. In this environment, some banks' credit card portfolios are experiencing higher loss rates, though they remain within historical norms. While bank losses for consumer loans remain modest, if there is a prolonged slowdown and localized areas experience layoffs, rising levels of noncurrent loans and increased charge-offs related to banks' consumer portfolios are likely. Overall, while the performance trends of consumer portfolios recently turned negative, the quality of consumer loans in the national banking system remains relatively stable.

Q.8. Remittances are a large and growing economic reality that affect millions of people both in America and south of the border. It has recently come to my attention that this industry, which recent estimates have put at more than $20 billion annually, often charges high fees and that many of the leading companies have been challenged in court for having hidden fees. In a *New York Times* article it is stated that "the fees have run from about 10 percent to 25 percent or more." Do you believe that there are problems in the manner in which the bulk of remittances are made today? What steps has your agency taken to analyze possible solutions including fostering or creating alternative transfer mechanisms?

A.8. Remittance services are often provided without complete information on the total costs incurred for the service. The total costs for international remittances may include both explicit fees, as well as an exchange rate for the foreign local currency that is disbursed from the amount sent in U.S. dollars. This exchange rate may not be favorable relative to market rates, and is often not explicitly disclosed to the customer.

The OCC recognizes the importance of this issue, as well as the many questions that would need to be answered before an effective policy response could be developed. The agency would welcome the

opportunity to work with other Federal bank regulatory agencies to discuss possible solutions.

Q.9. Former Treasury Secretary Summers has stated that "all high school students should receive a financial education" and that "though personal financial education must begin in the home, it must continue in the schools." Can you please comment on the state of financial literacy and education among Americans, including any deficiency in this area that should be addressed? If you see any deficiencies, what do you believe can and should be done with regard to these deficiencies in both a broad sense and with regard to your agency? At the hearing I asked for information regarding any initiatives that your agency has taken, including the Money Smart program. Could you please provide this information in your submission to the record?

A.9. While most individuals continue to enjoy the benefits of the longest period of sustained economic growth in the United States, a sizable portion of the U.S. population remains on the fringes of the banking system. According to the 1998 Survey of Consumer Finances published by the Federal Reserve Board, 10 percent of U.S. households do not have a depository account with a financial institution. Additionally, the number of check-cashing stores continues to rise, while the national savings rate has fallen to the lowest level in recent history. Concerns regarding abusive lending practices also indicate a need for consumer education.

Recent surveys suggest that financial literacy is low among the American population as a whole, and especially low among young people. A 2000 survey conducted by the JumpStart Coalition for Personal Financial Literacy found that most high school seniors failed a test of basic financial subjects involving questions on banking products, credit cards, taxes, savings, and investments.

In order to encourage bank participation in financial literacy initiatives, the OCC issued an Advisory Letter AL 2001–1 on January 16, 2001 (available on the OCC website at *www.occ.treas.gov/issuances*). This guidance provides national banks with information on the types of financial literacy programs that have been undertaken by banks and aspects of those programs that have been most important to their success. Released in conjunction with the advisory letter, the OCC maintains a resource directory available on the OCC website at *www.occ.treas.gov/cdd/commfoc.htm* that provides information about programs and initiatives that span the lifecycle from youth to retirement and illustrate the categories of financial literacy activities described in the advisory.

Also, the OCC is one of only four Federal agencies to have entered into a partnership with the National Academy Foundation, a nonprofit organization dedicated to supporting the development of the country's young people toward personal and professional success. Our partnership with NAF has centered on its Academy of Finance, which aims to promote financial literacy among high school students and helps to prepare those students for further education and careers in the financial services field. Most recently, OCC staff have undertaken a comprehensive revision of the Academy's course in Banking and Credit, to ensure that the material being taught to students in the NAF program is accurate and up-to-date.

The banking agencies recognize the impact of financial literacy programs through the Community Reinvestment Act. Bank participation in financial literacy programs that target both low- and moderate-income individuals can be structured to receive positive consideration under the lending, investment, and service tests of the Community Reinvestment Act.

The Money Smart program mentioned in the question is a joint initiative of the FDIC and the Department of Labor. The Money Smart program provides a comprehensive adult financial education curriculum at centers nationwide that offer employment and training services. Banks and other institutions can also use this curriculum to serve their communities. This type of initiative supports the goals of expanding financial education for consumers.

Q.10. What steps has the Federal Reserve taken to promote technology and innovation in the payments system, and what steps should it take? As well, are you concerned that the initiation of payments on the Internet, or through other electronic means, could affect the safe operation of the payments system? Note that the first part of this question is directed at the Federal Reserve System, thus the OCC response will speak only to the bolded section of the question.

A.10. OCC as supervisor for national banks examines those risks associated with national bank participation in the payments system, and takes actions as appropriate to ensure that banks conduct these activities in a safe and sound manner. The OCC is concerned about some specific issues that relate to Internet payments. One such issue is authentication. Confirming the identity of customers online is an issue with which the financial services industry is struggling. The OCC participated in a FFIEC Symposium on this topic in March, and will participate in the development of FFIEC guidance on electronic authentication.

In addition, the OCC recently issued guidance to national banks on complying with the new rules issued by the National Automated Clearing House Association (NACHA) on certain Internet-initiated automated clearing house payments. These important new rules are designed to reduce fraud by increasing the responsibilities of companies that enable customers to direct Internet payments through the Automated Clearing House (ACH) network. The OCC issued Advisory Letter 2001–3 in January to alert national banks to this rule change and will soon issue examination procedures.

The OCC is seeking to eliminate some of the uncertainty for national banks that exists in electronic banking activities, including payments. On a case-by-case basis, the OCC has authorized a number of activities in national banks including electronic bill payment and presentment and online merchant processing of credit card transactions. (These and other related decisions are posted on the OCC website *www.occ.treas.gov*). To further codify these and other positions that OCC has taken with regard to electronic banking, on July 3, 2001 the OCC published a proposed rule that would provide simpler and clearer guidance for electronic and developing technologies activities *www.occ.treas.gov/01rellst.htm*.

Q.11. Comptroller Hawke, at a speech you gave on December 2, 1999, you talked about privacy and consumers' interest in control-

ling the sharing of their personal confidential financial data with other companies for unintended purposes. You said, "The industry's argument was that to allow customers to prevent banks from sharing confidential customer information with their affiliates would destroy the synergies and efficiencies that would be made possible by the new law. I do not accept this argument . . ." It should not be assumed that customers will automatically opt out. If banks and other financial firms really have something to offer customers, they should be able to convince them not to opt out—that information sharing is really in their interest, if that is in fact the case. There is a certain patronizing quality in the argument that we should not allow customers to opt out because we really know what is best for them. Do you feel the synergies from the Gramm–Leach–Bliley Act can coexist with allowing customers to control the sharing of their information with affiliates?

A.11. Consumers already possess the ability to direct financial institutions not to share certain confidential information about them with affiliates under the Fair Credit Reporting Act. This opt out right pertains to consumer reporting information, such as application information that relates to a consumer's creditworthiness. There is no current evidence that this opt out right has harmed the business opportunities among affiliated financial institutions. Of course, affiliated companies must remain free to disclose customer information to one another in order to service or process a transaction that a consumer initiates. This type of information disclosure is consistent with that permitted between nonaffiliated third parties under the Gramm–Leach–Bliley Act (GLBA). Providing consumers with the ability to opt out of information disclosures among affiliated companies for marketing, however, would not appear to destroy potential synergies among the companies. Based on the rate of opt outs under both the FCRA and the GLBA, thus far, an assumption that customers will automatically opt out of affiliate information sharing would appear to be erroneous.

Q.12. On September 16, 1997, a Subcommittee of the Senate Banking Committee, chaired by Senator Bennett, held an important hearing on the issue of identity theft, which occurs when someone uses the personal information of another person to obtain credit cards or other financial instruments or assets. Just a few weeks ago, *The Washington Post* published an article by Robert O'Harrow which observed that "the Justice Department says that 'identity theft is one of the Nation's fastest growing white-collar crimes.'" How prevalent is this crime? What is its impact on bank customers and on banks? What efforts are being taken to end this practice?

A.12. The OCC does not have independent statistics about the prevalence of identity theft. However, there has been a significant increase in the incidence of identity theft reported in Suspicious Activity Reports (SAR's). SAR statistics compiled by FinCEN indicate that the number of reported incidents of identity theft increased from 44 in 1997 to 617 in the first 11 months of 2000. There are 1,030 SAR's in the system reporting identity theft and this number is likely to grow, especially in light of a recent OCC advisory letter to national banks on identity theft and pretext call-

ing, that instructed banks specifically how to report incidents of suspected identity theft and pretext calling on a SAR.

This year, the OCC's Consumer Assistance Group received 105 complaints involving identity theft. Seventy-eight complaints involved credit card accounts and 27 related to checking accounts. However, the FTC's identity theft hotline receives thousands of calls each week. Half of the complaints the FTC has been receiving involve credit card fraud. Figures are not available with respect to losses to banks or their customers as a result of identity theft. However, identity theft does result in monetary losses to both bank customers and the institutions themselves. Under Regulation Z, in instances involving identity theft, a consumer could incur liability for the unauthorized use of the consumer's credit card account up to $50. The card issuer is responsible for the remaining losses to the consumer. Under Regulation E, a consumer's liability for unauthorized electronic fund transfers involving his or her account varies depending upon the precise circumstances of the unauthorized use and the consumer's timeliness in reporting unauthorized transactions or the loss or theft of an access card, number, or other device. Where a consumer acts promptly upon discovering an unauthorized transaction, in most circumstances the bank will be responsible for the total amount of any such transaction.

As mentioned above, in April, the OCC issued Advisory Letter 2001–4 to increase banks' awareness in regards to identity theft and pretext calling and encourage banks to take specific measures to protect their customers against these types of fraud. The letter informs banks about safeguards to prevent identity theft—such as verification procedures for new customer accounts, verification of change of address requests, and implementation of the new interagency security standards. The advisory letter also encourages banks to educate their customers about ways to prevent identity theft and pretext calling and to assist those customers who may have been the victims of such fraud. The advisory directs banks to a consumer brochure on the OCC's website (*www.occ.treas.gov/idtheft.pdf*) on identity theft and pretext calling that banks may download and provide to their customers.

Q.13.a. According to the Japanese banking industry's own publicly disclosed numbers, about 30 percent of bank assets are classified by examiners as having problems. Experience in the United States and other industrialized countries indicates that if a bank has classified assets of 10 percent to 15 percent of total assets, it is in danger of becoming insolvent and needs immediate supervisory action. The Finance Minister of Japan is reported to have said a few months ago that "Japan's fiscal situation is at the verge of collapse." Data from various official and academic sources indicate Japan's government debt is well over 100 percent of GDP and growing rapidly, and some experts believe Japan is reaching its financing limits. What is your assessment of the Japanese banking system?

A.13.a. The Japanese banking system remains in poor condition. While the infusion of public money relieved some of the pressure from the 1998 crisis and reduced systemic risk, the resolution of bad assets has not been completed. In general, banks' earnings are weak. As domestic and global economic conditions slow, the health

of the banking sector may worsen. Additionally, the decline in Japan's stock markets combined with the application of more stringent mark-to-market accounting standards limits the banks' gains from sizable equity holdings, which have been a recurring source of significant income in the past.

Q.13.b. What risk, if any, does the situation in Japan pose to both U.S. financial institutions and to the U.S. economy?

A.13.b. Japan holds among the largest foreign exchange reserves in the world thereby mitigating transfer risks to U.S. financial institutions. But over the past decade of Japan's economic stagnation, U.S. financial institutions have been subject to increased credit risks on Japanese exposures. As a result, U.S. banks have reduced their Japan exposures from the peak of $103.5 billion at year end 1998 to $83.8 billion at year end 2000. About 54 percent of Japanese exposures are cross-border claims while the rest are booked in the Japanese offices of U.S. banks.

Japan's economy is important to the United States and global economies and financial markets. For many Southeast Asian countries, Japan is a major export market, investor, and, in certain industries, a competitor. Continued economic weakness in Japan can be expected to reduce growth and put downward pressure on currencies throughout Southeast Asia. Potential effects on the U.S. economy are not expected to be severe. But Japan is the third biggest market for U.S. exports and a major source of investment in U.S. markets, so the effects will be a factor for the U.S. economic markets. If Japan faces a liquidity crisis due to financial system weaknesses, Japanese investors may turn to their investments in the United States as a source of funds. Taken together, financial turmoil in Japan has the possibility of increasing volatility in U.S. debt and equity markets. The OCC maintains ongoing contact with Japanese bank supervisors, including periodic meetings with senior officials of the Financial Services Agency to regularly assess these potential developments.

Q.13.c. What actions should be taken to improve it?

A.13.c. Japan's economic and financial sector problems are deep rooted and require a comprehensive approach on a variety of fronts. Recently, the government outlined a series of steps, with one high priority the resolution of the bad loan problem. Effective follow-through on the stated priorities is essential to the recovery of the Japanese economy.

In recent years, the Japanese authorities have made progress in improving bank supervision. They established the Financial Services Agency (FSA) as the key financial services regulator, and they are building a more risk-focused supervisory function. U.S. regulatory agencies will continue to work with the FSA staff to promote a more effective global supervisory process.

Q.14. There have been reports that Argentina is facing serious economic peril. What can you tell us on the situation in Argentina? What effect, if any, do you see on the United States' economy as a whole, and specifically on the financial sector?

A.14. The Argentine government remains in a difficult situation as it tries to revitalize its economy. Argentina has been mired in a domestic confidence problem, which has slowed tax revenues causing

the government's fiscal deficit to escalate and investors to question whether the government could meet its debt payments. This concern is resurfacing, despite a restructuring of a significant amount of debt, as high-interest rates compound Argentina's debt servicing requirements.

U.S. national bank exposure is within reasonable bounds. Naturally, U.S. banks may experience some credit problems with their exposures, but U.S. banks generally have had sufficient time to position themselves to limit the effects from a full-fledged crisis. With respect to the U.S. economy overall, Argentina's recession and turbulence have not affected the United States to any significant degree as trade with Argentina is less than 1 percent of U.S. exports. The OCC continues to closely monitor developments in Argentina, as well as contagion and spill over effects, and the implications for the national banking system.

Q.15. Another disparity involves rules on loans to one borrower. National banks are generally allowed to lend no more than 15 percent of their capital on an unsecured basis to a single borrower. Many States have higher limits for the banks they charter. On June 8, 2001, the OCC announced a new pilot program allowing national banks with the highest supervisory rating to lend up to the State limit—but no more than 25 percent of capital—to single borrowers under certain circumstances. Please describe the competitive regulatory disparity that led the OCC to implement this pilot program.

A.15. As a routine and ongoing part of our supervisory activities, representatives of the OCC conduct outreach meetings with bankers in various settings across the country. During these meetings, bankers in States with higher legal lending limits indicate that this disparity in the amount of credit they are permitted to advance to one borrower puts them at a competitive disadvantage with State chartered banks. This is because they are not able to provide the level of services to some of their best customers that similar size State banks can provide. It is also viewed by many banks as a burden issue because if they want to make such loans they must find other banks to participate if they are to retain the lending relationship. Bankers also view this as a loss of potential loan income at a time when earnings trends are declining.

There are 25 States that have a lending limit for unsecured loans that is higher than the national bank lending limits. This pilot program allows eligible banks in those States with higher lending limits to make loans up to the State limits for residential loans secured by real estate and for unsecured small business loans. This program is only available to eligible banks, for example, they must be rated at least a composite "2," the management and asset quality components must be rated "1" or "2," and their participation is also subject to approval by their supervisory office. Also, at the discretion of the supervisory office, their authority under this program may be withdrawn at any time.

Q.16. In a speech before the American Bankers Association, Federal Reserve Board of Governors Member Edward Gramlich said that, "Higher rates of national savings are among the unsung heroes of good U.S. economic performance in the late 1990's." But the

most recent data from the White House shows a substantial decline in personal savings, from over 5 percent in 1996 to minus 0.9 percent today. Do you think that this is a serious problem, and if so, what can we do to ameliorate it? What position does this place Americans in if the economic slowdown worsens? What are the effects of this decline with respect to national investment levels and GDP growth?

A.16. The drop in the reported personal savings rate over the last 5 years from 5 percent to 0.9 percent provides a distorted measure of household finances and households' ability to continue spending. The reported savings rate as calculated from the National Income and Product Accounts (NIPA) is calculated as disposable personal income less personal outlays, as a percent of disposable income. The NIPA disposable income measure, however, understates household resources available for spending because it focuses on production and does not include realized or unrealized gains or losses from the sale of nonproduced assets, such as land or financial assets (stocks and bonds). Researchers at the Federal Reserve Bank of New York [2] have constructed a more meaningful measure of personal savings including capital gains. The results of their study indicate that the personal savings rate and the resources available to households for spending have not declined over the last 5 years. Thus, the reported personal savings rate may not fully reflect the financial position of households, and may mask the true increase in national savings referred to by Federal Reserve Board Governor Gramlich.

Q.17.a. What forms, if any, of bank surveillance are done through automated technology and/or the Internet?

A.17.a. The OCC has various automated systems to monitor the safety and soundness of the national banking system. This information is used on an individual bank basis to enable examiners and managers to identify potential risk areas and better allocate resources through more focused examinations. The following highlights both longstanding, as well as recently developed systems:

Uniform Bank Performance Reports

For the past two decades, staff at the OCC and other bank regulatory agencies have used the Uniform Bank Performance Report (UBPR) to monitor the condition of the banking system as well as perform analysis on individual banks. The UBPR packages a large amount of data covering balance sheet, income statement and off balance sheet components into an information oriented format that enables supervisors to evaluate bank specific risk profiles and growth trends, as well as comparisons to peer groups. Supervisory staff also has the ability to develop customized peer groups for banks with unique characteristics and in specific geographic areas.

Canary System

Canary is an automated early warning system designed to identify community and mid-size banks that may have high or increasing quantities of credit, liquidity or interest rate. Canary uses a

[2] Peach, Richard, and Charles Steindel. "A Nation of Spendthrifts? An Analysis of Trends in Personal and Gross Saving," *Current Issues in Economics and Finance,* Federal Reserve Bank of New York, Volume 6, Number 10 (September 2000).

combination of internal and external models that evaluate a bank's prospective profitability, as well as the probability of a bank becoming severely troubled under a variety of economic scenarios. The system also is used to identify banks designated as low risk. These are institutions with a low financial risk profile that are subject to streamlined supervision. Canary also facilitates the analysis of trends across the banking system.

Financial Market Information

The OCC tracks broad financial market information on the banking system as a whole, as well as individual banks. Information gleaned from the Internet, Bloomberg Analytics, Moody's Structured Finance DataBase, and the proprietary data bases of various research firms complement the onsite, bank specific information provided by OCC examiners. In addition to regular news flow on general matters, financial and commodity prices, the OCC tracks specific bank equity, debt, and asset-backed securities to evaluate current and changing market perceptions.

Examiner View

Examiner View (EV) is the supervisory information system used by all examiners who supervise mid-size and community banks, Federal branches and agencies, and technology service providers, to input examination information into a centralized database via personal computers. The system helps the supervisory process by facilitating the prompt and consistent aggregation of data.

Q.17.b. Does your agency have any plans to augment the role of automated technology in gathering and disseminating information?

A.17.b. The OCC will continually enhance various reporting features of Canary and Examiner View. Enhancements will facilitate more focused analyses of banks of varying sizes and business activities. Upgrades will also enable more efficient supervisory planning and allocation of resources.

The OCC's Supervision in the Future project is underway to prepare the OCC for the demands of future bank supervision. The goals of this project are to leverage computer and telecommunications technology, and ultimately to use leading edge risk analysis methods to improve the efficiency and effectiveness of the bank supervision process. One pilot project under this broader program is the development of a common file format for loan data that will provide more highly automated support technology to the credit review aspect of the examination process. If the pilot project is deemed successful, this type of program may be expanded to other areas of the supervision process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM DONNA TANOUE

Q.1. What do you think is the single greatest potential problem that is facing the United States financial system today?

A.1. Over the short run, the greatest concern is declining commercial credit quality. With problem loans rising and with this trend expected to continue, a downturn in economic activity could pose significant problems for some banking institutions.

In addition to concerns about credit quality, the flaws in the current deposit insurance system represent significant problems that should be addressed. The current system exacerbates downturns by requiring the highest premiums when banks can least afford to pay, underprices risk in general and subsidizes higher-risk institutions in particular, and allocates the assessment burden unfairly.

Over the longer run, industry consolidation presents concerns. The risk exposure of the deposit insurance funds is increasingly concentrated in relatively few large institutions. As these institutions continue to grow and their activities become more complex, this poses challenges to bank regulators in terms of monitoring and understanding the risk exposures of these institutions appropriately and devising effective supervisory approaches.

Q.2. While many analysts predict a recovery from the current economic slowdown in the second half of the year, there is still a chance that the downturn could be worse than expected. If the economy were to perform below expectations, what consequences would that have for the safety and the soundness of the banking system?

Specifically, I would like to ask about the banking system's risk exposure in the following areas:

- Noncurrent Loans
- Credit Card and Consumer Loans
- Mortgage Delinquencies
- Telecommunications Sector

A.2. The ratio of noncurrent loans to total loans is steadily rising. The ratio has edged up to 1.12 percent in the first quarter of 2001 from 0.92 percent one year earlier. In spite of this increase, the banking industry as a whole is in much better shape than it was during the last downturn. Noncurrent loans represented 3.25 percent of total loans—nearly three times higher than the current ratio—when the U.S. economy entered the last recession in 1990.

The credit quality of credit card and consumer loans has deteriorated somewhat in the past 2 quarters. The ratio of noncurrent credit card and consumer loans has edged up in the first quarter of 2001 and the net charge-off rate for credit card and consumer loans has also risen in the past 2 quarters. The rapid rise in consumer credit and indebtedness in recent years may cause the credit quality of credit card and consumer loans to deteriorate quicker in the case of further weakening in economic conditions. Net charge-off rates for credit card and consumer loans were considerably higher in the first quarter of 2001 than they were at the onset of the last recession.

Overall, the mortgage delinquency rate has been relatively stable in the past few quarters. According to Standard and Poor's, 90 day delinquencies of prime and subprime residential mortgage-backed securities have shown little increase in the early months of 2001.[1] However, mortgage delinquencies may rise, particularly among subprime mortgage loans, if the economy weakens further. Amid the weakening economy and rising layoffs, the percentage of non-

[1] Standard and Poors, "All Flat on the Housing Front," *Ratings Commentary,* June 15, 2001.

current FHA and VA loans has risen sharply in recent months (see enclosed chart).

The banking industry has significant exposure to the telecommunications sector from their syndicated lending activities. Regulators continue to work together and monitor banks' exposure to the sector through the Shared National Credit (SNC) review. The SNC data are obtained from the confidential onsite examination process. Should the Committee require more information about the result, it would be best handled through a confidential briefing by the appropriate regulator.

Q.3. After 5 very good years, the rate of nonperforming commercial, industrial, and personal loans increased by 26.6 percent in 2000. Can you please tell me what stress, if any, this places on the banking system, and whether or not you expect a similar rate of increase for this current year?

A.3. Although nonperforming loans have recently risen at a high percentage rate, they remain relatively low as a percent of total loans outstanding (1.12 percent as of March 2001).

Analysts generally agree that the increases in nonperforming loans during 2000 were the result of relatively weak loan underwriting in the late 1990's, a slowing U.S. economy, and the well-publicized problems that have affected certain industry sectors. These conditions are likely to contribute to the emergence of additional problem loans during the remainder of 2001. As a result, commercial loan losses are likely to rise further before stabilizing. Recent indicators show that consumer loan losses also are likely to rise in 2001, with their ultimate level depending on how the U.S. economy fares over the remainder of the year.

Although it appears likely that nonperforming bank loans will again rise at a double-digit rate in 2001, they also are likely to remain at manageable levels for the vast majority of insured institutions. At the end of 2000, less than 1 percent of insured institutions carried noncurrent loans (90 days or more past due plus nonaccrual) greater than 6.0 percent of total loans. As recently as 1991, almost 7 percent of insured institutions carried noncurrent loans above the 6.0 percent threshold.

Q.4. Though the delinquency rates for credit card and consumer loans are well below the high levels experienced during the last economic downturn, they have risen back to levels comparable to 1993. What do you think the effects of this increase in delinquency rates will be, with regard to both consumers and the financial institutions that you regulate?

A.4. With the exception of credit card lending, consumer loans have traditionally been one of the best-performing loan categories on bank balance sheets. Charge-off rates on credit card loans at FDIC-insured institutions remain high, which has helped to drive the aggregate consumer loan charge-off rate higher. Despite the higher charge-offs, most consumer lenders, and in particular credit card lenders, have developed sophisticated risk-management practices that have enabled them to enhance profitability in a higher-loss environment. However, insured institutions also have increased activity in the subprime consumer lending market, which has not yet been tested in an economic downturn. While it is unlikely that a

significant number of institutions would fail due solely to problem consumer loans, consumer lenders and current risk-management practices potentially could face a much tougher earnings environment if the economy should slow significantly.

Q.5. According to a Mortgage Bankers Association survey, 10 percent of mortgages backed by the Federal Housing Administration are now 30 or more days delinquent. An article in the June 12 *New York Times* stated, "The mortgage problems underscore one main reason many policymakers and economists are so concerned about whether the United States will enter a recession this year." Can you please tell the Committee your thoughts and concerns about the high level of mortgage delinquency?

A.5. The rise in delinquencies on mortgages backed by the Federal Housing Administration (FHA) reflects a potential rise in problem mortgage loans made to financially leveraged consumers. Past due FHA loans rose to an historical high of 11.2 percent in the fourth quarter of 2000. In contrast, past due conventional loans rose to only 3.1 percent, well below the 4.3 percent past due rate recorded in the fourth quarter of 1985. Problems in FHA backed mortgages are likely to appear more quickly than in conventional mortgages because FHA borrowers also are likely to experience financial problems more quickly if economic conditions deteriorate and the labor market weakens significantly.

Q.6. I have heard from varying persons that the banking industry has significant exposure in the telecommunications sector. What is the direct and indirect exposure of banks to the fall-out in the telecommunications sector?

A.6. As noted in Answer 2, the banking industry has significant exposure to the telecommunications sector from their syndicated lending activities. Regulators continue to work together and monitor banks' exposure to the sector through the Shared National Credit (SNC) review. The SNC data are obtained from the confidential onsite examination process. Should the Committee require more information about the result, it would be best handled through a confidential briefing by the appropriate regulator.

Q.7. According to the OCC, consumers are more highly leveraged now than at any measured point in history. Not only are debt service payments at historic highs, but the increase in debt has been financed through instruments other than mortgages. Credit card debt is rising very rapidly; the *Chicago Sun-Times* reported that the average credit card debt per household is $8,123 and has grown threefold over the past decade. Debt service payments constitute over 14 percent of disposable income. What do you believe the effects of this high level of personal debt will be with regard to consumers, the banking sector, and the economy as a whole? If the economic downturn is worse than expected, what would be the effect of having so many people so highly leveraged?

A.7. Highly indebted consumers could be at high risk in a slower growing economy. As income growth slows and unemployment rises, these consumers will find it more difficult to service mounting debts. Possible negative effects could include rising consumer bankruptcies, rising consumer loan charge-offs, and reduced consumer spending that could exacerbate an already slow-growing

economy. According to data from the Federal Reserve Survey of Consumer Finances, the burden of debt service falls disproportionately hard on families in lower income brackets. Consumer credit problems, particularly those in subprime loan portfolios, could also fall disproportionately hard on consumers in these income classes. Overall, consumers have recently assumed mortgage debt at a rapid rate. According to data from the Federal Reserve Flow of Funds, nearly $400 billion in home mortgages was added to the balance sheet of the household sector from year-end 1999 to year-end 2000.

Q.8. Remittances are a large and growing economic reality that affect millions of people both in America and south of the border. It has recently come to my attention that this industry, which recent estimates have put at more than $20 billion annually, often charges high fees and that many of the leading companies have been challenged in court for having hidden fees. In a *New York Times* article it is stated that "the fees have run from about 10 percent to 25 percent or more." Do you believe that there are problems in the manner in which the bulk of remittances are made today? What steps has your agency taken to analyze possible solutions including fostering or creating alternative transfer mechanisms?

A.8. We are not aware of major problems within the banking industry relative to excessive fees charged for remittances. *The New York Times* article referenced in the question refers to the excessive fees paid by Mexican migrants to transfer money back to their families in Mexico. Most of the abuses apparently involve people without legal status to have banking or checking accounts. The article also mentions that new wire transfer systems are being developed that will substantially reduce the costs of these wire transfers. Instead of the $80 to $90 fees that apparently have been charged to some unsophisticated customers to transfer $300 to Mexico, the new competitors are expected to charge less than one-fourth of that amount. This appears to be an example where the marketplace is taking proper steps to address abuses by increasing competition.

A more recent article in the *American Banker* notes that a White House task force is studying a broad array of United States-Mexican border issues including this one. The financial services industry should take steps to eliminate these types of abusive practices by ensuring that consumers are well informed and that transaction fees are fair, equitable, and fully disclosed. The FDIC will do its part to ensure similar abuses do not occur within the banking industry.

Q.9. Former Treasury Secretary Summers has stated that "all high school students should receive a financial education," and that "though personal financial education must begin in the home, it must continue in the schools." Can you please comment on the state of financial literacy and education among Americans, including any deficiency in this area that should be addressed? If you see any deficiencies, what do you believe can and should be done with regard to these deficiencies in both a broad sense and with regard to your agency? At the hearing I asked for information regarding any initiatives that your agency has taken, including the Money

Smart program. Could you please provide this information in your submission to the record?

A.9. Enclosed is a copy of my June 21, 2001 letter, pursuant to my testimony, that provided information on the FDIC's Money Smart Program. Financial literacy fosters financial stability for individuals and entire communities. The more people know about credit and banking services, the more likely they are to increase savings, buy homes, and increase their financial health and well being.

While financial literacy is a universal need, it can be particularly critical for individuals with a modest income and few, if any, assets. That is why the FDIC created Money Smart, a comprehensive curriculum to help adults outside the financial mainstream develop positive deposit and credit relationships with commercial banks and thrifts.

The Money Smart program explains basic financial instruments, services, and products in 10 instructor-led training modules. The curriculum begins with an introduction to bank services and progresses to choosing and maintaining a checking account, budgeting and saving, the importance of credit history, consumer rights and responsibilities, selecting and using credit cards, understanding other forms of consumer credit, and a very basic introduction to home ownership.

The FDIC provides the Money Smart curriculum to banks and to other organizations interested in sponsoring financial education workshops free-of-charge. The FDIC encourages banks to work with others in their communities to deliver financial education and appropriate financial services to individuals who may be unfamiliar with the benefits of having a relationship with an insured depository institution.

In addition, the FDIC and the Department of Labor (DOL) are working together to promote financial education and to make Money Smart available at employment centers, called One Stop Centers, across the country. To facilitate use of the program, FDIC and DOL are scheduling orientation sessions for bankers and One Stop Centers in urban and rural locations around the country.

Q.10. The percentage of commercial and industrial loans that are noncurrent, that is, delinquent, has increased over the past 3 years. Over the past year, there has been an increase in these types of loans held by large banks, while there has not been a similar increase among small banks. Do you think that increased consolidation has had a negative effect on the quality of loans held by large banks?

A.10. The decline in credit quality is attributable to a confluence of factors. These factors include a weakening of underwriting standards in the optimistic climate of a long run economic boom, increasing corporate leverage, and intense competition and earnings pressure in the financial services sector. It is difficult to identify any independent effect of consolidation per se on credit quality.

Q.11. Over the last decade, core deposits have declined as a percentage of bank and thrift assets, as individuals have taken advantage of new investment options. Declining deposits have forced banks to look elsewhere for sources of liquidity. Small community banks, which may have limited access to alternative funding

sources, are increasingly relying on advances from the Federal Home Loan Banks as a way to meet their liquidity needs. Do you have any comments on this development and its implications, if any, for the financial services industry?

A.11. Increased reliance on liabilities other than core deposits implies potentially higher and more volatile funding costs for banks. However, with appropriate risk-management practices, banks can incorporate nondeposit funding into their business operations in a safe and sound manner. Indeed, there is evidence that many banks are now using FHLB advances to hedge interest-rate exposures of their longer-term assets. The situations that have raised concerns for FDIC examiners thus far have involved institutions with a heavy reliance on advances and bank management that did not fully understand the risks associated with these instruments. To address such concerns, the FDIC issued examiner guidance for reviewing FHLB advances late last year.

Q.12. In a speech before the American Bankers Association, Federal Reserve Board of Governors Member Edward Gramlich said that, "Higher rates of national savings are among the unsung heroes of the good U.S. economic performance in the late 1990's." However, the most recent data from the White House shows a substantial decline in personal savings, from over 5 percent in 1996 to minus 0.9 percent today. Do you think that this is a serious problem, and if so, what can we do to ameliorate it? What position does this place Americans in if the economic slowdown worsens? Finally, what are the effects of this decline with respect to national investment levels and GDP growth?

A.12. Many policymakers and analysts have expressed concerns about the sharp decline in personal savings rate in recent years. Related to this decline in personal savings are concerns about an increasing level of household debt and reliance on foreign capital to fuel domestic investment in the short term, as well as longer-term concerns about the adequacy of retirement savings. However, the seriousness of this problem may depend on how well the official personal savings rate captures actual changes in household savings. Some analysts argue that the official personal savings rate significantly understates household savings because of its inconsistent treatment of durable goods, payments from corporations, inflation, and taxes, as well as its exclusion of capital gains.[2]

However, the rising household debt level does raise concerns, particularly in times of an uncertain economic environment. In spite of lower interest rates, if the economy worsens with continued layoffs and a decline in personal income, households are likely to face an increase in the debt service burden, which is already near its historical high. From a macroeconomic perspective, robust consumer expenditures and corporate investment that accompanied the decline in personal savings were important contributing factors behind robust GDP growth in the past few years. Both consumer expenditures and corporate investment were funded mainly by government surplus and foreign capital. Foreign capital inflows have

[2] William G. Gale, "A Crisis in Saving?" *Barrons*, August 16, 1999; Eric M. Engen, William G. Gale and Cori E. Ucello, "The Adequacy of Household Saving," *The Brookings Institute Working Paper,* January 2000; William G. Gale and John Sabelhaus, "Perspectives on the Household Saving Rate," *Brookings Papers on Economic Activity 1,* 1999.

continued in recent months in spite of signs of a sharp slowdown in the U.S. economy. However, if the economic situation worsens, foreign capital inflows to the United States could drop significantly, having an adverse effect on consumption and investment.

Q.13. What steps has the Federal Reserve taken to promote technology and innovation in the payments system, and what steps should it take? As well, are you concerned that the initiation of payments on the Internet, or through another electronic means, could affect the safe operation of the payment system?

A.13. By issuing guidance that is technology neutral, the Federal regulators have sought to foster innovations such as Internet banking and Internet-initiated payments. The Federal Reserve has taken a number of steps to promote technology and innovation in the payments system. For example, the Federal Reserve Board recently requested comment on five interim rules to establish uniform standards for the electronic delivery of notices to consumers, namely: Regulations B (Equal Credit Opportunity); E (Electronic Fund Transfers); M (Consumer Leasing); Z (Truth in Lending); and DD (Truth in Savings). Also, on May 16, the Federal Reserve requested comment on how the Board's regulations may be adapted to online banking and lending.

The FDIC has also taken a number of steps to promote technology and innovation in financial services and was one of the first bank regulators to provide guidance to the industry on issues related to technology and payment systems. The FDIC has issued more than 20 guidance documents pertaining to topics such as Internet banking and payments. Furthermore, to ensure that the opportunities and risks associated with technology are monitored and responded to a Bank Technology Group was created within the Chairman's Office. An important example of steps that the FDIC has taken to promote the safe use of information technology in banking is the Security Standards for Customer Information issued in March 2001. The FDIC worked with the other Federal financial institution regulators to develop the standards, as required by Section 501 (b) of the Gramm–Leach–Bliley Act. The standards were crafted to be technology-neutral so as not to inhibit innovation. The FDIC continues to work closely with the industry and with other Federal and State regulators to ensure that safety and soundness is preserved in this increasingly networked environment.

As a public network, the Internet is inherently less secure than the traditional payment networks that preceded it. As financial institutions connect to the Internet and permit payments to be initiated over this channel, additional security measures are necessary. The FDIC is committed to monitoring new developments in technology and related risks to the banking and payment systems. Through supervisory processes, guidance, and education, we will continue to emphasize to the industry the importance of security and effective controls.

Q.14.a. What forms, if any, of bank surveillance are done through automated technology and/or the Internet?

A.14.a. All insured depository institutions are required to file consolidated Reports of Condition and Income (Call Reports) on a quarterly basis in an electronic format. The information is exten-

sively used by the bank regulatory agencies in their daily offsite bank monitoring activities. Call Report data also is used by the public, the Congress, State banking authorities, researchers, bank rating agencies, and the academic community. The FDIC is fully responsible for maintaining an accurate and up-to-date Call Report database readily available to all users through the Internet. The FDIC uses the data collected in the Call Reports most extensively for supervisory/surveillance purposes in an effort to detect emerging risks. The FDIC has several surveillance programs and early warning models it uses to achieve these objectives.

The offsite systems are designed to support FDIC's examination and risk assessment functions by identifying potential downgrades of CAMELS "1" and "2" rated institutions, flagging institutions with high-risk profiles, or calculating capital requirements for institutions projected to fail in the short term. The three primary offsite models used by the FDIC Division of Supervision (DOS) are Statistical CAMELS Offsite Rating system (SCOR), Growth Monitoring System (GMS), and Real Estate Stress Test (REST).

Statistical CAMELS Offsite Rating (SCOR)

In the mid-1990's, the FDIC developed an offsite rating tool called SCOR to more effectively and efficiently monitor risk to the banking and thrift system. SCOR uses Call Report data to identify institutions likely to receive a rating downgrade at their next examination. The system uses sophisticated statistical techniques to estimate the relationship between Call Report/Thrift Financial Report data and examination results. SCOR is available to FDIC supervisory personnel on the FDICnet and to other regulators, including State banking authorities, through the Extranet.

Growth Monitoring System (GMS)

GMS is an offsite rating tool that effectively and efficiently identifies institutions that have grown rapidly and/or have a funding structure highly dependent on noncore funding sources. GMS is a prospective model that focuses on the relationship between loan growth and noncore funding sources. Using statistical techniques, GMS analyzes financial ratios and changes in dollar balances to identify banks that have experienced rapid growth. Plans are to provide the results of the GMS to FDIC personnel and other regulators through automated technology being developed in the Virtual Supervisory Information On the Net (ViSION) project.

The purpose of ViSION is to provide an integrated, state-of-the-art technology solution to support the Division of Supervision. ViSION will create a system that will enable DOS staff to perform their work within an integrated system. When completed, staff will have the ability to review, process, and distribute examination reports, offsite analysis reports, applications, risk-related premium assessments, and correspondence within the system. Such a system envisions data being manually or electronically entered into the new system only once and electronically manipulated thereafter.

Real Estate Stress Test (REST)

REST identifies financial institutions likely to be vulnerable to a real estate crisis similar to what occurred in New England in the early 1990's. REST attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to that

of New England. Plans are to provide the results of REST to FDIC personnel and other regulators through automated technology being developed in the ViSION project.

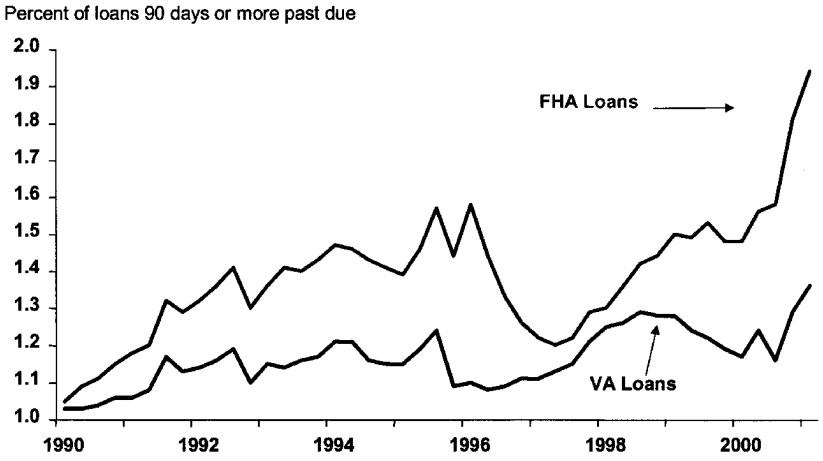
Other offsite tools used by the FDIC include the Uniform Bank Performance Report (UBPR) and the Large Insured Depository Institution Program (LIDI). The UBPR is a report available to the public on the Internet that uses the Call Report data to provide information (ratios, percentages, and dollar amounts) on individual bank performance. Each UBPR also includes data for the bank's peer group averages and percentile rankings for most ratios. The comparative and trend data contained in these reports complement the offsite analysis process performed prior to examinations.

The LIDI is a Division of Supervision quarterly review of the industry's largest banks and thrifts. Its purpose is to assist staff by culling company-specific and market information on the largest financial entities. The information is detailed on the LIDI web page and facilitates continuous offsite monitoring of the largest insured financial entities. A central component of the site is timely analytical reports prepared by case managers of the Division of Supervision that summarize current developments and risks facing an institution.

Q.14.b. Does your agency have any plans to augment the role of automated technology in gathering and disseminating information?

A.14.b. The FDIC does plan to use automated technology to gather information about financial institutions. A future module in ViSION known as Risk Management, will "crawl" other web sites (newspapers, SEC filings, First Call, etc.) looking for information on a regulated entity and join this information with existing Call Report, UBPR, SCOR, GMS, and systems from other regulators to identify increasing risk in a bank. As far as other gathering and disseminating of information, FDICconnect is being designed to be the business to Government (B2G) connection where banks and other FDIC business partners can submit information such as applications, bills, make payments, ask questions, and receive information such as assessment bills, exam reports, approved applications, Financial Institution Letters. FDICconnect recently started a pilot with 86 banks and can conduct a very small number of transactions. FDICconnect also was initiated to meet an Executive Order to have each agency provide an electronic means to transact business with Government agencies by 2002 or 2003.

Mortgage loan delinquencies appear to be rising fast



Source: Mortgage Bankers Association

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONNA TANOUE
CHAIRMAN

June 21, 2001

Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to testify on the condition of the banking and thrift industries. Pursuant to your question posed yesterday on financial literacy, I am pleased to advise you that the Federal Deposit Insurance Corporation is initiating a significant new program to promote and facilitate financial education.

Enclosed is a brochure and a press release describing that program, which we call *Money Smart*. The program is a comprehensive curriculum to help adults outside the financial mainstream develop positive deposit and credit relationships with commercial banks and thrifts. The program explains basic financial instruments and products. Its ten modules cover such topics as an introduction to bank products and services, choosing and maintaining a checking account, budgeting and saving, understanding credit history, selecting and using credit cards, understanding other forms of consumer credit, and an introduction to home ownership.

We have joined forces with the Department of Labor to promote financial education and to make *Money Smart* available at employment centers, called One Stop Centers, across the country. The formal rollout will occur in the next few weeks. To promote and facilitate the use of *Money Smart*, the FDIC and the Department of Labor will conduct orientation sessions for bankers and One Stop Centers throughout the country. In addition, the FDIC will provide a copy of the *Money Smart* curriculum – including an instructor's manual and participant handouts – free of charge to any financial institution wishing to offer the program in its community.

Again, I appreciate your interest in our efforts on financial literacy. If you have any further questions, Alice C. Goodman, Director of our Office of Legislative Affairs, can be reached at (202) 898-8730.

Sincerely,

Donna Tanoue

Donna Tanoue
Chairman

Enclosures

Joint Release

Federal Deposit Insurance Corporation
Department of Labor

FDIC, DEPARTMENT OF LABOR INTRODUCE MONEY SMART PROGRAM

FOR IMMEDIATE RELEASE
PR-6-2001 (1-19-2001)

Media Contact:
Phil Battey (202) 898-6993

The Federal Deposit Insurance Corporation (FDIC) and the Department of Labor today announced a joint initiative, called *Money Smart* , which offers basic financial education for the first time to people taking part in Welfare-to-Work and Workforce Investment Act programs nationwide.

Beginning in the second quarter of 2001, *Money Smart* will be available through a national network of more than 800 One Stop Centers, which provide employment and training services for persons seeking new jobs or entering the workforce, including individuals participating in Welfare-to-Work programs. The program also gives financial institutions a new tool to use in serving their communities.

Developed by the FDIC, *Money Smart* is designed to help adults currently outside the financial mainstream build financial knowledge and develop positive relationships with financial institutions.

"This is an important initiative, and the FDIC is delighted to partner with the Department of Labor to address the needs of individuals in Welfare-to-Work and Workforce Investment Act programs and their families," said FDIC Chairman Donna Tanoue.

"Financial education is important to prepare workers for a secure future," said Secretary of Labor Alexis M. Herman. "*Money Smart* will expand the Labor Department's efforts to help American workers and their families improve their financial fitness."

Money Smart consists of 10 training modules covering basic financial education topics. The modules are being piloted in the District of Columbia's Naylor Road One Stop Center and with the District of Columbia's Office of Banking and Financial Institutions and the North Capitol Neighborhood Development Corporation.

Said one student from the class at the Naylor Road One Stop Center after opening her first checking account at a local bank: "I got a lot out of this program and now understand that I am more than a customer. I can ask questions. I feel more confident and comfortable at the bank." The *Money Smart* program will be ready for distribution to One Stop Centers and financial institutions in the second quarter of 2001. The program's 10 modules are:

Bank On It - an introduction to bank services
Borrowing Basics - an introduction to understanding credit
Check It Out - how to open and maintain a checking account
Pay Yourself First - the importance, benefits, and methods for saving money
Money Matters - preparing a personal budget
Keep It Safe - consumer rights and responsibilities
To Your Credit - the importance of credit history
Charge It Right - the costs and benefits of using a credit card
Loan To Own - the costs and benefits of consumer loans
Your Own Home - an introduction to home loans

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Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 10,101 banks and savings

associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed.

FDIC press releases and other information are available on the Internet via the World Wide Web at www.fdic.gov and may also be obtained through the FDIC's Public Information Center (800-276-6003 or 202-416-6940).

Last Updated 1/19/2001 communications@fdic.gov

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM ELLEN SEIDMAN

Q.1. What do you think is the single greatest potential problem facing the United States financial system today?

A.1. Both the nature and magnitude of risks facing the thrift industry change over time. At this point, a shift in funding sources away from low-cost retail deposits over the past 5 to 10 years is currently the most noticeable risk for the thrift industry. Asset quality concerns remain subdued. However, we continue to closely monitor asset quality trends, which are very sensitive to changes in the U.S. economy.

Retaining low-cost stable deposits has become a challenge for the majority of financial institutions. Competition continues unabated. Disintermediation has forced financial institutions to seek alternative funding sources. Wholesale borrowings have become an increasing important source of funding for some institutions in recent years. We are continuously monitoring and assessing risks associated with this trend.

As illustrated in the table below, as a percentage of all fundings, small balance deposits have declined from 67 percent in 1995 to 49 percent in 2000. This decline has been replaced by increases in large balance deposits and FHLB borrowings.

Thrift Funding Sources

(Dollars in Billions)

	1995		2000	
	($)	(%)	($)	(%)
Total Deposits	535.0	76.5	529.4	63.7
<$100k	468.8	67.0	409.5	49.3
>$100k	66.2	9.5	119.9	14.4
FHLB Advances	85.1	12.2	218.3	26.3
Other Borrowings	79.3	11.3	83.0	10.0
Total	699.4	100.0	830.7	100.0

There are several risks associated with the trend in funding sources. The most serious potential risk is the liquidity concerns that would result from any flight to quality crisis. A significant negative financial or economic event could cause investors to move money into safe instruments, such as U.S. Treasuries, and to discontinue lending arrangements to smaller businesses. Small and medium size thrifts could be impacted by this flight to quality regardless of the strength of the operations, resulting in liquidity, funding, and operational problems for these institutions. This type of risk is greatest among institutions that engage in secondary market activities and are dependent upon private funding sources for the continued sale of loans held for sale. Over the past 5 years, several thrifts and holding companies have experienced disruptions in this regard.

In each case, the institutions were engaging in higher risk lending such as auto, subprime, or high loan-to-value mortgages. In

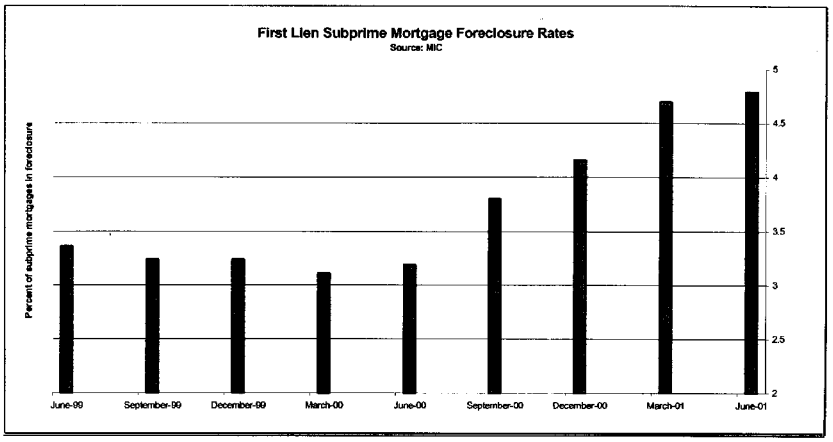
each case, the thrift successfully managed the difficulties. We consistently assess the liquidity risk and contingency plans for thrifts and holding companies engaged in this type of activity.

The other funding risk faced by thrifts is the higher cost associated with borrowed funds and noncore deposits. Thrifts with increased reliance on these funding sources must consistently pay higher rates and are prone to rate spikes due to increased competition or a rise in overall interest rates. Thrifts can experience a compression in the interest margin, and there is the risk that thrift management will shift to higher risk activities to offset the decline in interest spread.

Institutions that rely on borrowings sometimes opt to use complex instruments that require sophisticated analysis to evaluate the risk thoroughly. We have issued several bulletins to the industry warning of the risk associated with these complex instruments and setting standards for the evaluation of the risks. In addition, we have recently enhanced our interest rate risk model to account for impact of complex debt instruments on a thrift's interest rate risk profile.

Q.2. While many analysts predict a recovery from the current economic slowdown in the second half of the year, there is still a chance that the downturn could be worse than expected. If the economy were to perform below expectations, what consequences would that have for the safety and the soundness of the banking system?

A.2. Despite the recent weakness in economic activity, the overall financial condition and performance of the thrift industry is strong. The level of credit quality in the thrift industry has remained high—in part due to the industry's concentration in residential mortgage lending and its limited exposure to commercial lending. In general, while the overall quality of conventional residential mortgage loan portfolios has remained high, the sharpest deterioration in credit quality has occurred in the commercial, industrial, and nontraditional mortgage sectors of the market. For instance, the chart below shows the percentage of subprime mortgages, tracked by the Mortgage Information Corporation that were in foreclosure over the last 8 quarters. The data includes all grades of first lien subprime mortgages. Since June 2000, the percentage of the 2.3 million subprime mortgages in foreclosure has increased by 47.3 percent, from 3.19 percent to 4.70 percent. Not shown in the chart is a similar deterioration in the percentage of these mortgages that are 30 days or more past due, which, as of March 2001, stood at 11.59 percent. The only positive news is that although the June quarter illustrates further deterioration in the subprime portfolio, the rate of increase in delinquencies is not as large as it has been over the last 3 quarters.



The thrift industry's loan portfolio is heavily dependent on the financial health of consumers since over 50 percent of thrift assets are held in direct loans to individuals residential mortgages (48 percent of assets) and consumer loans (6 percent). We continue to monitor the economic factors that impact the performance of consumer debt. The number of personal bankruptcies continues to increase, and the debt burden shouldered by consumers is near an all-time high. In response, we closely monitor the risk-management practices of thrifts, especially ones that have higher levels of unsecured consumer lending or engage in high loan to value mortgage lending. However, the impact of higher bankruptcies on most thrifts will be muted due to the collateral coverage of real estate loans. Although the level of subprime lending is not pervasive, it is one of the fastest growing business segments in the banking and thrift industries. We continue to closely monitor thrifts with significant levels of subprime assets and note that some institutions have begun to retrench their activities in this area. While subprime lending can be profitable, some insured institutions have entered this business line without the appropriate risk-management practices, reserves, or capital support, and a disproportionate number of problem situations and failures have resulted.

The thrift industry's overall financial condition at this point in the economic cycle is quite strong, and its level of capital and reserves is more that adequate to absorb higher levels of loans that might be expected should the economy perform below expectations for some period.

Q.3. After 5 very good years, the rate of nonperforming commercial, industrial, and personal loans increased by 26.6 percent in 2000. Can you please tell me what stress, if any, this places on the banking system, and whether or not you expect a similar rate of increase for this current year?

A.3. Troubled assets, which include seriously delinquent (noncurrent) loans and repossessed assets, climbed to 0.62 percent of total savings and loan assets as of March 31, 2001, from 0.60 percent at year-end 2000. Troubled assets reached a record low of 0.58 percent of assets in the third quarter of 2000. As of the end of March 2001,

noncurrent loan rates (loans over 90 days past due or in nonaccrual status) increased to 0.53 percent of assets from the year-end 2000 level of 0.50 percent. Noncurrent consumer loans stood at 0.83 percent of consumer loans as of March 31, 2001, up from 0.81 percent at year-end. Noncurrent commercial loans jumped to 1.64 percent of all commercial loans at the end of March from 1.52 percent at the end of 2000.

While the recent increase in nonperforming consumer and commercial loans has put downward pressure on earnings, the current level of nonperforming loans in the thrift industry is still relatively low. To date, nonperforming loans have not placed an undue level of stress on the thrift industry. Indeed, the earnings of the thrift industry have remained strong by historical standards and the industry as a whole is adequately reserved and well capitalized. Moreover, in contrast to noncurrent loans, delinquent loans (those 30 to 89 days past due) actually declined for most types of loans during of the first quarter of 2001. While the recent decrease in delinquent loans 30 to 89 days past due is encouraging, our ability to foresee turning points in the credit cycle is limited, and continued weakness in economic activity is likely to cause credit quality to erode.

Q.4. Though the delinquency rates for credit cards and consumer loans are well below the high levels experienced during the last economic downturn, they have risen back to levels comparable to 1993. What do you think the effects of this increase in delinquency rates will be, with regard to both consumers and the financial institutions that you regulate?

A.4. The increase in delinquency rates on consumer loans in general and credit cards loans in particular is likely to result in some tightening of credit standards, making it more difficult and costly for marginal borrowers to obtain credit. In addition, financial institutions are increasingly imposing automatic increases in credit card lending rates when payments are past due.

As noted above, noncurrent consumer loans stood at 0.83 percent of all consumer loans as of March 31, 2001, up 0.81 percent at the end of last year. The consumer loan noncurrent rate is well below the recent peak of 1.32 percent reached in 1991. The recent increase in consumer loan delinquencies has not had a significantly adverse effect on the thrift industry in part because the noncurrent rate is still relatively low. Moreover, only 6.3 percent of the industry's assets are in the form of consumer loans. Nevertheless, the rise in delinquencies is likely to prompt some thrift institutions to improve risk-management practices, boost reserves, tighten lending standards and increase lending rates and late fees.

The effect of higher delinquency rates on the availability of credit is uncertain. We have seen a continued increase in personal bankruptcies over recent periods; which has not been accompanied by reduced credit availability. One factor that may account for this effect is the use of improved tools for risk adjusted loan pricing, such as credit scoring and automated underwriting systems. Therefore, financial institutions have continued to lend to consumers with various levels of credit risk.

Q.5. According to a Mortgage Bankers Association survey, 10 percent of mortgages backed by the Federal Housing Administration are now 30 or more days delinquent. An article in the June 12 *New York Times* stated, "The mortgage problems underscore one main reason many policymakers and economists are so concerned about whether the United States will enter a recession this year." Can you please tell the Committee your thoughts and concerns about the high level of mortgage delinquency?

A.5. The vast majority of mortgages held by thrifts are non-FHA insured, single-family mortgages. FHA mortgages are typically made to low- and moderate-income families and many first-time homebuyers. Although thrifts originate FHA mortgage loans, they typically sell them to investors in the secondary market.

The delinquency rate on FHA mortgages is considerably higher than the delinquency rate on non-FHA, single-family mortgages. The delinquency rate on single-family mortgages held by thrifts was only 1.67 percent as of March 31, 2001, slightly above the 10 year low of 1.66 percent in 1999.

The difference in the performance of the FHA mortgages relative to the mortgages held by insured depositories has widened considerably. According to data from the Mortgage Information Corporation, the difference in performance (as measured by 30 days past due) was negligible in the early 1990's. As of the first quarter of 2001, FHA loans had a delinquency rate 5 times higher than that of conventional mortgages held by depository institutions.

The overall credit risk of the FHA mortgages has been affected by increases in ARM lending, and by higher effective loan-to-value lending programs. It has also been affected by the ability of private sector lenders to offer more creditworthy borrowers better terms than before, thus lowering the credit quality of the pool of FHA borrowers, as those able to get better terms elsewhere forego FHA loans. While the rise in delinquencies of FHA mortgages is a matter of concern, the thrift industry exposure to that sector of the mortgage market is limited.

Q.6. I have heard from varying persons that the banking industry has significant exposure in the telecommunications sector. What is the direct and indirect exposure of banks to the fallout in the telecommunications sector?

A.6. Fitch Investors Service reports that telecommunications defaults for the first half of the year reached $15.5 billion or 1.4 percent for the sector. Although many telecom companies continue to struggle, there is minimal direct exposure to the thrift industry. The troubled telecom companies will mainly affect U.S. commercial banks. Mostly impacted by this fallout are banks that have underwritten a company's bond offering or the larger commercial banks that have private equity investments in these companies.

Nevertheless, the thrift industry could experience some indirect exposure through a rippling effect. If the financial stability of these companies remains uncertain or worse, it may adversely impact the surrounding area in which the business operates. The most material indirect impact for thrifts would be a decline in home values. However, most of the markets that have a concentration of telecom companies also have relatively diversified economies.

There is also some limited exposure if a telecommunication company is providing services to a thrift. The inability of a troubled telecommunication company to support the institution's system may cause continuity of service problems and create a reputation risk for the institution. Therefore, the quality of a thrift's contingency plan is key to its success in overcoming any failure. In addition to having a solid contingency plan, management should fully understand each vendor's capabilities, financial viability, and the extent of repercussions if disruption of service occurs. Further, management must understand the importance of utilizing a company with a sound infrastructure. These steps should help mitigate any potential failures within the telecom sector.

Q.7. According to the OCC, consumers are more highly leveraged now than at any measured point in history. Not only are debt service payments at historic highs, but the increase in debt has been financed through instruments other than mortgages. Credit card debt is rising very rapidly; the *Chicago Sun-Times* reported that the average credit card debt per household is $8,123 and has grown threefold over the past decade. Debt service payments constitute over 14 percent of disposable income. What do you believe the effects of this high level of personal debt will be with regard to consumers, the banking sector, and the economy as a whole? If the economic downturn is worse than expected, what would be the effect of having so many people so highly leveraged?

A.7. Consumer spending constitutes two thirds of our economy. Consumer debt finances much of this spending. High levels of consumer debt provides an immediate benefit to the consumer (increased consumption), to the banking sector (as provider of financial services), and promotes current economic growth. That is not to say, though, that high levels of household debt are not without costs and risks.

The cost of borrowing against future income to finance current consumption (as opposed to investment) is that it will eventually reduce future consumption. The risk of leverage is that income might become insufficient to service the debt, causing delinquencies and eventually, bankruptcies, creating costs not only for the consumer, but also for the banking sector and the economy as whole.

Three recent developments may affect consumers' ability to service their high level of debt. The first is the Federal Reserve's recent repeated cuts in interest rates. This will tend to lower consumers' servicing costs, as, for example, when they refinance their mortgages. The second is the recently enacted tax cuts, which will leave consumers with more after-tax income to service their debt. The third countervailing development is the current economic slowdown, which will tend to reduce income, thus making debt servicing more difficult for many.

If the economic downturn is sharper and more prolonged than expected, we would expect that payment delinquencies and bankruptcies to rise, for the banking sector to face increasing loan and revenue losses, and an economic recovery to take longer, as consumer credit would become less available. For an assessment of the specific impact on the thrift industry, see our answers to question 2 and 4.

Q.8. Remittances are a large and growing economic reality that affect millions of people both in America and south of the border. It has recently come to my attention that this industry, which recent estimates have put at more than $20 billion annually, often charges high fees and that many of the leading companies have been challenged in court for having hidden fees. In a *New York Times* article it is stated that "the fees have run from about 10 percent to 25 percent or more." Do you believe that there are problems in the manner in which the bulk of remittances are made today? What steps has your agency taken to analyze possible solutions including fostering or creating alternative transfer mechanisms?

A.8. The cross-border transfer of money between Mexicans who work in the United States and family members in Mexico is a financial service that is largely provided outside the insured depository banking system. These "remittances" represent an activity valued by ethnic market segments that the traditional banking sector has not fully recognized as a worthwhile business opportunity. OTS has been active in encouraging thrifts to understand the changing demographics of their communities and to explore the needs of emerging markets. We support institutions that develop creative products to respond to underserved communities and that implement these business initiatives responsibly and in a strategically and financially sound manner.

Q.9. Former Treasury Secretary Summers has stated that "all high school students should receive a financial education," and that "though personal financial education must begin in the home, it must continue in the schools." Can you please comment on the state of financial literacy and education among Americans, including any deficiency in this area that should be addressed? If you see any deficiencies, what do you believe can and should be done with regard to these deficiencies in both a broad sense and with regard to your agency? At the hearing, I asked for information regarding any initiatives that your agency has taken, including the Money Smart program. Could you please provide this information in your submission to the Record?

A.9. Anecdotal evidence suggests and is now confirmed by a recent study by the Fannie Mae Foundation on financial literacy education in the United States (see attached) that an increasing number of public and private sector entities are taking a more active role in helping to improve the "financial literacy" of Americans. From our vantage point, we have noticed a significant increase in the involvement of insured depository institutions in financial literacy initiatives through in school banking programs, homebuyer education programs, and other financial education initiatives targeted at youth, the elderly, lower income families, new immigrants, Native Americas and others.

Many Americans lack basic skills in the management of their personal finances. According to the JumpStart Coalition, many young adults are unable to balance a checkbook and do not understand financial principles involved with earning, spending, saving and investment. Many young adults establish poor financial management habits, and accumulate high consumer debt. Moreover, the population of new immigrants in this country is growing. This

poses additional challenges given the language and cultural barriers that often exist, as well as a lack of understanding distrust of the banking system. The rise in elder financial abuse, bankruptcies and predatory lending problems is in part attributed to poor financial decisions and the ability of others to prey on those who are financially vulnerable or unsophisticated.

Deficiencies that we have observed with respect to financial literacy programs are the lack of resources (financial or human) to sustain programs or to expand their reach to a broader audience. Moreover, there is not a good system nationally for sharing best practices and program curriculum—be they employer based, community based, or in school programs.

Employer based educational programs and school based programs are excellent ways to reach very large populations of people. However, this type of training is generally not part of the school curriculum nor is it offered is most workplace settings. We would recommend urging more employers to offer personal finance courses dealing with wealth creation, avoiding financial problems or pitfalls, money management, savings and investment strategies and retirement planning. Probably the best time and place for people to learn the importance of money management and wealth creation is in schools. In school banking programs have had success in certain communities, as have volunteer in school training programs such as Junior Achievement and the JumpStart Coalition. Promoting and supporting in school financial literacy programs is equally important.

In underserved populations, community and faith-based organizations play a major role in meeting the need of individuals in these communities. These organizations are often able to provide more than financial education. Support programs aimed at life planning issues are often needed by many individuals in addition to practical money skills. However, the resources of these organizations are usually very limited and must be used to address a variety of community development or social service needs. Thus, these entities are well positioned to reach a large segment of the market but are not well equipped with the resources.

In addition to employer and school based programs, and programs offered through community and faith-base organizations, financial education for older Americans should be a priority. Financial management can help older adults avoid scams and financial abuse, budget, plan, and manage daily money matters. Education on alternative sources for healthcare, homecare, estate planning and more complex financial products, such as reverse equity products if they are homeowners, would benefit older Americans.

OTS established a Community Service Program in 1998. OTS employees participate as volunteer tutors in established, legitimate financial education programs in local schools and in the community as part of the agency's Community Service Program. Examples of financial education programs that agency staff has participated in over the past 3 years include Junior Achievement, American Bankers Association's National Teach Children to Save Day, Seahawks Academy Financial Literacy Training, Central City Lutheran Mission Financial Literacy Training, Operation Hope's Banking of the

Future Day and the Neighborhood Housing Services of New York Financial Life Skills Course.

OTS participates in the Department of Treasury Partnership in Education program, cosponsored with the National Academy Foundation (NAF), by hiring summer interns from local high schools. The National Academy Foundation is a nonprofit educational organization that works to improve the quality of education for students and access to career opportunities by supporting partnerships between business and public schools. OTS employees have also served as board members of the National Academy Foundation Advisory Board.

OTS staff is also active with the Women in Housing & Finance Foundation's Personal Finance Committee. The Personal Finance Committee, co-chaired by an OTS staff member, provides an opportunity for WHF members to offer volunteer-based financial education to primarily low-income women and their families in the Washington, DC area through partnerships with local community organizations such as the Latin American Youth Center, Ellen Wilson Community Development Corporation, Girl Scouts, Jubilee Jobs, Cornerstone Group, For Love of Children, Community Family Life Services, Hopkins House. Most recently, we helped organize a financial education session on credit and money management that was offered at the Women's Wealth Building Symposium, a one day conference sponsored by Fannie Mae and the McAuley Institute.

OTS has produced several financial literacy and consumer education publications. Primarily through the *Community Liaison*, a quarterly newsletter edited and produced by the Community Affairs staff, OTS works to inform and educate the industry about financial literacy issues and to highlight programs that the industry is involved in. These consumer education materials are available on OTS's web site, *www.ots.treas.gov*, and include:

Individual Development Accounts (IDA's): Strategy for Asset Accumulation, November 1998, Office of Thrift Supervision.

"Looking for the Best Mortgage," an interagency brochure with tips on shopping for a mortgage, 1999.

"Working with America's Youth," *Community Liaison,* June 1999, Volume No. 99–02. An article discussing financial literacy programs in which some OTS regulated institutions are involved.

"How to Pickle a Coin of Fun Money in Cyberspace," *Community Liaison,* June 2000, Volume No. 2000–01. Discussion of financial literacy web sites for kids.

"Domestic Financial Abuse of the Elderly," *Community Liaison,* September 2000, Volume No. 2000–02. Article about what banks can do to combat elder financial abuse.

"The Path to Homeownership," *Community Liaison,* January 2000, Volume No. 00–01. Article discusses several programs that promote homeownership through vehicles such as IDA's and homebuyer education.

"Washington Mutual Opens the Door to Affordable Homeownership in Orlando," *Community Liaison,* November 1999, Volume No. 99–03. This article highlights WAMU's homeownership center that is used to educate consumers on the home buying process.

"Hope is Spreading," *Community Liaison,* June 2000, Volume No. 2000–01. This article profiles Operation Hope's financial literacy program.

Q.10. Another disparity involved rules on loans to one borrower. National banks are generally allowed to lend no more than 15 percent of their capital on an unsecured basis to a single borrower. Many States have higher limits for the banks they charter. On June 8, 2001, the OCC announced a new pilot program allowing national banks with the highest supervisory rating to lend up to the State limit—but no more than 25 percent of capital to single borrowers under certain circumstances. Please describe the competitive regulatory disparity that led the OCC implement this pilot program.

A.10. This question can more appropriately be answered by the OCC. Therefore, we defer to the OCC.

Q.11. In a speech before the American Bankers Association, Federal Reserve Board of Governors Member Edward Gramlich said that, "Higher rates of national savings are among the unsung heroes of the good U.S. economic performance in the late 1990's." However, the most recent data from the White House shows a substantial decline in personal savings, from over 5 percent in 1996 to minus 0.9 percent today. Do you think that this is a serious problem, and if so, what can we do to ameliorate it? What position does this place Americans in if the economic slowdown worsens? Finally, what are the effects of this decline with respect to national investment levels and GDP growth?

A.11. This answer can more appropriately be answered by the Federal Reserve Board. Therefore, we defer to the Federal Reserve Board.

Q.12. What steps has the Federal Reserve taken to promote technology and innovation in the payments systems, and what steps should it take? As well, are you concerned that the initiation of payments on the Internet, or through another electronic means, could affect the safe operation of payments systems?

A.12. This answer can more appropriately be answered by the Federal Reserve Board. Therefore, we defer to the Federal Reserve Board.

Q.13.a. What forms, if any, of bank surveillance are done through automated technology and/or the Internet?

A.13.a. OTS employs automated technology and the Internet to conduct surveillance and monitoring activities. OTS developed several automated systems to monitor the financial condition and performance thrift institutions. These systems include the Risk Assessment Model (RAM), the Thrift Monitoring System (TMS), and the OTS Net Portfolio Value Model (NPV Model).

The RAM is used to identify thrifts exhibiting characteristics that may lead to a CAMELS rating downgrade. RAM uses a series of financial ratios to generate a "RAM score," which ranks the likelihood of a ratings downgrade.

The TMS is used to identify particular areas of thrift's operations that may warrant special attention and analyses. TMS uses a series of financial ratios to measure adverse trends in earnings, asset quality, liquidity, and capital. TMS also incorporates Internet links

to facilitate access to publicly available information. TMS includes direct links to the home websites of individual thrift institutions, as well as links to sites with stock prices, credit ratings, Securities and Exchange Commission filings, and news items. (All OTS analysts and examiners have Internet access from their personal computers in addition to that provided through TMS.)

The NPV Model is used to monitor the interest rate risk exposure of individual savings associations. The NPV Model employs scenario analysis to "stress test" the vulnerability of thrifts to different interest rate enviromnents. In addition to providing a means of identifying thrifts with high levels of interest rate risk exposure, the NPV Model allows OTS to distinguish between the speculative and nonspeculative use of derivatives products.

OTS has an automated central filing system, the Electronic Continuing Exam File (ECEF), which provides OTS staff with access to essential information on individual thrift institutions. The ECEF contains financial data, correspondence, examination reports, enforcement actions, news items, monitoring comments and other relevant information. The ECEF facilitates examination planning and reduces time gathering information prior to an onsite examination.

Q.13.b. Does your agency have plans to augment the role of automated technology in gathering and disseminating information?

A.13.b. Yes, we are continually exploring ways to take advantage of new technology to further the mission of OTS, to improve our efficiency and effectiveness, and to minimize the burden on the institutions we regulate.

Since 1993, OTS has provided the thrift industry with electronic filing software to facilitate data entry, editing, and transmission of regulatory financial reports. The software includes validation edits, so the thrifts can check reports for errors prior to transmission to OTS. The software saves considerable time for both OTS and the industry and helps to ensure greater data accuracy. We have enhanced the software to provide the industry with the capability of communicating electronically with OTS, a significant improvement in expediting the data edit/validation process. We are currently exploring the use of web-based technology to achieve greater efficiencies in data collection and dissemination.

We have approved an initiative to stand up an Extranet to facilitate the secure exchange of information with the institutions we regulate and other regulatory agencies. Thrifts would use the Extranet to file financial data with OTS, to retrieve information for their institution (that is, interest rate risk reports, performance data, examination reports), and to submit corporate applications (that is branch office, change of address) electronically to OTS. The Extranet would also serve as the secure, electronic distribution point for data we currently share with the other financial regulatory agencies via tapes, CDs, etc.

We are continually adding to the information available through our public website to enhance the flow of information to thrift institutions and other interested parties. Current OTS web content includes: press releases, proposed regulations, comments on proposed regulations, OTS contacts, institution directory, applications received, CRA public evaluations, OTS handbooks, Thrift Financial Report forms and instructions, technical bulletins, and more.

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Personal Finance and the Rush to Competence: Financial Literacy Education in the U.S.

Lois A. Vitt, Project Director
Carol Anderson, Jamie Kent, Deanna M. Lyter, Jurg K. Siegenthaler, Jeremy Ward

EXECUTIVE SUMMARY

Since the mid-1990s, an increasing number of public and private sector organizations have begun helping Americans enhance their financial preparedness for life events, most notably retirement. National campaigns that call on Americans to increase personal savings, invest in pension programs, prepare the transition from welfare to work, and obtain computer literacy skills, as well as the growing media interest in personal finance, have all contributed to a "money aware" public. Most people are getting the idea that they must take more responsibility for their present and future financial well being. This report is about the educational resources that exist to help them.

STUDY PURPOSE AND METHODS

The Fannie Mae Foundation commissioned this study of the current state of financial literacy education to inform its philanthropic efforts. The research was designed to ascertain major trends in financial literacy education, to learn what challenges are being faced by program managers and educators, and to identify the strategies and practices in use that are particularly effective. We are pleased that the Foundation has chosen to share these findings broadly, and we hope that as a result many more organizations will become interested in sponsoring programs to help Americans achieve competence in personal finance.

The information contained in this study came from the following sources: (1) literature; (2) telephone, in-person and faxed interviews with program directors of a sample of 90 personal financial education programs; (3) site visits; (4) focus group or individual interviews with 78 participants who attended courses or seminars at the sites visited; and (5) interviews with industry leaders. The study is a process evaluation that employed benchmarking tools to learn the breadth and depth of financial education programs nationwide and to identify "effective strategies" of those that excel in one or more areas.

We used a stage model of organizational development derived from Ronald Manheimer's[1] planning phases of educational programs. We used a modified version of this model to examine the steps that organizations take as they plan, assess the need for, implement and evaluate financial education programs. Details of the study methods can be found in the full report.

BACKGROUND AND TRENDS

Financial literacy education is increasing in all United States sectors largely in response to public initiatives that call on Americans to save and invest for long-term financial independence. Concerns about the adequacy of Social Security, and shifts in responsibility from government to citizens and from employers to employees are drivers alerting individuals and families to bleak future prospects without an accumulation of adequate monetary resources for later life.

Campaigns to Save, Invest, and Learn

The American Savings Education Council (ASEC), a coalition of private and public sector institutions, was organized in July 1995 to raise public awareness about the need for increased personal savings. ASEC's goal is to make saving and planning a vital concern of Americans and in the economic interests of employers. The Jump$tart Coalition for Personal Financial Literacy also started in 1995 to promote personal finance in schools and improve the financial knowledge and abilities of children and young adults. In 1998, the Securities and Exchange Commission (SEC) launched the "Get the Facts on Saving and Investing Campaign" to further help Americans increase savings and invest wisely. In April 2000, Treasury Secretary Lawrence Summers formed the National Partners for Financial Empowerment (NPFE), a public-private partnership to promote the development of personal financial skills for all Americans.

Financial Literacy

Personal financial literacy is the ability to read, analyze, manage, and communicate about the personal financial conditions that affect material well-being. It includes the ability to discern financial choices, discuss money and financial issues without (or despite) discomfort, plan for the future, and respond competently to life events that affect everyday financial decisions, including events in the general economy.

In the "Financial Literacy 2000" project,[2] a national effort was made to assess public patterns of financial knowledge and consumer confidence. A sample of 1000 adults was surveyed for the purpose of providing financial literacy profiles of the U.S. population for a subsequent responsive educational campaign to improve financial literacy. Cutler and Devlin conceived of financial literacy as comprising both a knowledge and a confidence dimension. Devlin implied that financial literacy is a function of the financial information to which one has access:[3]

> *"...the key to getting people to improve their financial behavior is to first give them the information which they can then use to confidently engage in the desired behavior."*

Financial information, however, is now widely available through financial services providers, educational resources, and an increased focus on money and investing in books, articles, Internet sites and television. As SEC Chairman, Arthur Levitt observes:

> *"Today there is a glut of information. But the irony is: Do people have the foundation in the financial basics that will allow them to use that information?"*

Rep. Harris Fawell (R-Ill.), author of the Savings Are Vital to Everyone's Retirement Act of 1997 (SAVER Act), warns that America faces *"a ticking demographic time bomb that requires increased retirement savings."*[4] Educating the public, Fawell urges, is the first step in defusing this time bomb.

Financial Literacy Education

General education determines occupation and income, which in turn, influences place of residence, social contacts, consumer choices, and activities. *Financial literacy education* shapes the life course in other, extended ways by enhancing access to investment income, asset accumulation and asset protection. When education about personal finance reflects socio-cultural sensitivity, moreover, the confidence dimension that Cutler and Devlin conceptualized as a requirement for achieving financial literacy is far more likely to be realized.

Confidence in one's ability to do a thing successfully increases the likelihood of undertaking it and the probability of success. In the personal finance classroom, seminar or counseling program, the following factors build or enhance a participant's confidence:

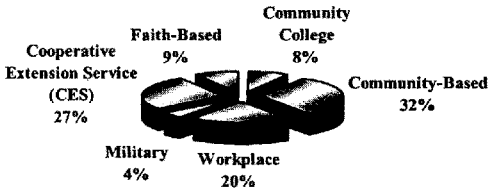
- The opportunity to undertake a specific action that challenges one's sense of self-sufficiency *without* overwhelming it;
- The presence of supportive and reassuring others; and
- The experience of succeeding at something, with confirming feedback from others.

STUDY FINDINGS

Characteristics of Organizations that Sponsor Financial Education

The 90 programs in our sample are remarkably diverse. They include: (1) eighteen workplace financial education programs; (2) twenty-four Cooperative Extension Service (CES) programs; (3) four U.S. military programs—the U.S. Army, U.S. Air Force, the U.S. Marine Corps and the U.S. Navy; (4) eight faith-based programs; (5) seven community college programs; (6) twenty-nine community programs. In addition, we looked at over 150 Internet sites.

Financial Literacy Education Program Sectors



We surveyed workplace programs that target employees facing retirement. We reviewed programs now mandated by the U.S. military for all incoming enlisted personnel. Twelve programs in four categories of education providers specialize in helping women. Some community programs we investigated have been organized to help immigrant populations understand basic banking services, budgeting and the personal credit system in America. We talked to sponsors of programs that specialize in preparing renting populations to become future homeowners. Other community-based and faith-based programs use financial literacy training to

help participants find jobs, finish high school education, apply to college, or start small businesses.

Our interviews included programs that help participants from low-income African American, Latino, disabled, and new American populations. We spoke with young, first-time homebuyers and persons in transition through various life disruptions. We talked with grandmothers struggling to raise their children's children, and we learned about elderly populations in need of personal financial education that covers health care financing, sustainable homeownership and reverse mortgages, among other topics.

Our report includes six case studies of programs run by the organizations named below. These organizations employ educational and operating strategies that, we believe, optimize the effectiveness of their offerings for participants:

- Weyerhaeuser & Co.
- United Parcel Service
- Rutgers Cooperative Extension
- Mississippi Housing Initiative
- International Institute of Boston
- MidAmerica Leadership Foundation

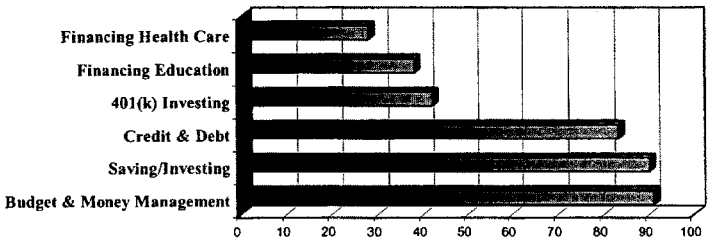
Selected Financial Education Program Characteristics

Reasons given by organizations for sponsoring a financial education program fall into one or more of four categories: (1) empower participants to take charge of their financial lives; (2) help participants get out of or avoid financial problems; (3) comply with regulations or requirements imposed by an outside authority; and (4) meet an organizational goal (e.g. military readiness, increased stewardship, increased employee satisfaction or productivity).

The following summarizes responses to selected questions. Full survey results are summarized in Chapter Two of the report and detailed by program sector in Chapters Four through Nine.

- Sixty-five percent of programs began in the 1990s. Seventy-five percent of these started in the late 1990s or 2000.
- Only 22 percent of program organizers conducted a formal needs assessment. The "need was obvious" was the reason given for not conducting an assessment of need.
- Sixty-two percent of programs operate under a written mission statement.
- Eighty-nine percent of educators use participant evaluation forms to assess program success. Sixty-four percent follow up to learn how participants are applying the skills and knowledge received.
- Length of program offerings range from one hour to 120 hours.
- Frequency of program delivery range from once a year to "ongoing," "continuous," or "unlimited."
- Thirty-four percent of programs incorporate computer technology to enhance or more broadly deliver financial education.

Least and Most Frequently Taught Financial Education Topics



Program Challenges

We asked program leaders and managers to identify challenges they faced during the design, implementation and operations stages of their programs. Challenges reported fell into one or more of three categories: (1) having inadequate resources to design, evaluate, revise, or expand programs; (2) inexperience in socio-cultural aspects of program design, marketing and evaluation; and (3) the need to attract or expand programs to reach many more participants than they presently do. What emerged from our analyses were solutions found by other program managers to many of these challenges. We chose our case studies to highlight programs that had succeeded in solving problems using strategies we think are particularly effective. Building on the literature and on our analyses of responses from program managers and participants, we offer what we believe constitute effective strategies and practices in personal financial education today.

Seven Dimensions of Effective Personal Financial Education Programs

1. Unambiguous Mission and Purpose

A mission shapes an organization's identity, gives it direction and serves as a unifying force. For successful financial literacy education programs, a clearly articulated mission defines the program's scope of operations, reflects its values, priorities, and goals. With a program mission *"to rebuild Chicago communities through the ministry of asset-building,"* MidAmerica Leadership Foundation was quick to recognize that if personal asset building is to occur, financial literacy education must become a priority. As a consequence of its commitment to financial education, MidAmerica not only created value for program participants but also significantly increased its understanding of both the people and the communities served by the organization.

2. Targeted Outreach

Organizations using creative recruitment techniques are flexible, market driven, and know their target audience. Since the need for financial literacy training is ubiquitous in many under-served settings, formal needs assessments are often not conducted, but the characteristics of the target population must be well known in order for the education to be effective. The International Institute of Boston (IIB) employs bilingual Vietnamese, Haitian-Creole, Cape Verdean Creole, Portuguese, and Chinese instructors, who are from the populations served by this organization.

The success of the IIB program can be attributed to these instructors who teach and are recruited within their communities. They identify which newspapers reach the most people, when radio is an effective tool, or if posting notices in housing units is an appropriate way to find participants.

3. Adequate Resources

Organizations have the best chance for achieving program success when they can commit the necessary resources to their programs. United Parcel Service (UPS) has committed the resources required to reach 42,000 of its employees with information that integrates company benefits with personal financial instruction and allows participants to attend workshops on company time. UPS partnered with PricewaterhouseCoopers to design the program, develop the materials, and train the instructors. Consequently, UPS is able to offer workshops frequently enough to meet demand. Some UPS participants benefited so much from the program that they believe it "should become mandatory."

4. Successful Evaluation and Follow-Up

Having evaluation tools is important and necessary, but using them to improve and upgrade course offerings is vital to program success. Effective programs are flexible enough to change direction, even curricula, when evaluations deem such changes will improve the course or program. Successful programs contain two *participant-centered* evaluation components, both of which must be voluntarily offered by participants:

1. Immediate Program Response Measures—to learn participants' satisfaction with the education, and
2. Follow-Up Action Measures—to ascertain participants' application of what has been taught.

When *business-centered* results of courses are needed to demonstrate links between increased participant well-being and positive organizational impact, additional components must be designed that include pre- and post-education measures.

Rutgers Cooperative Extension assesses the monetary impact of its Money2000 Program at the county, state, and national levels using both participant-centered and business-centered evaluation components. Measures are used that explore participant satisfaction with courses and actions taken by participants six months after instruction. Periodic dollar amounts of savings and debt reduction are obtained from participants, and the Extension is thus provided with data on behavioral changes as well as information that can be used to tabulate the cumulative monetary impact of the education.

5. Program Accessibility

Decisions regarding the scale of a program relate directly to time frame; scope of curriculum; geographic; workplace or community delivery locations; and program duration. Effective programs take all of this into consideration when scheduling courses or counseling sessions.

Weyerhaeuser permits its employees to attend personal financial education courses of up to two-and-one-half days during working hours. In most cases, employees report that supervisors are very supportive of allowing time off to attend programs. Employees expressed appreciation for Weyerhaeuser's program accessibility and the ease of participation that is encouraged in this workplace employee education setting.

6. Relevant Curriculum

Effective programs use carefully crafted, or adapted, Participant Texts, Workbooks and other written materials, and we found many examples in use—too many to address in this study. (An on-line resource for reviewing financial literacy education materials is available at www.nefe.org.) A curriculum must meet the needs of learners. It must be geared to their level of general literacy, written in understandable language—even native language, when appropriate or necessary—responsive to their present socio-economic situation and sensitive to their cultural background.

In Boston, the IIB translated the city's documents on homebuying into five languages, which makes homeownership more accessible and demystifies the homebuying process. The use of native language instructors allows materials to be shaped to fit the specific needs and sociocultural issues that exist for participants and fosters heightened communication, interaction and learning in the classroom.

7. Dynamic Partnering

Effective programs don't hesitate to enlist the help of partners to accomplish whatever is required. Dynamic partnering refers to the practice of two-way service and sharing. For example, a commercial bank or mortgage banker can be a good community partner, provide help with curriculum design, supply committed teachers, and help post notices of financial literacy course offerings. In return, course participants may look to the bank or mortgage banker to provide banking or mortgage financing services upon completion, or as a result of having participated in financial literacy educational offerings.

The Mississippi Housing Initiative (MHI) succeeded in creating a single, statewide homebuyer education program by building a fairly extensive system of networks. MHI has relied on networking on multiple levels and at various stages of development and implementation, from the initial formation of MHI to the connection with agencies that provide the education, to grassroots recruiting techniques. County networking is particularly important in rural areas where potential participants are more difficult to target, reach, and attract.

ISSUES AND RECOMMENDATIONS

- Workplace financial education is the venue for reaching most people. Rewards can be numerous and mutually beneficial for both employer and employee. We urge many more employers to offer personal finance courses in workplace settings and we support public policy initiatives that offer incentives to those employers who do.
- While workplace financial education can reach the most people, evidence shows that faith-based and other community-based organizations provide the most comfortable setting for many people. More importantly, in under-served populations, these organizations offer hope, motivation, and emotional support, which are necessary for learning that leads to feelings of increased opportunity and personal efficacy. We recommend that public and philanthropic resources increasingly support these critically important community efforts.

- We recommend that socioculturally sensitive teaching methods be incorporated into financial literacy education curricula. Language, family and community process issues, anxieties and fears, lifestyle issues and other human concerns must be approached more openly by educators within the context of financial decision-making.
- Topics, terminology, and teaching materials need to be developed that emphasize financial "discovery," the learning process that many participants actually experience. In addition, "coping skills" and "recovery methods" must be formulated, taught and encouraged for periods of financial adversity. Labels such as "bad" credit risk must be rethought—corporations and municipalities seeking credit are graded AA, A, B. We recommend nonpejorative terminology for humans too.
- Life planning approaches should increasingly be built into curricula in order to help pre-retirement populations learn proactive ways to think about the future. Retirement planning approaches should be expanded beyond the financial to include life-style choices and other so-called "soft" course topics and materials that are so meaningful to seminar participants when they are included.
- Financial literacy education is lifelong learning. Educators should make this very clear to participants, emphasizing courses that teach resourcefulness—where and how to find information, how to find and when to use financial consultants, what financial designations mean, and how to use print media and the Internet to assist in financial planning.
- We recommend that financial education for older Americans become a national priority, since we believe the need may be particularly acute. Financial resource management can help older adults avoid scams and other forms of financial abuse, and plan, budget, choose or find alternative sources for healthcare, homecare, medication, and daily money management assistance. In addition, older adult homeowners need help in understanding the availability and terms of equity conversion tools and with budgeting the proceeds of reverse mortgages or other lump sum payments when they are received.
- Technological teaching methods must be employed to reduce the cost and widely increase the availability of personal financial education. These, however, must be combined with an instructor-based teaching and a supportive learning environment. Investment is needed in intelligent tutoring models that include interaction and encourage innovation in teaching materials making financial learning more accessible, attractive, and successful.
- Financial literacy is two-dimensional. Personal financial education for every socioeconomic and sociocultural level is challenging. Yet, there must be a willingness by the financial services industry to meet the *document literacy needs* of the public by producing clear, plain English contracts, and other documents. We see this as a marketing opportunity for financial services firms who can become "lifestyle allies" in the escalating competition for the business of increasingly savvy consumers.

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[1] Manheimer, Ronald J., et al. 1995. *Older Adult Education: A Guide to Research, Programs, and Policies*. Westport, CT: Greenwood Press.
[2] Cutler, N. E. and S. J. Devlin. 1996. "Financial Literacy 2000," *Journal of the American Society of CLU & ChFC*.
[3] Devlin, S. J. 1995. Private Correspondence to Stefanie Sonnenberg at ISFS.
[4] Grangaard, Paul A. 1999. "Managing Financial Assets During Retirement: A Whole New Ball Game," *Personal Finances and Worker Productivity*, 3:2:99.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONNA TANOUE
CHAIRMAN

June 21, 2001

Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to testify on the condition of the banking and thrift industries. Pursuant to your question posed yesterday on financial literacy, I am pleased to advise you that the Federal Deposit Insurance Corporation is initiating a significant new program to promote and facilitate financial education.

Enclosed is a brochure and a press release describing that program, which we call *Money Smart*. The program is a comprehensive curriculum to help adults outside the financial mainstream develop positive deposit and credit relationships with commercial banks and thrifts. The program explains basic financial instruments and products. Its ten modules cover such topics as an introduction to bank products and services, choosing and maintaining a checking account, budgeting and saving, understanding credit history, selecting and using credit cards, understanding other forms of consumer credit, and an introduction to home ownership.

We have joined forces with the Department of Labor to promote financial education and to make *Money Smart* available at employment centers, called One Stop Centers, across the country. The formal rollout will occur in the next few weeks. To promote and facilitate the use of *Money Smart*, the FDIC and the Department of Labor will conduct orientation sessions for bankers and One Stop Centers throughout the country. In addition, the FDIC will provide a copy of the *Money Smart* curriculum – including an instructor's manual and participant handouts – free of charge to any financial institution wishing to offer the program in its community.

Again, I appreciate your interest in our efforts on financial literacy. If you have any further questions, Alice C. Goodman, Director of our Office of Legislative Affairs, can be reached at (202) 898-8730.

Sincerely,

Donna Tanoue

Donna Tanoue
Chairman

Enclosures

*Materials available in Committee files

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONNA TANOUE
CHAIRMAN

June 21, 2001

Honorable Thomas Carper
United States Senate
Washington, D.C. 20510

Dear Senator Carper:

This letter is to follow up on our conversation concerning identity theft during my appearance before the Senate Banking Committee yesterday.

The Federal Deposit Insurance Corporation shares your interest in this issue. While consumer education is the best defense against identify theft, the banking regulators have taken on the responsibility to educate the industry as well on how best to protect their customers.

As promised, I am enclosing materials we have provided to bankers and consumers on identity theft. The enclosed Financial Institution Letters are coordinated with the other federal banking agencies and are provided to the Chief Executive Officer of every federally-insured financial institution. The enclosed *Consumer News* publication is distributed free of charge to approximately 52,000 subscribers, including households, syndicated columnists and other consumer news media. In addition, *Consumer News* is posted on our Website (www.fdic.gov) and read by thousands more.

I appreciate your interest in this matter and hope that this information proves helpful. If you have any further questions, Alice C. Goodman, Director of our Office of Legislative Affairs can be reached at (202) 898-8730.

Sincerely,

Donna Tanoue

Donna Tanoue
Chairman

Enclosures

*Materials available in Committee files