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S. HRG. 111–141

LESSONS LEARNED IN RISK MANAGEMENT OVERSIGHT AT FEDERAL FINANCIAL REGULATORS

HEARING

BEFORE THE

SUBCOMMITTE ON SECURITIES, INSURANCE, AND INVESTMENT

OF THE

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

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

DISCUSSING THE ROLE OF FEDERAL FINANCIAL REGULATORS IN THE FINANCIAL CRISIS IN THE UNITED STATES AND REFORMING REGULATION TO ENSURE A STRONG FINANCIAL SYSTEM

MARCH 18, 2009

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

52–966 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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LESSONS LEARNED IN RISK MANAGEMENT OVERSIGHT AT FEDERAL FINANCIAL REGULATORS

WEDNESDAY, MARCH 18, 2009

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 3:34 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR JACK REED

Senator REED. Let me call the hearing to order. Let me first apologize for the extra delay. We were engaged in voting, and these things take longer than we usually expect, but thank you very much.

I want to thank you all for joining us here today. This financial crisis has demonstrated that, contrary to the presumption of many, financial institutions were unprepared and in many cases incapable of adequately assessing the risks that they were bearing on their books. The governance structures, the firm managers, and sophisticated models all failed to capture the magnitude of the risks that were building. Now the mistakes and poor risk management by these financial institutions and their regulators have become the taxpayers' problems, with the effects spiraling through the broader global economy.

The trillions of dollars in losses stand as witness to the many failures of risk management at these firms. Blame must primarily be placed at the feet of these financial institutions which gambled and then cashed in on exorbitant transaction fees for creating exotic new financial products.

The guiding presumption of many, including former Federal Reserve Chairman Alan Greenspan, was that self-interest would keep these firms from engaging in overly risky behavior; and if that was not sufficient, then surely market discipline would rein in excesses. But, in reality, both proved inadequate to constrain excessive risk taking. The drive for short-term profits led to irrational behavior that affected many, not just a few firms.

When self-interest and market discipline break down, we hope that the safety net of regulators will guide us out of the storm. However, if the people engaging in these complex transactions did

not understand the risk, the regulators, it appears, based upon the report we have been given today, might have known even less. The capacity to conduct oversight of the risk management function at these firms was in many cases lacking.

During the good times, when all the excesses were building up, the regulators did not press hard enough. Yet it is during these times that it is most important, as excesses encourage a sense of fearlessness about risk taking, that the regulators act promptly to constrain the exuberance.

Perhaps more fundamentally, the regulators should be asking hard questions. When new financial products are drawing in unprecedented profits, they should be asking pointed questions about the cash-flows and how the products work, including how they perform in good times and bad. Reverse engineering these products is critical if regulators are to understand how they operate and know their embedded risk.

Regulators also need a firm-view on risk. As we heard in testimony last week concerning AIG, the firm stopped offering credit default swaps on CDOs and mortgage-backed securities in one area of the firm, at the same time it started risky securities lending in another area of the firm.

Another bank claimed it was never involved in subprime lending, yet it was buying mortgage lenders engaged in the practice and securitizing such products.

Last June, I called a similar hearing to discuss risk management and its implications for systemic risk. Unfortunately, further variances in risk management have taken place since that time.

The purpose of this hearing is to bring to light the specific problems and to find a positive way forward. This hearing is particularly important given the need for swift and yet deliberate regulatory reform.

GAO at my request, after last June's risk management hearing, undertook a study of the risk management function of those regulators responsible for large financial institutions. GAO reviewed a sample of large, complex financial institutions to determine what the regulators knew, when they knew it, and what changes were requested as a result of the regulatory examinations and inquiries. While GAO will be sharing this in testimony, I wanted to highlight a few findings that I found particularly troubling.

Regulators found problems as early as 2005, 4 years ago, with the risk management systems at large, complex financial institutions, but often were not aggressive in insisting on changes at firms until market events made the problem self-evident.

A Federal Reserve review conducted in 2006 concludes that no large, complex financial institutions they reviewed had sufficient enterprise-wide stress tests to determine what economic or other scenarios might render the entire company insolvent. Moreover, many large, complex financial institutions could not sufficiently measure or manage all of their risk at a consolidated level; rather, they focused on risk within various subsidiaries without looking at the health of the entire holding company. Even knowing this, regulators did not significantly change their ratings of such firms until the crisis emerged.

Because of the sensitive nature of the information, I would ask that my colleagues avoid asking about any currently ongoing financial institution by name. Instead, I think the focus here is on the performance of the regulator and also in general the performance of these regulated entities.

The GAO's review comes at an important time in our history. It is the kind of deep analysis that should guide us forward as we take up questions on regulatory reform that will serve as the foundation for financial oversight as we go forward. In short, major regulatory reform is coming. I hope that we can learn from what has transpired, move forward with a stronger safety net, and build a strong financial system.

At this time, I would like to recognize the Ranking Member, Senator Bunning. Senator.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Chairman Reed. This is my first hearing working with you on this Subcommittee. I am glad to be here, and I look forward to working with you for years to come.

I think what we are going to hear today from our witnesses is that failures in risk management that contributed to our current economic crisis were not just the result of problems with our laws or poor decisions by firms. No, there was also a failure by regulators to recognize the dangers and, even worse, a lack of will to do something about the problems that they did find.

Mr. Chairman, I find that deeply troubling. I also find the example of the 2006 Federal Reserve study mentioned in the report to be extremely troubling. The Fed found that none of the institutions it looked at had stress tests that covered the entire company and none of the tests to see what would make them insolvent. That is bad and shows the irresponsibility of the firms. But as far as I can tell, the Fed also did little or nothing about it. That is worse and should throw cold water on the idea of some that the Fed should be the new risk regulator.

I find the admission by some regulators to GAO that they did not understand the real risk or the importance of contributing factors to be refreshing, but still very troubling. Those admissions should raise questions about whether we can ever create a risk regulator that will understand and act to stop systemwide risk. In a system of "too big too fail" when market discipline has been removed by bailouts, we have to rely on regulators to make sure firms do not get into trouble.

But if our regulators are unable to find problems and unwilling to do something about them, we are in real trouble, and maybe we need to reconsider the whole concept of relying on regulators to be the last line of defense against all problems.

Why should we think a few changes in the law will magically make them more effective the next time around? We can try to fix problems with our current system, but we cannot legislate will or competency. Instead, we need to build a system where everyone is accountable and has incentives to perform due diligence, a sort of check-and-balance, so if any one party does not do so, it will not lead to an overall failure.

The system also needs to be robust enough to handle the failure of individual firms, and we should assume that firms will fail, because they do. To handle that, we need to improve the authority of regulators to take control of and shut down failing firms through some type of orderly bankruptcy. We also need to hold directors and executives accountable. If everyone knows they will face the consequences of their actions, they will be more careful in the future. I think that will go a long way in the future to creating a stable financial system than rearranging the furniture downtown at various regulators.

Again, thank you, Mr. Chairman. I am looking forward to hearing from the witnesses.

Senator REED. Thank you, Senator Bunning. I, too, look forward not only to hearing from the witnesses, but working with you on this Subcommittee. Thank you very much.

Let me introduce our panel. Ms. Orice Williams is the Director of the Financial Markets and Community Investment group at the Government Accountability Office.

Mr. Roger Cole is Director of the Division of Banking Supervision and Regulation, Federal Reserve Board.

Mr. Timothy Long is the Senior Deputy Comptroller, Bank Supervision Policy and Chief National Bank Examiner for the Office of the Comptroller of the Currency.

Mr. Scott Polakoff is the Acting Director of the Office of Thrift Supervision.

And Dr. Erik Sirri is the Director, Division of Trading and Markets, U.S. Securities and Exchange Commission.

All of your testimony will be made part of the record. You may summarize if you wish. In fact, that is encouraged. And I understand both Ms. Williams and Mr. Polakoff have had a long day of testimony, so thank you particularly for waiting and being with us today.

Ms. Williams, would you please begin?

STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Ms. WILLIAMS. Mr. Chairman and Ranking Member Bunning, I am pleased to be here today to discuss lessons learned from risk management oversight at large, complex institutions. At your request, we initiated work in December to review the risk management oversight of large institutions by the banking and securities regulators, namely, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Securities and Exchange Commission, and FINRA.

Our objectives were to: one, identify how regulators oversee risk management at large institutions; two, identify the extent to which regulators identified shortcomings in risk management at selected institutions prior to the financial crisis; and, three, how some aspects of the regulatory system may have contributed to or hindered their oversight.

However, I need to note that Section 714 of the Federal Banking Agency Audit Act generally prohibits GAO from disclosing nonpublic information about an open bank. Therefore, I will not dis-

close the banking institutions included in our sample or provide detailed information obtained from the examinations or interviews with examination staff.

First, we found the regulators generally maintained continuous contact with large complex institutions using a risk-based examination approach that aims to identify areas of risk and assess these institutions' risk management systems. But the approaches of the banking and securities regulators varies somewhat.

Likewise, the regulators generally use a combination of tools and activities to assess the quality of risk management. For example, bank examiners review the activities, products, and services that an institution engaged in to identify risk and then, through continuous monitoring and targeted examinations, assess how the institution manages those risks. When regulators identify weaknesses in risk management at an institution, they have a number of formal and/or informal supervisory tools they can use for enforcement and to effect change.

For the examinations we reviewed, we found that regulators had identified numerous weaknesses in institutions' risk management systems prior to the beginning of the financial crisis. However, regulators did not effectively address the weaknesses or in some cases fully understand their magnitude until the institutions were stressed. In hindsight, the regulators told us that they had not fully appreciated the risks to the institutions or the implications of the identified weaknesses for the stability of the overall financial system.

We also found that some aspects of the regulatory system may have hindered regulators' oversight of risk management. For example, no regulator systematically and effectively looks across all large, complex institutions to identify factors that could have a destabilizing effect on the overall financial system.

In closing, I will share a few observations.

First, while an institution's risk managers directors, and auditors, all have key roles to play in effective corporate governance, regulators, as outside assessors of the overall adequacy of the system of risk management, also have an important role in assessing risk management. Yet the current financial crisis has revealed that many institutions had not adequately identified, measured, and managed all core components of sound risk management. We also found that for the limited number of large, complex institutions we reviewed, the regulators failed to identify the magnitude of these weaknesses, and that when weaknesses were identified, they generally did not take forceful action to prompt these institutions to address them.

Second, while our recent work is based on a limited number of institutions, these examples highlight the significant challenges regulators face in assessing risk management systems at large, complex institutions. While the painful lessons learned during the current crisis bolster market discipline and regulatory authority in the short term, effective regulation requires that regulators critically assess their regulatory approaches, especially during good times, to ensure that they are aware of potential regulatory blind spots. This means constantly re-evaluating regulatory and super-

visory approaches and understanding inherent biases in regulatory assumptions.

While we commend recent supervisory efforts to respond to the current crisis, the new guidance we have seen tends to focus on issues specific to this crisis rather than on broader lessons learned about the need for more forward-looking assessments and on the reasons that regulation failed.

Finally, the current institution-centric approach has resulted in regulators all too often focusing on the risks of individual institutions and regulators looking at how institutions are managing individual risks, while missing the implications of the collective strategy which is premised on the institution having little liquidity risk and adequate capital. Whether the failures of some institutions ultimately come about because of a failure to manage a particular risk, such as liquidity or credit risk, these institutions often lack some of the basic components of good risk management, for example, having boards of directors and senior managers set the tone for proper risk management across the enterprise.

Mr. Chairman, Ranking Member, this concludes my oral statement, and I would be happy to answer any questions at the appropriate time.

Senator REED. Thank you, Ms. Williams.

Mr. Cole, please. Is your microphone on, Mr. Cole?

Senator BUNNING. Would you put your microphone up to your mouth a little closer?

Senator REED. Thank you.

STATEMENT OF ROGER T. COLE, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. COLE. Chairman Reed, Ranking Member Bunning, it is my pleasure today to discuss the state of risk management in the banking industry and the steps taken by supervisors to address risk management shortcomings.

The Federal Reserve continues to take vigorous and concerted steps to correct the risk management weaknesses at banking organizations revealed by the current financial crisis. In addition, we are taking actions internally to improve supervisory practices addressing issues identified by our own internal review.

The U.S. financial system is experiencing unprecedented disruptions that have emerged with unusual speed. Financial institutions have been adversely affected by the financial crisis itself, as well as by the ensuing economic downturn.

In the period leading up to the crisis, the Federal Reserve and other U.S. banking supervisors took several important steps to improve the safety and soundness of banking organizations and the resilience of the financial system, such as improving banks' business continuity plans and the compliance with the Bank Secrecy Act and anti-money-laundering requirements after the September 11 terrorist attacks.

In addition, the Federal Reserve, working with the other U.S. banking agencies, issued several pieces of supervisory guidance before the onset of the crisis such as for nontraditional mortgages, commercial real estate, and subprime lending, and this was to

highlight the emerging risks and point bankers to prudential risk management practices they should follow.

We are continuing and expanding the supervisory actions mentioned by Vice Chairman Kohn last June before this Subcommittee to improve risk management at banking organizations. While additional work is necessary, supervised institutions are making progress. Where we do not see sufficient progress, we demand corrective action from senior management and boards of directors.

Bankers are being required to look not just at risks from the past, but also to have a good understanding of their risks going forward. For instance, we are monitoring the major firms' liquidity positions on a daily basis, discussing key market developments with senior management and requiring strong contingency funding plans. We are conducting similar activities for capital planning and capital adequacy, requiring banking organizations to maintain strong capital buffers over regulatory minimums.

Supervised institutions are being required to improve their risk identification practices. Counterparty credit risk is also receiving considerable focus. In all of our areas of review, we are requiring banks to consider the impact of prolonged, stressful environments.

The Federal Reserve continues to play a leading role in the work of the Senior Supervisors Group whose report on risk management practices at major U.S. and international firms has provided a tool for benchmarking current progress. Importantly, our evaluation of banks' progress in this regard is being incorporated into the supervisory exam process going forward to make sure that they are complying and are making the improvements we are expecting.

In addition to the steps taken to improve banks' practices, we are taking concrete steps to enhance our own supervisory practices. The current crisis has helped us recognize areas in which we can improve. Vice Chairman Kohn is leading a systematic internal process to identify lessons learned and develop recommendations. As you know, we are also meeting with Members of Congress and other Government bodies, including the Government Accountability Office, to consult on lessons learned and to hear additional suggestions for improving supervisory practices.

We have already augmented our internal process to disseminate information to examination staff about emerging risks within the industry. Additionally, with the recent Federal Reserve issuance of supervisory guidance on consolidated supervision, we are not only enhancing the examination of large, complex firms with multiple legal entities, but also improving our understanding of markets and counterparties, contributing to our broader financial stability efforts.

Looking forward, we see opportunity to improve our communication of supervisory expectations to firms we regulate to ensure those expectations are understood and heeded. We realize now more than ever that when times are good and when bankers are particularly confident, we must have even firmer resolve to hold firms accountable for prudent risk management practices.

Finally, despite our good relationship with fellow U.S. regulators, there are gaps and operational challenges in the regulation and supervision of the overall U.S. financial system that should be addressed in an effective manner.

I would like to thank you and the Subcommittee for holding this second hearing on risk management, a crucially important issue in understanding the failures that have contributed to the current crisis. Our actions with the support of Congress will help strengthen institutions' risk management practices and the supervisory and regulatory process itself—which should, in turn, greatly strengthen the banking system and the broader economy as we recover from the current difficulties.

I look forward to answering your questions.

Senator REED. Mr. Long.

STATEMENT OF TIMOTHY W. LONG, SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. LONG. Chairman Reed, Ranking Member Bunning, my name is Tim Long. I am the Senior Deputy Comptroller for Bank Supervision Policy at the OCC. I appreciate this opportunity to discuss the OCC's views on risk management and the role it plays in banks we supervise, the weaknesses and gaps that we have identified in risk management practices and the steps we are taking to address those issues, and how we supervise risk management at the largest national banks.

Recent events have revealed a number of weaknesses in banks' risk management processes that we in the industry must address, and we are taking steps to ensure this happens. More importantly, these events have reinforced that even the best policy manuals and risk models are not a substitute for a strong corporate governance and risk management culture, a tone and approach to business that must be set at the top of the organization and instilled throughout the company.

While risk management practices are legitimately the focus of much current attention, risk management is hardest when times are good and problems are scarce. It is in those times when bank management and supervisors have the difficult job of determining when accumulating risks are getting too high and that the foot needs to come off the accelerator. These are never popular calls to make, but in retrospect, we and bankers erred in not being more aggressive in addressing our concerns.

However, we must also not lose sight that banks are in the business of managing financial risks. Banks must be allowed to compete and innovate, and this may at times result in a bank incurring losses. The job of risk management is not to eliminate risk, but to ensure that those risks are identified and understood so that bank management can make informed choices.

Among the lessons we have learned are: Underwriting standards matter, regardless of whether the loans are held or sold. Risk concentrations can excessively accumulate across products and business lines. Asset-based liquidity is critical. Back-room operations and strong infrastructure matters. And robust capital and capital planning are essential.

As described in my written testimony, we are taking steps to address all of these issues. Because the current problems are global in nature, we are working closely with my colleagues here and

internationally. Critical areas of focus are on improved liquidity risk management, stronger enterprise-wide risk management, including rigorous stress testing, and further strengthening the Basel II capital framework.

Risk management is a key focus of our large bank supervision program. Our program is organized with a national perspective. It is centralized and headquartered in Washington and structured to promote consistent and uniform supervision across the banking organizations. We establish core strategic objectives annually based on emerging risks. These objectives are incorporated into the supervisory strategies for each bank and carried out by our resident onsite staff with assistance from specialists in our Policy and Economics Unit.

Examination activities within a bank are often supplemented with horizontal reviews across a set of banks. This allows us to look at trends not only within but across the industry.

Throughout our resident staff, we maintain an ongoing program of risk assessment and communication with bank management and the board of directors. Where we find weaknesses, we direct management to take corrective action. For example, we have directed banks to make changes in personnel and organizational structures to ensure that risk managers have sufficient stature and ability to constrain business activities when warranted.

Through our examinations and reviews, we have directed banks to be more realistic about recognizing credit risks, to improve their valuation techniques for certain complex transactions, to aggressively build loan loss reserves, to correct various risk management weaknesses, and to raise capital as market opportunities permit.

Finally, the Subcommittee requested the OCC's views on the findings that Ms. Williams from the GAO will be discussing with you today. Because we only recently received the GAO's summary statement of findings, we have not had an opportunity to review and assess their full report. We take the findings from GAO very seriously, and we would be happy to provide the Subcommittee with a written response to this report once we receive it.

My preliminary assessment based on the summary we were provided is that the GAO raised a number of legitimate issues, some of which I believe we are already addressing; and others, as they pertain to the OCC, may require further action on our part.

Thank you, and I will be happy to answer questions you may have.

Senator REED. Thank you.

Mr. Polakoff, please.

STATEMENT OF SCOTT M. POLAKOFF, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good afternoon, Chairman Reed, Ranking Member Bunning. Thank you for inviting me to testify on behalf of OTS on the lessons the current economic crisis has taught us about risk management.

The topic is timely and important because, as you know, the heart of bank supervision is in monitoring for risks, to help prevent them from endangering the health of regulated financial institutions. Some of the risks I will discuss today not only endangered

institutions during this crisis, but played major roles in some failures.

The financial crisis has had serious consequences for our economy and for public confidence in the safety of their bank accounts and investments. This confidence and the trust it engenders are necessary for both the smooth operation of our financial system and the larger economy. Restoring confidence is essential to achieving full economic recovery.

In my comments today, I will focus on three risks that I think are most significant: concentration risk, liquidity risk, and the risk to the financial system from unevenly regulated companies, individuals, and products. Shortcomings in responding to each of these risks have significant consequences.

Let me start with concentration risk, which is basically the risk of a financial institution having too many of its eggs in one basket. If something bad happens to that basket, the institution is in trouble. Although concentration risk is one of the main risks that our examiners traditionally watch closely, the current crisis exposed a new twist to concentration risk, and the OTS has acted to address that risk.

The new twist was the risk of a business model heavily reliant on originating mortgage loans for sale into the private label secondary market. The freeze-up in this market for private label mortgage-backed securities in the fall of 2007 exposed this risk for institutions with an originate-to-sell business model. Their warehouse and pipeline loans could no longer be sold and had to be kept on their books, causing severe strain.

To prevent this problem in the future, the OTS reviewed all of its institutions for exposure to this risk, updated its examination handbook in September 2008, and distributed a letter to the chief executive officers of OTS-regulated thrifts on best practices for monitoring and managing this type of risk.

The financial crisis also taught us lessons about liquidity risk when some of our institutions experienced old-fashioned runs on the bank by panicked customers. In some cases, the size and speed of the deposit withdrawals were staggering. The event showed that the prompt corrective action tool created to prevent a gradual erosion of capital during the financial crisis of the late 1980s and early 1990s is inadequate to address a rapidly accelerating liquidity crisis. Rather than seeking a new type of prompt corrective action for liquidity, Federal banking regulators plan to issue guidance to examiners and financial institutions to incorporate lessons learned on managing liquidity risk.

Finally, I would like to discuss the risk to the financial system and the larger economy by companies, individuals, and products that are not regulated at the Federal level or, in some cases, at any level. These gaps in regulation are, in my mind, the root cause of the crisis. If you could distill the cause to a single sentence, I think it would be this: Too much money was loaned to too many people who could not afford to pay it back.

The simple lesson is that all financial products and services should be regulated in the same manner, whether they are offered by a mortgage broker, a State-licensed mortgage company, or a federally regulated depository institution. To protect American con-

sumers and safeguard our economy, consistent regulation across the financial services landscape is essential.

Thank you again, Mr. Chairman, for having us here today. I look forward to answering your questions.

Senator REED. Thank you, Mr. Polakoff.

Dr. Sirri?

STATEMENT OF ERIK SIRRI, DIRECTOR, DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Reed, Ranking Member Bunning, and members of the Subcommittee, I am pleased to have the opportunity today to testify concerning insights gained from the SEC's administration of the Consolidated Supervised Entities, or CSE, program, as well as the SEC's long history of regulating the financial operation of broker-dealers and protecting customer funds and securities.

The turmoil in the global financial system is unprecedented and has tested the resiliency of financial institutions and the assumptions underpinning many financial regulatory programs. I believe that hearings such as this, where supervisors reflect on and share their experiences from this past year, will enhance our collective efforts to improve risk management oversight of complex financial institutions.

A registered broker-dealer entity within the CSE group was supervised by an extensive staff of folks at the SEC and at FINRA, the broker SRO. All U.S. broker-dealers are subject to the SEC's rigorous financial responsibility rules, including the net capital rules, the customer protection rules, and other rules designed to ensure that firms operate in a manner that permit them to meet all obligations to customers, counterparties, and market participants.

The CSE program was designed to be broadly consistent with the Federal Reserve oversight of bank holding companies. Broker-dealers have to maintain the minimum of $5 billion of tentative net capital to qualify for the program and no firm fell below this requirement.

The CSE regime was also tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflected the resilience of securities firms on mark-to-market—the reliance of securities firms on mark-to-market accounting as a critical risk and governance control.

Second, the CSE firms were required to engage in liquidity stress testing and hold substantial liquidity pools at the holding company.

We also required firm-wide stress testing as a prerequisite to being allowed to enter the program, a requirement that was put in place well before the crisis started. For most firms, the stress testing comprised a series of historical or hypothetical scenarios that were applied across all positions, not just across one product or business line. While the set of scenarios did not cover every plausible scenario, they included major financial shocks or stresses to the market, such as the fall 1988 failure of long-term capital in the Russian default as well as the 1987 stock market crash. The CSE

firms later expanded these scenarios or created others to stress their hedge fund counterparty credit risk exposures.

I, too, appreciate the work that GAO did to review the supervision of financial institutions' risk management programs across the various regulators and find their observations on these programs very helpful. We are reviewing the recommendations and findings and we look forward to working with GAO as we fully consider their report.

The SEC's supervision of investment banks has always recognized that capital is not synonymous with liquidity and the ability of a securities firm to withstand stress events depends on having sufficient liquid assets, cash and high-quality instruments, such as U.S. Treasuries, that can be used as collateral to meet their financial obligations as they arise. For this reason, the CSE program required stress testing of liquidity and substantial liquidity pools at the holding company to allow firms to continue to operate normally in stressed market environments. But what the CSE regulatory approach did not anticipate was the possibility that secured funding, even that funding backed by high-quality collateral, such as U.S. Treasury and agency securities, would become unavailable.

Thus, one lesson of the SEC's oversight of CSEs, Bear Stearns in particular, is that no parent company liquidity pool can withstand a run on the bank. Such a liquidity pool would not suffice in an extended financial crisis of the magnitude we are now experiencing. In addition, these liquidity constraints are exacerbated when clearing agencies' sizable amounts of capital for clearing deposits to protect themselves against intraday exposures to the firm.

Another lesson relates to the need for supervisory focus on the concentration of illiquid assets held by financial firms, particularly in entities other than a U.S.-registered broker-dealer. Such monitoring is relatively straightforward with larger U.S. broker-dealers, which must disclose illiquid assets on a monthly basis in financial reports that are filed with their regulators. For the consolidated entities, supervisors must be well acquainted with the quality of assets on a group-wide basis and monitor the amount of illiquid assets and drill down on their relative quality.

Leverage tests are not accurate measures of financial strength for investment banks, in particular due to their sizable matchbook or derivatives business. Leverage tests do not account for the quality or liquidity of assets. Rather, they rely on overly simplistic measures of risk, such as leverage ratios. Regulators of financial firms have gone to a great deal of effort to develop and continue to refine capital rules that are risk sensitive and act as limiters on the amount of risk that can be taken by a firm.

Finally, any regulator must have the ability to get information about the holding company and other affiliates, particularly about issues and transactions that impact capital and liquidity. As we have witnessed with Lehman Brothers, the bankruptcy filing of a material affiliate had a cascading effect that can bring down the other entities in the group.

For these reasons and to protect the broker and its customer assets, the SEC would want not only to be consulted before any such liquidity drain occurs at the parent, but to have a say, likely in coordination with other interested regulators, in the risk, capital, and

liquidity standards that the holding company must maintain. Our experience last year with the failure of Lehman's U.K. broker and the fact that the U.S.-registered broker-dealers were well capitalized and liquid throughout the turmoil has redoubled our belief that we must rely on and protect going forward the soundness and the regulatory regime of the principal subsidiaries.

Thank you for this opportunity to discuss these important issues and I am happy to take your questions.

Senator REED. Thank you very much.

Senator Bunning had to step out. He will rejoin us for his questioning, but let me begin.

I want to address a question to all the regulators. first, let me say that I thought the GAO did a very responsible and thorough examination. Thank you and your colleagues Ms. Williams. But the basic questions are, and I will begin with Mr. Cole, just as you happen to be sitting next to Ms. Williams, but when did you first institutionally become aware of the significance of the risk difficulties in your supervised entities, and how did you communicate these concerns both to your supervisors, to your fellow regulators, and to a broader audience, and when did that communication become public? Mr. Cole?

Mr. COLE. Well, I really need to go back somewhat in time in answering that, but in 1995, we issued a supervisory letter to our examiners directing them in terms of taking a systematic approach to assessing the risk management, including the major risk categories of credit risk, market risk, operational risk, liquidity, reputational, and legal risk, and then that became part of the formal exam process and rating process.

Kind of fast forwarding to the 9/11-type situation, as I mentioned in my testimony, we focused on some significant risk issues there that we thought needed to be addressed, and some of them tended to focus on, say, operational risks, such as payments and settlements, others on contingency planning, locating backup facilities at appropriate different distances, and then very importantly on BSA/AML, Bank Secrecy/Anti-Money Laundering. In that regard, with regard to one of the institutions in question, we took very strong action to require a significant change in their business risk management and that was accomplished with a very forceful hand in terms of requiring them to make those changes. So I think that is a good example of where, when we see a significant problem, we do act.

Senator REED. Let me be more specific. The issue, I think, that the GAO has revealed is a lack of the capacity of large complex financial institutions, which all of you regulate, to assess adequately all of the risks they face, not so much a particular risk——

Mr. COLE. OK.

Senator REED.——but the fact that they did not have systems in place to adequately assess the risk, which I think is a fair conclusion of the report of the GAO. At what point did this fact or this observation become resonant with the Fed and how was it communicated to the banking community, to the regulating community, and on to the broader audience, the Congress, for one?

Mr. COLE. We have been engaged consistently, I think, since—just going back, say, to the 1995 letter, in terms of working with

institutions to enhance the risk management process. Now, in terms of moving right to the current situation, this stress testing example is a good example because we believe going into that stress test that there was a significant opportunity to put pressure on the big firms to improve their ability to pull positions together on a firm-wide basis and develop a really robust stress test.

The horizontal review that we did provided very significant information for us on a peer basis that they were not able to do that, that the stress that they typically came up with was one quarter's worth of earnings, and that was based on a fairly flawed system of not being able to comprehensively pull the positions together on an integrated firm-wide basis.

Senator REED. That was——

Mr. COLE. We used that as a major tool in terms of pushing on those firms. It was feedback from that exercise and saying, look, you need to do more here, and that is one of the main tools that we have, is that type of horizontal review. So that occurred, say, in June 2007, that kind of feedback with the firms on the findings from that stress testing.

Then I would move just a little bit further——

Senator REED. Can I just clarify? Is it June 2007 or 2006?

Mr. COLE. The actual exercise was in 2006. We did the report in 2007 and then the feedback to the firms, I think was in June of 2007.

Senator REED. It raises an issue, which is that in 2006, you had at least had serious concerns because of the stress testing that these firms could not handle or have systems in place to deal with the risk The whole point, I think, of the report of the GAO is that having that knowledge of those suspicions, it didn't seem to produce a timely, rapid response——

Mr. COLE. Well, Senator, I think that at the same time that we were doing the stress testing, we were also reviewing and having very significant interactions with these firms in terms of various aspects of their risk process——

Senator REED. Let me just ask. Did you communicate in 2006 with other supervisors, OTS, Comptroller, SEC, your concerns that some of the institutions that you were the overall supervisor had these deficiencies in risk assessment?

Mr. COLE. Well, we have very frequent conversations with——

Senator REED. Would you say fairly that you communicated these concerns to the other regulators, or you heard similar concerns from them?

Mr. COLE. I would say fairly that, as we are working on, for example, infrastructure requirements for the use of models and so on, we have had consistent communications with the other regulators that there are significant deficiencies in risk management.

Senator REED. And let me just ask a final question, because I do want your colleagues to respond, too. What broader audience did you communicate these concerns about the lack of adequate systems in place?

Mr. COLE. We have throughout the development, for example, of qualifying criteria for the use of Basel II and the so-called Pillar 2 criteria indicated the need for improvement to the firms we have been working with.

Senator REED. Mr. Long, similar questions. When did you, not personally, but the organization, become aware, if you did, of failings in the management of risk by entities you supervised? Did you communicate them to your fellow supervisors? Did they communicate with you, and then what broader audience?

Mr. LONG. Yes, I do think we began to communicate pretty well in the 2006 range, as my colleague says, but let me back up to answer you. I want to make sure I answer your question.

As I stated in my written testimony—it is difficult at times to strike that balance of letting a bank keep competitive and innovative at the same time and order a bank to constrain a certain business activity because we believe they are taking on too much risk. It is always a delicate balance and it is something we work hard to do.

But I think we did, going back to 2004. I know at the OCC and amongst other regulators, we did begin to see this buildup of risk and this buildup of excessive aggregation of risk. We issued guidance going back to 2004. We had the interagency credit card guidance. We issued guidance on home equity lending, on non-traditional mortgage products, on commercial real estate lending, and then most recently some interagency guidance on complex structured products. As we issued guidance to the industry, our examiners were in the banks and they were examining for this. We frequently cited matters requiring attention and began taking actions, various types of actions, surrounding these guidance.

So from 2004 up to 2007, I think we all saw the accumulation of risk. At the OCC, we looked vertically very well into those companies. If there were lessons learned by us, it was probably in two things. Number one, we underestimated the magnitude of the effects of the global shut-down beginning in August of 2007, and we did not rein in the excesses driven by the market.

So a real lesson learned, and I think you have heard it in some of the statements and in the GAO report, the ability to look vertically into these companies is good. The ability to look across the companies in terms of the firms we supervise, we need to get better at that, and looking horizontally across the system is something I think we all need to do.

A good example of that is in the firms that we supervise, we underestimated the amount of subprime exposure they had. We basically kicked the subprime lenders out of the national banking system. Our banks were underwriting very little of the subprime loans. What we didn't realize is that affiliates and subsidiaries of the banks that we supervised were turning around, buying those loans, structuring them, and bringing that risk back in in another division in the bank, and that is a good example of being able to look horizontally across a company and see that coming.

Senator REED. What inhibited you from looking across these other subsidiaries?

Mr. LONG. Well, Senator, there are two things. You know, internally, from the OCC's standpoint, we need to get better at doing more horizontal work, and I think we have. I think we started doing that probably a year and a half ago, where we have networking groups. We do more horizontal-type exams to where REICs can share information amongst themselves.

Where we are continuing to work with our other colleagues with the other agencies is making sure that we try to gather the risk in the entire system. But obviously all of us are constrained somewhat by GLBA.

Senator REED. Let me, Mr. Polakoff can I finish this line of questioning and then I will recognize you, Jim.

Senator BUNNING. I will stay as long as you want.

Senator REED. Thank you.

Mr. POLAKOFF. Senator, thank you. I don't want to embellish on what my colleagues have said. It is a consistent message.

I would say a trip-wire date for us was June of 2007 when the liquidity market shut down. What it proved to us and probably all of us at this table is we did not stress test models sufficiently for that kind of catastrophic event. So risk management turned upside down at that point in time. When any of these models predicted a stress scenario, and even a more stress scenario, none of us, none of the entities still predicted or had a model that stressed a scenario for what ultimately we saw starting in June of 2007 forward. That is a critical lesson learned for all of us.

Senator REED. Dr. Sirri?

Mr. SIRRI. The one thing I would point out that is slightly different with the CSEs that reentered this business in a different manner, the firms that we regulated under the CSE program came to us because of the European Union Financial Conglomerates Directive for that purpose. They needed a consolidated holding company supervisor and they didn't have one for that purpose.

So we came at this from rule, not by statute. We crafted the regime where in exchange for certain capital treatment we would be given a limited amount of access to the holding company. What we focused on and what that access related to were financial and operational risk controls, and in that sense, I think that was very helpful, informed broker-dealer oversight issues as well as certain issues of the holding company.

But, for example, as my colleagues have pointed out, Gramm-Leach-Bliley limits the way we touch upon other regulated entities. We defer to the functional regulator in that sense. And so our knowledge there was more limited.

So I think what you are really asking is a point which was made in the GAO report which says, if an enterprise, if a modern firm manages risk at an enterprise level, how can you as a regulator that is in many ways functionally based replicate that in your own regulatory program, and I acknowledge that is a challenge.

Senator REED. Let me follow up with a very quick question because I want to recognize Senator Bunning. Given the fact that you had to rely upon other regulatory agencies, what was the level of communication? If, in fact, by 2004 or 2005 the OCC was aware of buildup of risk, at 2006 the Federal Reserve was aware of risk, I would presume that in that same—so did anyone sort of, in a systematic way, say, you know, you should be aware that we are concerned about risk assessment, about the ability to manage this enterprise risk? Did that ever become part of the discussion?

Mr. SIRRI. I think we all—I won't speak for others. I think we understood, and my impression was all of these regulators understood, that we were limited in part. We had dialog amongst our-

selves. Staff on the ground talked to staff from other regulators. In addition, the firm—it is not like the firms drew up walls and said, we won't give you information on that bank, or we won't give you information on that thrift. They would provide such information. But in the sense of integrated enterprise risk management, I think it was not what it could be.

Senator REED. Senator Bunning, and take as much time as you want.

Senator BUNNING. Thank you, Mr. Chairman.

Welcome back from your vacations that you have been on for the last 5 years, and I say that not kiddingly. I say that as meaningful as I can, because if we would have had good regulators, we wouldn't be in the crisis we are in right now.

Ms. Williams, at the bottom of page 24, you said the Fed did not identify many of the issues that led to the failure of some large institutions. Can you tell us what some of these issues that they are, what they missed?

Ms. WILLIAMS. Absolutely. I would direct your attention to a couple of pages later, on page 26. We note that the Fed began to issue risk committee reports, and in February of 2007 they issued perspectives on risk, and we list a number of issues that we pulled from that report. For example—the report stated that there were no substantial issues of supervisory concern for large financial institutions; that asset quality across the systemically important institutions remains strong; in spite of predictions of a market crash, the housing market correction has been relatively mild and while price appreciation and home sales have slowed, inventories remain high and most analysts expect the housing boom to bottom out in mid-2007.

Overall, the impact on a national level will likely be moderate. However, in certain areas, housing prices have dropped significantly. They also noted that the volume of mortgages being held by institutions or warehouse pipelines had grown rapidly to support collateralized mortgage-backed securities and CDOs and noted that the surging investor demand for high-yield bonds and leveraged loans, largely through structured products such as CDOs, was providing a continuing strong liquidity that resulted in continued access to funding for lower-rated firms at relatively modest borrowing costs. So those are some of the——

Senator BUNNING. Would you like to comment on counterparty exposures, particularly to hedge funds?

Ms. WILLIAMS. This was another area that was identified. The regulators had focused on counterparty exposures, particularly to hedge funds.

Senator BUNNING. Mr. Cole, would you like to respond?

Mr. COLE. I would indeed, and thank you for the opportunity, Senator. First of all, I would say that my understanding is that the report that the GAO has done is really based on review of one institution.

Senator BUNNING. That is incorrect, but that is fine.

Mr. COLE. OK, and that we received this report with reference to perspectives on risk just in the last couple days. So we would like an opportunity to go over these findings with the GAO, as we typically do in GAO reviews. We have not had that opportunity.

But I will say this, that I think that what Ms. Williams quoted from is in the report, but unfortunately, there are other parts that were not quoted, and one in particular is, quote:

> The effects of a long period of easy liquidity and benign credit conditions have continued to weaken underwriting standards across all major credit portfolios. Finally, we note that investor demands appear to be encouraging large financial institutions to originate more assets and even greater volumes of low-quality assets, and in order to distribute them through the capital markets.

In response to that, we took very firm actions, and that——

Senator BUNNING. When?

Mr. COLE. That included——

Senator BUNNING. When? When did you take firm actions?

Mr. COLE. Let me see. A perspectives of risk report was issued in February 2007——

Senator BUNNING. Two-thousand-and-seven?

Mr. COLE. And we initiated major analysis of subprime mortgage markets in March and published an interim report in June of that year.

Senator BUNNING. Two-thousand-and-seven?

Mr. COLE. That is correct.

Senator BUNNING. OK. That is about 5 years after the——

Mr. COLE. Well, that is——

Senator BUNNING. That is about 5 years after the subprime and the mortgage mess hit the fan. Two-thousand-and-two and 2003 is when it hit.

Mr. COLE. Yes.

Senator BUNNING. OK.

Mr. COLE. But could I also——

Senator BUNNING. No, you can't.

Mr. COLE. OK.

Senator BUNNING. What did the Fed do about the 2006 review that showed institutions did not have overall stress testing for their own enterprise? Did you require your regulated firms to fix those problems?

Mr. COLE. Yes. I actually touched upon that in a prior response, that we did follow up with the institutions, that a very critical part of this type of horizontal peer review is going back to the institutions, which we did in June of 2007. The report was actually issued in February of 2007 and had communications with those firms indicating that there was significant need for improvement.

We also, I am told, communicated to the primary regulator——

Senator BUNNING. You were told or you know?

Mr. COLE. No, I know. I was informed in the interim of my last question that the primary regulators of these institutions were informed of the deficiencies we observed, as well as the President's Working Group. So it was——

Senator BUNNING. Well, that is all well and good if you followed up and made sure that they weren't going to repeat the same mistakes in the immediate future and subject the country to the recession that we are now in.

Mr. COLE. Right, and——

Senator BUNNING. If you sat on your hands, which the Fed did in overseeing mortgages and mortgage lenders and banks that were

under your jurisdiction, then I think that the Fed is a failure in doing what they are supposed to do.

For anyone, did the board of directors understand the risk their firms were taking?

Mr. POLAKOFF. Senator, I would say they understood the risk for the period of time that they were operating in, but failed to——

Senator BUNNING. In other words, what I am trying to get at, there is a reasonable rate of return on equity that everybody expected at a given point in time. Somehow, that got out of kilter, and instead of being happy with a 7 or 8 percent return on equity, people were leveraging from—and I don't blame anybody, but regulators ought to be looking at the rate of return on equity and not giving permission for these firms to get into mischief, and that is what happened. That is why we are here today asking you these questions. The regulators should have stopped the risk takers taking undue risk with taxpayers' money or with equity that has been invested. Now the taxpayers are paying the price.

So go ahead, finish your answer.

Mr. POLAKOFF. I agree with what you said, Senator.

Senator BUNNING. And how do we improve senior management and boards' understanding of an accountability for risk? How do we get that regulated?

Mr. POLAKOFF. Well, across the spectrum, all of the boards, I believe, are held accountable for the risk and——

Senator BUNNING. Is that right? Is that why we are paying bonuses to each and every one at AIG for—they were the board, they were the people that were supposed to regulate AIG. So we are paying them bonuses for taking $160 billion in taxpayers' money. Are you kidding me? Explain that to the American people.

Mr. POLAKOFF. AIG right now is not a regulated company. I——

Senator BUNNING. It is. It is owned by the Federal Government, so the Federal Government is the regulator. It is owned by the Federal Government. The contracts that have been paid out were OKed by the Federal Government. So it is regulated.

Mr. POLAKOFF. Yes, sir. I was speaking only from an OTS perspective.

Senator BUNNING. OK. It is not yours. It is ours.

How did you miss the risk and possibility of liquidity drying up? How did you miss it?

Mr. SIRRI. I can speak for the firms that we regulate. For a trading firm, for a securities firm, they do not take deposits as a commercial bank or a thrift does. Their primary means of funding is through the capital markets, especially through a market known as the repurchase market.

Senator BUNNING. I am familiar.

Mr. SIRRI. What a firm does is it takes the security it has, it gives it someone who lends it out——

Senator BUNNING. I am familiar.

Mr. SIRRI.——it comes back. Because that is a secured lending market, the lenders were thought to be not sensitive to the health of the firm, but sensitive to the quality of the collateral they got. So our thought was always that if you as a firm gave someone a Treasury bill or gave them an agency security, they would take that and fund you, even if you as a firm were in trouble. That was

an assumption we made, and that is, I think, many in the financial community made. And we were wrong.

When firms got in trouble, other funding counterparties—money market funds, people with cash to lend—would not take Treasury's to fund, and that was something we had never seen before.

Senator BUNNING. Mr. Long, what changes in law do you suggest to protect against future failures like we are in right now?

Mr. LONG. Senator, I do not know if I can think of a change in law that we need. We need to continue to have rigorous supervision around these companies. As I said in my written statement, you need a strong corporate culture, and it needs to start at the top of the organization, and it needs to be led by the Chairman and put down into the company. It is a simple——

Senator BUNNING. That, unfortunately, is not an answer.

Ms. Williams, do you have any changes in law that we can get a hold of as we are looking for as Members of Congress to prevent any more of the debacle that is going on right now?

Ms. WILLIAMS. I would just touch on a couple of issues. In January, GAO issued a framework for reforming the current financial regulatory system, and we point out a couple of issues. One would be clearly articulated goals; that is, Congress needs to be very clear about the goals that they expect regulators to achieve. There also needs to be a systemwide focus in the structure. And——

Senator BUNNING. In other words, A watching B and B watching C?

Ms. WILLIAMS. Not necessarily, but systemwide from the perspective of not focusing on particular institutions and getting caught up in the institution or type of product; but having a regulator that can focus attention on anything that poses a risk to the overall system.

Senator BUNNING. Then we would need one for about 25 major market banks, money market banks in New York City, one regulator each for each one, because those are the ones that are too big to fail. That is what we have been told by our Chairman of the Fed, in fact. And we have also been told that by the Secretary of the Treasury. So if that is the case, we need an awful lot of regulators.

Scott, do you have some suggestions?

Mr. POLAKOFF. Senator, I would offer that we need to ensure that there is a level playing field. We have had some products—80 percent of subprime loans were underwritten by mortgage brokers. There is no Federal oversight for that.

Senator BUNNING. Well, I am sorry, but the Federal Reserve got that job in 1994. That was their job. I mean, we wrote a law that gave them that job. Whether they did it or not is another question, but we handed that over to the Fed.

SEC?

Mr. SIRRI. Our charge is the broker-dealer, primarily, and so I am going to translate your question as: What do you need to make sure that we keep safe the customer's——

Senator BUNNING. No. What would give the SEC the ability to discover this situation that we are in now before or as it is happening and do something about it?

Mr. SIRRI. Drexel, Lehman Brothers taught us the same lesson. The lesson is that the health of a broker-dealer could be affected

by entities outside the broker-dealer—commercial banks, thrifts, unregulated affiliates that deal in derivatives. We need to touch on those entities. We need to have a say-so on risk.

Senator BUNNING. In other words, we should take all manners of dealing with a broker-dealer, whether it be securities, whether it be bonds. You mentioned some other things that they are dealing with now. But we should have someone watching the store for all entities.

Mr. SIRRI. I think, again, I was focusing on the broker-dealer, but I know that our charge is affected by risks that are taken outside the broker-dealer. You do not hold derivatives in a broker-dealer, because we haircut the capital—we haircut you, we charge you capital. So firms respond by moving the risk outside the broker-dealer, by moving illiquid instruments outside the broker-dealer. That still imperils the broker-dealer. We need to touch on those. We need——

Senator BUNNING. Well, then you need regulations over those people that are dealing in the entities.

Mr. SIRRI. For preserving the broker-dealer, that would be very helpful.

Senator BUNNING. Thank you very much, Mr. Chairman.

Senator REED. Thank you, Senator Bunning.

Let me raise a few questions. You mentioned, Dr. Sirri, that really what happened, in your view, was a run on the bank. And I think that begs the question: What caused the run on the bank? There are some people that suggest the huge amount of leverage which the market became aware of just undercut any sort of willingness to accept even Treasury securities. And that leverage ratio was something that was approved by the SEC—at least not effectively disapproved—and I think you had the authority to do that. Can you comment on that?

Mr. SIRRI. Sure. The question of a "run on the bank," which is the term I used, is always a difficult one because it implicitly depends on confidence in the institution. Of course, we did not have a bank, and the run was different. It was not deposits. But, nonetheless, it was funding with certain kinds of securities through the repo market.

You know, it is hard to know why something like that starts. The instruments became the instruments in these firms, in some of the firms that are no longer with us. Lehman Brothers, for instance, suffered a lot of uncertainty about valuation, so you have a financial firm, they are typically opaque. You do not know exactly what is going on with them. That is the nature of a financial firm. Valuations become questions because you are holding, for example, commercial whole loans in the case of Lehman, where people doubted valuations.

In a situation like that, people will be wary about funding because even if you can potentially get your money back, you are not in the business of getting tied up in an uncertainty. And that causes a situation that can cause a run.

Senator REED. Thank you very much.

Let me ask a general question, which I do not think requires a specific answer unless you—my assumption is that the umbrella regulator—and each one of these large institutions had an umbrella regulator—had the responsibility for the risk assessment

throughout the organization, that it was not a case where the overall enterprise risk assessment or enterprise activities were not at all under the authority of a regulator. Is that your understanding, Dr. Sirri, in terms of the law?

Mr. SIRRI. Well, I think the authority stems from different places. Again, we had no statutory authority.

Senator REED. Right, right.

Mr. SIRRI. We crafted rules. I think in other places it is statutory. And, again, our ability—our question of where we would look was governed by a certain set of precepts and risks. Our concern was always the broker-dealer. Risks that pertained to things other than the broker-dealer that might imperil other entities were not our charge, and our program was not crafted to cover those.

Senator REED. Mr. Polakoff, your responsibility derived from statute. Did you feel at OTS that those entities you were the umbrella supervisor, that you had responsibility for enterprise risk analysis, assessment by the enterprise?

Mr. POLAKOFF. Yes, sir. The only thing I would offer is per Gramm-Leach-Bliley we did rely to a great extent on functional regulators within the system. But as the holding company regulator for our institutions, absolutely we had the overall umbrella responsibility.

Senator REED. Mr. Long, is that your understanding? I know OCC is—do you have an umbrella responsibility? Let me ask the basic——

Mr. LONG. We are the primary regulator for the bank, absolutely. Our authority and how we conduct our risk assessments I think works very well, and we feel like we have the proper authority.

Senator REED. So you understand that you have to collaborate with others, but that ultimately there is one Federal regulator under the statute—Mr. Sirri has an exception—that had responsibility to look across the organization for risk assessment, risk evaluation, and risk compliance?

Mr. LONG. Well, I am sorry. Maybe I did not understand your question. The way it works now is it is dependent on how well we communicate with each other and—if that is what you are asking, Senator. I want to make sure I am answering your question right. Is there a systemic umbrella regulator right now that——

Senator REED. I am not talking systemic. I am talking about you have a large, integrated financial organization that is regulated under statute. There is one regulator who is responsible for the overall operation, and let me ask the question. Is there one regulator responsible for the overall operation of the entire enterprise?

Mr. LONG. Well, the OCC is responsible for the bank, and the Fed is responsible for the holding company.

Senator REED. Let me talk to Mr. Cole. As the umbrella regulator of several large financial institutions, do you feel that you are responsible, the Federal Reserve is responsible for the overall capacity of that institution as an enterprise to evaluate risk?

Mr. COLE. Yes, sir, we do, and we have gone, I think, an extra mile to make sure that that is very clear with the firms and our examiners by rolling out a Consolidated Supervision Program in October of last year and communicating that very clearly with the other agencies.

Senator REED. Let me go back to the point that was raised between Ms. Williams and Senator Bunning about the large financial institutions' perspective on risk, the 2005 reports, the 2006, 2007 reports. These were internal documents, Ms. Williams, of the Fed? These were not released to the public?

Ms. WILLIAMS. Yes, these were internal.

Senator REED. And then there was an interruption in the reports, but then in April of 2007, there was a report, "Perspective of Risk." Was that an internal document, too?

Ms. WILLIAMS. Yes, all of them were internal.

Senator REED. And it raises the question with respect to the Federal Reserve that if these documents are solely within the purview of the Federal Reserve, how is the broader financial community and the broader community and how is Congress to inform itself of critical issues that you feel could have profound consequences, which have profound consequences?

Mr. COLE. One issue is just getting our own shop in order in terms of pulling all the information that is available to gather and creating a perspective on risk from a financial stability point of view. There is that process. We do have that process. We have a formal umbrella group that is in charge of making periodic reports to the board on information that is drawn from research and from our shop and other payments areas and so on. So we are very focused in terms of creating a holistic picture of what is happening in the financial system now. That is very important.

Now, you know, the question in terms of how do we go kind of the step of somehow making that public, and it could well be—you know, it obviously would be worthwhile in some form to be public. I cannot answer that at this point.

Senator REED. Well, you know, I guess one presumption would be to have this information. I understand there is proprietary information that you have, and also there is a concern about causing market movements based not upon, you know, financial information but other information. But I think if such information was in the public domain in some capacity in 2005 and 2006 and 2007, it was available to Congress, and there was no opportunity for testimony to communicate that, that there might have been earlier prompter and more effective action to deal with some of these issues which are bedeviling us at the moment.

In that regard, too, I know, because we have had the chance to meet, that the Federal Reserve and all those agencies are taking a serious look backwards. You know, you have described some of your conclusions. Ms. Williams and her colleagues have provided some perspective. But these reports—I will use the term I learned as a youth. These After Action Reports have to become public, particularly in the context of organizing a systemic regulator. Because if we are unaware, if you remain, you know, opaque, it is hard for us, I think, to make a reasoned judgment about who should have responsibilities, what could be the lines of communications.

I know Governor Kohn and his colleagues are working on this report.

Mr. COLE. Yes.

Senator REED. I would hope it would be public.

Let me ask another question, and it comes from the GAO report, which is the comment and the conclusion that in many respects you are captives of the information of the organization you are regulating, that you have to rely to a certain degree on their models, their information. And in some cases, I think talking with respect to counterparty risk, there are intuitions about the creditworthiness of counterparties. Is that a fair summary of your conclusions, Ms. Williams?

Ms. WILLIAMS. Basically.

Senator REED. Let me begin with Dr. Sirri and work the other way, which is, you know, being a captive to information to systems to model sometimes does not give you the leverage you need to take action. Is that, one, accurate? And, two, how do you change that?

Mr. SIRRI. I think there is an element of accuracy to that, but I think there are tools available to us as regulators. Let me give you a specific instance.

You are right, a particular complex financial firm will develop a model for risk, but they will have a process around that model for risk. And we care about the processes and the robustness of the processes and controls. So, for example, a model for risk is developed. Who validates it? Who verifies it? Who runs that model?

If they report to the trading desk whose assets they are pricing, that is not helpful and that is problematic.

If they report to an independent third-party that perhaps reports directly to the CFO or a risk officer, much stronger structure, gives you some comfort.

Again, let me take a second one, a price verification group. You may have a firm that trades assets, but they have problems valuing assets, as you do when liquidity dries up. When valuations are struck, how are those valuations struck? There may be a model. Who validates the model? And how do you resolve disputes? If the trader says it is worth more than the risk person says it is worth, how do you resolve that? Is there a process where it could go up to the audit committee? And if it goes to the audit committee, does the After Action Report—the phrase you used—for that instance, does that go to the board of directors? Such processes, if they are in place, tell you that that firm is taking their job seriously.

Senator REED. I would presume, and correct me, that those procedures, those appropriate procedures you described, were not being deployed very successfully at Bear Stearns or Lehman Brothers. Were you aware of kind of those deficiencies contemporaneously with their——

Mr. SIRRI. I do not want to comment on any one firm, but what I will say is that there was considerable variation across the firms, especially with—let us take that same point, pricing. And one thing we saw—and this is mentioned—issues like this are dealt with in the Senior Supervisors report that the New York Fed led. The stronger your governance, the stronger your controls, it turns out the better you probably weathered the storm. The best-run firms had good processes, and some of the firms that got into the most trouble had distinct weaknesses. It varied from firm to firm.

Senator REED. Just to follow up, the firms that you saw, and some of which have failed, did you note those weaknesses? Did you communicate those weaknesses to the board? It goes to the essence

of many of the questions we have raised. You know, making the diagnosis that you are ill and then not treating the patient is, you know, malpractice. What do you think?

Mr. SIRRI. We had escalation procedures, and we used them. I do not want to come here and tell you that every time we did it perfectly. But I personally met with audit committee members when I felt that there was an issue that was not being resolved properly. But I do not want to overstate and say in each way we escalated as far as we should have looking back. We probably should have done more at times.

Senator REED. Mr. Polakoff, same general line of questions about the reliance upon internal models, the data of the company, sort of captive of what they are doing versus being—having the resources to leverage appropriately behavior.

Mr. POLAKOFF. Senator, I would say that there is an element of truth to that statement in the report, but it probably does not capture the entire universe. What we do and we do very well is put boots on the ground. We have examiners that go onsite from one large institution to another large institution. And while there may be a stable—and there is a stable examiner in charge, we send specialists from institution to institution, which allows a horizontal review, which allows an assessment of best practices. So whether it is modeling, whether it is pricing, whether it is risk factors, we do not silo the examination approach. And that is very helpful in addressing these kind of issues. That is number one.

Number two, we look to the outside parties, so whether it is the external auditors, whether it is the external accountants, we work with them on models, because they also bring a similar expertise of looking horizontally across a number of institutions for best practices in a number of areas.

And then, number three, like Erik said, we look at the corporate governance of the institution itself; how is it structured, how robust is the risk management committee, how robust is the audit committee as part of the board, how are the reporting lines handled.

Each of those three areas, I think, allows us to very independently assess and judge whether it is the risk models or other factors.

Senator REED. Having listened to that, it is, I think, very insightful, and it seems to be a great approach. It just does not seem to have worked in the case of some of the institutions that you regulated. What would you point—that was not the approach that was being used in 2004, 2005, and 2006? Or it was an approach, but something else undermined it?

Mr. POLAKOFF. It was the approach. Senator, the one common theme that all of us see is an economic cycle that was unprecedented in its deterioration. All of our institutions, all of our risk management practices, all of our examination approaches work well, but it is difficult to look at all the risk models and stress them to unprecedented degrees and then require institutions to operate within those stress models.

You know, in hindsight, we should have predicted a little better in 2004 and 2005 what the economy was going to look like now, but the economy we are operating in now has an absolute direct effect on the performance.

Senator REED. Well, let me raise—because this has been publicly discussed. I think we actually discussed it last week. In 2005, the Financial Products Division of AIG concludes that mortgage-backed securities are too risky a bet. At the same time, the securities lending operation decides that they want to take the cash that they are getting and invest it decisively in these types of securities.

You know, where was the risk assessment at the enterprise, as you described it? And where was the OTS to say, wait a second, you cannot have two contradictory approaches based upon, one, this is the best investment, and, two, this is the worst investment?

Mr. POLAKOFF. So, Senator, you are right, and you identified what is either a hole or an overlap, depending on one's view. Those activities, as you remember, were regulated by the State insurance commissioners. So under Gramm-Leach-Bliley, the umbrella regulator typically will defer to the functional regulator to assess the risks and then report up to the umbrella regulator.

Senator REED. But, you know, it goes back to the question I raised before, to which I think you affirmatively responded, that in terms of overall risk mechanisms or risk compliance, that it was clear that the umbrella regulator had that responsibility. And here, if you had communicated with the supervisor and they had indicated that this was the investment pattern of the securities lending—their regulated insurance part, it would have seemed to have raised a huge red flag. You both cannot be right.

Mr. POLAKOFF. Senator, I can assure you that there was ample communication between OTS in its umbrella responsibility and the functional regulators. But you are identifying an absolute inconsistency, which is, Why did we stop one function from performing that kind of activity? And why did another functional regulator allow its entities to move forward with it? There has to be a postmortem on what broke down in that process.

Senator REED. Yes. Mr. Long, the same sort of set of issues about reliance upon information and being a captive of the regulated entity.

Mr. LONG. Well, I agree with what Scott said. I am not going to repeat it. I think we have ample authority to take whatever action we need. I think it is an oversimplification to say that this was a modeling problem. If you go back to the last time we went through this and you talk to the CEOs that went through this back in the late 1980s and early 1990s, they are going to tell you there are two things that got them: one was the concentrations, and number two, mitigating the policy overrides on the underwriting.

Quite frankly, I think that is really the center of this thing. This was not that we missed a bunch of models. Clearly, the banks were not modeling in their tail risk that there would be a complete shutdown of the liquidity across the system. And that was a problem with their models.

But this goes to basic underwriting, and it goes to basic concentration risk. They had too much of a bad deal, and that has compounding effects on liquidity, and on capital. And when the global liquidity market shut down, they had a real problem.

So, yes, we look at all of it. We look at corporate governance. We look at underwriting. We look at all of the risk areas. And, clearly, we look at modeling, too. We have rigorous stress testing around

those models. And, quite frankly, a lot of people missed it—they would stress tail risk in the company. They did not stress tail risk across the world.

Senator REED. Mr. Cole, briefly, if you could, please. I have additional questions.

Mr. COLE. Indeed, Senator, we clearly, as umbrella oversight supervisors, rely significantly on the functional regulators. I will say, though, that in terms of really doing our job, if we sense that there are deficiencies and need to do more than the functional regulator is doing, we do reserve the ability, I think—under Gramm-Leach-Bliley, in fact, by authority to go in and do more.

Senator REED. Ms. Williams, you talked about and we have had a discussion about communicating concerns, looking at regulatory structures, looking at the governance, *et cetera.* But there is another way sort of to get the message across to the marketplace, and that is enforcement action. That is public enforcement action that is clear to everyone that there is not only a particular situation, but a category of situations that regulators are concerned about.

Did you touch upon that in your report about the—or your review about the follow-up enforcement, any follow-up enforcement, official enforcement actions, rather than informal discussions?

Ms. WILLIAMS. I think we did touch on the process and the range of options, and the fact that with the banking regulators, in particular, there was a tendency not to pursue formal public actions, formal public enforcement actions. It has to do with the fact that it does become public and that can have an adverse impact on an open bank.

Senator REED. Can I—can you cite a situation, Dr. Sirri, where the SEC took a formal enforcement action with respect to the risk practices of any of the regulated entities?

Mr. SIRRI. I am not sure I can cite a public action, something that has happened and been closed.

I will cite something that is public. I do not know the current list, but a number of months ago we stated how many cases we had in progress on matters related to subprime mortgages. Now subprime mortgages run the gamut, the cases from issues about origination through issues related to other things within large firms. It would not surprise me, and it may be possible, I honestly do not know, that there might be something related in there. But I truly do not know. And even if I did, I should not comment.

Senator REED. Mr. Polakoff?

Mr. POLAKOFF. Absolutely, Senator. We took public enforcement action against AIG regarding some of its inappropriate lending.

Senator REED. No, I am talking about the issue of risk assessment, risk management, the issues that have been the subject of this GAO report?

Mr. POLAKOFF. I cannot—I am not sure about all of the specifics from the GAO report, but I think Ms. Williams said that for some of the larger institutions the regulators were shy in pursuing formal enforcement action because it was public. And I would like to suggest that that would not be an accurate statement, at least from an OTS perspective.

Senator REED. And what actions did you take with respect to AIG?

Mr. POLAKOFF. It was a cease and desist order. We took a cease and desist order against a large institution on the West Coast for BSA-related problems. And these are all formal and public. I do not think any of the banking regulators would shy away from taking formal enforcement action because it is public. We do not shy away because it is public. We do not shy away even when an institution is trying to raise capital. We have to do the right thing from an enforcement action perspective.

Senator REED. Mr. Long, your view?

Mr. LONG. Congressman, we have taken both formal and informal enforcement actions, and we use them regularly.

But let me clarify something because I think it is important to this point. Congress specifically gave the banking regulators specific authority to either do a series of informal actions or a series of formal actions. And you know, in some cases, we choose to go informal and we go non-public.

I want to assure you that that is no less rigorous than formal action. I have been in the boardroom for the signings of many informal documents throughout my career and recently. And I can assure you that the environment in that room in the signing of the informal documents can be a career-altering experience for the management of that firm.

The fact that it is informal does not mean that it is not serious and not taken seriously.

Senator REED. I am not suggesting that these are not serious actions and you are not serious about your actions. It is just that many times an action which is publicized gets the attention of more people than just the people in the boardroom. And behaviors change not just within that boardroom of that organization but throughout the system.

Mr. LONG. Senator, that is a good point and we look at every action that we take and we weigh the pros and cons. We feel like we use both effectively. But we do utilize both and we do it regularly.

Senator REED. Mr. Cole?

Mr. COLE. Yes, with regard to the BSA situation that I mentioned earlier, that was a formal public action. I would tend to agree very much with Mr. Long in terms of figuring out what the most effective approach is given the management situation. And if we can effect change by going directly to the management and accomplishing that, that is what we would tend to do rather than taking the next step of going to a formal action.

Senator REED. Well, I do not think there is a—this is so specific of a situation that you have to have some deference to regulators. But going to the core issue we have had of just the perception, I think, that was growing throughout the community of regulators that risk systems, risk compliance, attention to risk was not being emphasized enough, and then trying to deal with it on a case-by-case quietly, did not seem to work. I think that might be one of the conclusions we draw. Not to say you did not have the authority to do it or your judgment was—but it just did not seem to work.

I want to thank you. I want to thank, again, Ms. Williams and her colleagues for, I think, a very good report. I want to thank you for questions and we will continue to probe all of these issues as we go forward.

Thank you very much. The hearing is adjourned.

[Whereupon, at 5:09 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Securities, Insurance, and Investments, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Wednesday, March 18, 2009

FINANCIAL REGULATION

Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions

Statement of Orice M. Williams, Director
Financial Markets and Community Investment

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GAO-09-499T

March 2009

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Highlights

Highlights of GAO-09-499T, a testimony to the Subcommittee on Securities, Insurance and Investments, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

FINANCIAL REGULATION

Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions

Why GAO Did This Study

Financial regulators have an important role in assessing risk management systems at financial institutions. Analyses have identified inadequate risk management at large, complex financial institutions as one of the causes of the current financial crisis. The failure of the institutions to appropriately identify, measure, and manage their risks has raised questions not only about corporate governance but also about the adequacy of regulatory oversight of risk management systems.

GAO's objectives were to review (1) how regulators oversee risk management at these institutions, (2) the extent to which regulators identified shortcomings in risk management at certain institutions prior to the summer of 2007, and (3) how some aspects of the regulatory system may have contributed to or hindered the oversight of risk management. GAO built upon its existing body of work, evaluated the examination guidance used by examiners at U.S. banking and securities regulators, and reviewed examination reports and work papers from 2006-2008 for a selected sample of large institutions, and horizontal exams that included additional institutions.

In January 2009, GAO designated the need to modernize the financial regulatory system as a high risk area needing congressional attention. Regulatory oversight of risk management at large, financial institutions, particularly at the holding company level, should be considered part of that effort.

View GAO-09-499T or key components. For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The banking and securities regulators use a variety of tools to identify areas of risk and assess how large, complex financial institutions manage their risks. The banking regulators–Federal Reserve, Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—and securities regulators—Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—use somewhat different approaches to oversee risk management practices. Banking examiners are assigned to continuously monitor a single institution, where they engage in targeted and horizontal examinations and assess risks and the quality of institutions' risk management systems. SEC and FINRA identify areas of high risk by aggregating information from examiners and officials on areas of concern across broker-dealers and by monitoring institutions. SEC and FINRA conduct discrete targeted and horizontal examinations. The banking regulators focused on safety and soundness, while SEC and FINRA tended to focus on compliance with securities rules and laws. All regulators have specific tools for effecting change when they identify weaknesses in risk management at institutions they oversee.

In the examination materials GAO reviewed for a limited number of institutions, GAO found that regulators had identified numerous weaknesses in the institutions' risk management systems before the financial crisis began. For example, regulators identified inadequate oversight of institutions' risks by senior management. However, the regulators said that they did not take forceful actions to address these weaknesses, such as changing their assessments, until the crisis occurred because the institutions had strong financial positions and senior management had presented the regulators with plans for change. Regulators also identified weaknesses in models used to measure and manage risk but may not have taken action to resolve these weaknesses. Finally, regulators identified numerous stress testing weaknesses at several large institutions, but GAO's limited review did not identify any instances in which weaknesses prompted regulators to take aggressive steps to push institutions to better understand and manage risks.

Some aspects of the regulatory system may have hindered regulators' oversight of risk management. First, no regulator systematically looks across institutions to identify factors that could affect the overall financial system. While regulators periodically conducted horizontal examinations on stress testing, credit risk practices, and risk management for securitized mortgage products, they did not consistently use the results to identify potential systemic risks. Second, primary bank and functional regulators' oversee risk management at the level of the legal entity within a holding company while large entities manage risk on an enterprisewide basis or by business lines that cut across legal entities. As a result, these regulators may have only a limited view of institutions' risk management or their responsibilities and activities may overlap with those of holding company regulators.

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to participate in today's hearing on regulators' oversight of risk management at large, complex, financial institutions. As you know, financial regulators have a role in assessing the risk management systems at the financial institutions they supervise. This oversight is a responsibility of both federal regulatory agencies, including the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Securities and Exchange Commission (SEC), and of self-regulatory organizations, such as the Financial Industry Regulatory Authority (FINRA). Several significant analyses of the current financial crisis, which has threatened the stability of the financial system and led to the insolvency of some large U.S. financial institutions, have identified inadequate risk management at large financial institutions as one of the causes of the crisis.[1] Major institutions across the financial sector—Lehman Brothers, Washington Mutual, and Wachovia—have failed or been rescued at the last moment by mergers and acquisitions, and the factors that led to these failures such as poor underwriting standards for mortgages and a lack of understanding of the risks posed by some structured products, as well as the failures themselves, have led to instability of the financial system in the United States. The failures of these institutions to appropriately identify, measure, and manage their risks have raised serious questions about the adequacy of the regulators' oversight of risk management. Moreover, these failures raise a number of questions about what lessons can be learned from the current crisis that should be considered as Congress and the Administration begin to rethink the current financial regulatory system.

My statement today focuses on our review of regulators' oversight of risk management systems at a limited number of large, complex financial institutions (initiated at the request of Chairman Reed) as well as our past work on the federal regulatory system. Specifically, I will discuss (1) how

[1]Senior Supervisors Group, *Observation on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008; The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, March 13, 2008; Financial Stability Forum *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 7, 2008; and Basel Committee on Banking Supervision: The Joint Forum, *Cross-sectoral review of group-wide identification and management of risk concentrations*, April 2008. Institute of International Finance, *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Industry Response to the Market Turmoil of 2007-2008*, July 2008.

regulators oversee risk management at large financial institutions, (2) the extent to which regulators identified shortcomings in risk management at selected institutions prior to the beginning of the financial crisis in the summer of 2007, and (3) how some aspects of the regulatory system may have contributed to or hindered the oversight of risk management.

To prepare for this testimony, we built upon our existing body of work on regulatory oversight of risk management.[2] We evaluated the examination guidance used by examiners at the Federal Reserve, OCC, OTS, and SEC. We also conducted a literature review to identify good risk management practices. We identified and used as criteria The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Enterprisewide Risk Management—Integrated Framework* and several analyses of risk management as they relate to the current financial crisis including the Institute of International Finance's (IIF) *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations* and the Senior Supervisor Group's *Observations on Risk Management Practices During Recent Turbulent Times*. Finally, for the the period 2006-2008, we reviewed the authorities under which the regulators exercise oversight of risk management, examination reports, and workpapers supporting these reports for a small number of large financial institutions that we selected. The results cannot be projected to the universe of large complex institutions but rather provide examples of risk management oversight at the selected institutions. In this regard, I note that the statutory authority providing for GAO audits of the federal bank regulators generally prohibits GAO from disclosing regulatory nonpublic information identifying an open bank. Therefore, we will not disclose the banking institutions included in our study or detailed information obtained from the examinations or interviews with the examination staff.

We conducted this work from December 2008 to March 2009 in accordance with generally accepted government auditing standards. Those

[2]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007); *Risk-focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, GAO/GGD-00-48 (Washington, D.C.: Jan. 24, 2000); *Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk*, GAO/GGD-98-153 (Washington, D.C.: July 20, 1998); *Financial Derivatives: Actions Taken or Proposed Since May 1994*, GAO/GGD/AIMD-97-8 (Washington, D.C.: Nov. 01, 1998) GAO/GGD/AIMD-97-8; and *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133, (Washington, D.C.: May 18, 1994).

standards require that we plan and perform the audit to obtain sufficient evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In Summary

The Federal Reserve, OCC, OTS, and SEC maintain continuous contact with large, complex institutions, using a risk-based examination approach that aims to identify areas of risk and assess these institutions' risk management systems but the approaches of banking and securities regulators varies somewhat across regulators. The banking regulators (Federal Reserve, OCC, and OTS) use a combination of supervisory activities, including informal tools and examination-related activities to assess the quality of risk management. For example, bank examiners review the activities, products, and services that an institution engages in to identify risks and then through continuous monitoring and targeted examinations assess how the institution manages those risks. Banking examiners use the information they gather to assign a rating that, among other things, includes an assessment of the quality of the institutions' risk management systems including its governance and policies. The Federal Reserve and OCC have detailed risk assessment frameworks or processes. Both OCC and the Federal Reserve conduct a number of targeted examinations. SEC's and FINRA's risk management assessment of broker-dealers primarily relies on discrete targeted examinations to determine whether institutions are in compliance with regulatory rules and securities laws. Generally, all the regulators look at risk management at the institutional level, but they also perform horizontal examinations—coordinated supervisory reviews of a specific activity, business line, or risk management practice across a group of peer institutions. When bank regulators identify weaknesses in risk management at an institution, they have a number of informal and formal supervisory tools they can use for enforcement and to effect change.[3] Similarly, SEC and FINRA have specific tools for effecting risk management improvements that are used when institutions are not in compliance with specific rules or regulations.

[3]Informal enforcement actions include commitment letters, memoranda of understanding, and for bank regulators safety and soundness plan. Formal actions are authorized by statute, are generally more severe, and are disclosed to the public. Formal actions include consent orders, cease and desist orders and formal written agreements, among others.

In the examination materials we reviewed, we found that regulators had identified numerous weaknesses in the institutions' risk management systems prior to the beginning of the financial crisis; however, regulators did not effectively address the weaknesses or in some cases fully appreciate their magnitude until the institutions were stressed. For example,

- Some regulators found that institutions' senior management oversight of risk management systems had significant shortcomings, such as a lack of a comprehensive means to review enterprisewide risks, yet some regulators gave the institutions satisfactory assessments until the financial crisis occurred.

- Regulators identified other risk management weaknesses, such as the testing and validation of models used to assess and monitor risk exposures and price complex instruments. For example, some regulators found that institutions had not tested the assumptions in models used to evaluate risks—such as the likelihood of a borrower to default—but, for at least one institution, examiners did not prohibit the institutions from using untested models nor did they change their overall assessment of the institutions' risk management program based on these findings.

- In a 2006 review, the Federal Reserve found that none of the large, complex banking institutions it reviewed had an integrated stress testing program that incorporated all major financial risks enterprisewide, nor did they test for scenarios that would render them insolvent.

In these instances, regulators told us that they did not fully appreciate the risks to the institutions under review or the implications of the identified weaknesses for the stability of the overall financial system. One regulator told us it was difficult to identify all risk management weaknesses until these systems became stressed by the financial crisis.

Some aspects of the regulatory system may have hindered regulators' oversight of risk management. One is that no regulator systematically and effectively looks across all large, complex financial institutions to identify factors that could have a destabilizing affect on the overall financial system. As a result, both banking and securities regulators continue to assess risk management primarily on an individual institutional level. Even when regulators perform horizontal examinations across institutions in areas such as stress testing, credit risk practices, and the risks of structured mortgage products, they do not consistently use the results to identify potential systemic risks. In addition, in 2005, when the Federal

Reserve implemented an internal process to evaluate financial stability issues related to certain large financial institutions, it did not consider risks on an integrated basis and, with hindsight, we note that it did not identify in a timely manner the severity of the risks that ultimately led to the failure or near failure of some of these institutions and created severe instability in the overall financial system. Another aspect of the regulatory system that hinders regulators' oversight of risk management, by creating areas of overlap or limiting their view of risk management, comes from primary bank and functional regulators— such as the regulator of a broker-dealer—overseeing risk management at the level of a legal entity within a holding company that owns a number of subsidiary entities. While these regulators focus on depositories or broker-dealers, large financial institutions manage risks on an enterprisewide basis or by business lines that cut across legal entities. To the extent that a primary bank or functional regulator concentrates on the risks of a legal entity within an enterprise, the regulator will have a limited view of how the enterprise as a whole manages risk. On the other hand, if the regulator reviews risks outside the legal entity, it may be duplicating the oversight activities of other regulators including the holding company regulator. Finally, when a financial institution manages risks such as market risk across the depository and broker dealer, the primary bank and broker-dealer regulators may be performing duplicative oversight of certain functions as well.

Background

Financial institutions need systems to identify, assess, and manage risks to their operations from internal and external sources. These risk management systems are critical to responding to rapid and unanticipated changes in financial markets. Risk management depends, in part, on an effective corporate governance system that addresses risk across the institution and also within specific areas of risk, including credit, market, liquidity, operational, and legal risk.[4] The board of directors, senior

[4]Credit risk is the potential for financial losses resulting from the failure of a borrower or counterparty to perform on an obligation. Market risk is the potential for financial losses due to the increase or decrease in the value or price of an asset or liability resulting from broad movements in prices, such as interest rates, commodity prices, stock prices, or the relative value of currencies (foreign exchange). Liquidity risk is the potential for financial losses due to an institution's failing to meet its obligations because of an inability to liquidate assets or obtain adequate funding. Operational risk is the potential for unexpected financial losses due to inadequate information systems, operational problems, and breaches in internal controls, or fraud. Legal risk is the potential for financial losses due to breaches of law or regulation that may result in heavy penalties or other costs.

management (and its designated risk-monitoring unit), the audit committee, internal auditors, and external auditors, and others have important roles to play in an effectively operating risk-management system. The different roles that each of these groups play represent critical checks and balances in the overall risk-management system.

Since 1991, the Congress has passed several laws that emphasize the importance of internal controls including risk management at financial institutions and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has issued guidance that management of financial institutions could use to assess and evaluate its internal controls and enterprisewide risk management.

- Following the savings and loan crisis in the 1980s, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) strengthened corporate governance in large U.S. banks and thrifts. FDICIA required management to annually assess its system of internal control over financial reporting and the external auditors to attest to management's assertions. The corporate governance model established under FDICIA emphasized strong internal control systems, proactive boards of directors, and independent, knowledgeable audit committees.

- During 1992, and with a subsequent revision in 1994 COSO issued its Internal Control – Integrated Framework. The COSO Framework set out criteria for establishing key elements of corporate governance, especially the "tone at the top." The framework also set forth the five components of an effective system of internal control: control environment, risk assessment, control activities, information and communication, and monitoring.

- With the failures of Enron and WorldCom, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) which required managements of public companies to assess their systems of internal control with external auditor attestations, though the implementation for smaller public companies has been gradual and is not yet complete. Under section 404 of SOX, the SEC required that management identify what framework it used to assess the system of internal control over financial reporting. Though it did not mandate any particular framework, the SEC recognized that the COSO Framework satisfied the SEC's own criteria and allowed its use as an evaluation framework.

- In 2004, COSO issued Enterprise Risk Management – Integrated Framework (ERM Framework), though it is not a binding framework for any particular entity or industry. The ERM Framework, which

encompasses the previous internal control framework, establishes best practices and expands the criteria and tools that management can use to assess whether it has an effective risk management system. The framework encourages the board of directors and senior management, in their corporate governance roles, to set the risk appetite of the entity, which is the amount of risk the entity is willing to accept in its overall strategy. Management further sets risk objectives to achieve the entity's goals and sets risk tolerances to ensure that the risk appetite is not exceeded.

Regulators also have a role in assessing risk management at financial institutions. In particular, oversight of risk management at large financial institutions is divided among a number of regulatory agencies. The Federal Reserve oversees risk management at bank holding companies and state member banks that are members of the Federal Reserve System; OTS oversees thrift holding companies and thrifts; SEC and FINRA oversee risk management at SEC-registered U.S. broker-dealers; and OCC oversees risk management at national banks.

The Federal Reserve and OTS have long had authority to supervise holding companies. The Federal Reserve's authority is set forth primarily in the Bank Holding Company Act of 1956, which contains the supervisory framework for holding companies that control commercial banks. OTS's supervisory authority over thrift holding companies is set forth in the Home Owners Loan Act. In the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress expanded the range of permissible holding company activities and affiliations and also set forth restrictions and guidance on how those companies should be supervised. However, Congress did not clearly express the aims of holding company supervision. GLBA authorizes the Federal Reserve and OTS to examine the holding company and each subsidiary in order to: (a) inform the regulator of "the nature of the operations and financial condition" of the holding company and its subsidiaries; and (b) inform the regulator of the financial and operational risks within the holding company system that may threaten the safety and soundness of the holding company's bank subsidiaries and the systems for monitoring and controlling such risks; and (c) monitor compliance with applicable federal laws. On the other hand, GLBA specifies that the focus and scope of examinations of holding companies and any of their subsidiaries shall "to the fullest extent possible" be limited to the holding company and "any subsidiary that could have a materially adverse effect on the safety and soundness of a depository institution subsidiary" due to the size, condition or activities of the nonbank subsidiary or the nature or size of transactions between that subsidiary and the banking subsidiary. In

our work over the years, we have encountered a range of perspectives on the focus of holding company examinations, some of which emphasize the health of the depository institution as the primary examination focus and some of which look more expansively to the holding company enterprise under certain conditions.

In addition to the provisions generally applicable to holding company supervision, GLBA also limits the circumstances under which both holding company regulators and depository institution regulators may examine functionally regulated subsidiaries of bank holding companies, such as broker-dealers. Gramm-Leach-Bliley permits holding company regulators to examine functionally regulated subsidiaries only under certain conditions, such as where the regulator has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated bank or that an examination is necessary to obtain information on financial and operational risks within the holding company system that may threaten an affiliated bank's safety and soundness. The examination authority of depository institution regulators permits the examination of bank affiliates to disclose fully an affiliate's relations with the bank and the effect of those relations on the bank. However, with respect to functionally regulated affiliates of depository institutions, Gramm-Leach-Bliley imposes the same restraint on the use of examination authority that applies to OTS and the Federal Reserve with respect to holding companies. That is, Gramm-Leach-Bliley instructs that bank and holding company supervisors generally are to limit the focus of their examinations of functionally regulated affiliates and, to the extent possible, are to reply on the work of primary bank and functional regulators that supervise holding company subsidiaries. An example of this situation would be where a holding company has a national bank or thrift subsidiary and a broker-dealer subsidiary. Under GLBA, the holding company regulator is to rely "to the fullest extent possible" on the work of primary bank and functional regulators for information on the respective entities. Also under GLBA, bank supervisors are similarly limited with respect to affiliates of the institutions they supervise.

SEC's authority to examine U.S. broker-dealers is set forth in the Securities and Exchange Act of 1934. Under the 1934 act, SEC's examination authority over broker-dealers does not permit SEC to require examination reports on affiliated depository institutions, and if SEC seeks non-routine information about a broker-dealer affiliate that is subject to examination by a bank regulator, SEC must notify and generally must consult with the regulator regarding the information sought. Oversight of U.S. broker-dealers is performed by SEC's Division of Trading and Markets

(Trading and Markets) and Office of Compliance, Inspections, and Examinations (OCIE). In addition, SEC delegates some of its authority to oversee U.S. broker-dealers to FINRA, a self-regulatory organization that was established in 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

Under the alternative net capital rule for broker-dealers, from 2005-2008, SEC conducted a voluntary consolidated-supervised entity program under which five investment bank holding companies voluntarily consented to having SEC oversee them on a consolidated basis.[5] Today, no institutions are subject to SEC oversight at the consolidated level, but several broker-dealers within bank holding companies are still subject to the alternative net capital rule on a voluntary basis.[6]

Regulators Identify Areas of Risk and Examine Risk Management Systems, but Their Specific Approaches Vary

The Federal Reserve, FINRA, OCC, OTS, and SEC each identify areas of risk relating to the large, complex financial institutions they oversee and examine risk management systems at regulated institutions. However, the banking and securities regulators take different approaches. The banking regulators (Federal Reserve, OCC, and OTS) use a combination of supervisory activities, including informal tools and examination-related activities to assess the quality of institutional risk management systems and assign each institution an annual rating. SEC and FINRA aggregate information from officials and staff of the supervised institutions throughout the year to identify areas of concern across all broker-dealers. For those broker-dealers covered by the alternative net capital rule, SEC and FINRA emphasize compliance with that rule during target examinations. Under the CSE program, SEC continuously supervised and monitored the institutions in the program.

[5]17 C.F.R. § 240.15c3-1.

[6]Bear Stearns was acquired by JPMorgan Chase, Lehman Brothers failed, Merrill Lynch was acquired by Bank of America, and Goldman Sachs and Morgan Stanley have become bank holding companies.

Banking Regulators Use a Number of Supervisory Activities for Assessing Risk Management at Large, Complex Institutions

Banking regulators carry out a number of supervisory activities in overseeing risk management of large, complex financial institutions. To conduct on-site continuous supervision, banking regulators often station examiners at specific institutions. This practice allows examiners to continuously analyze information provided by the financial institution, such as board meeting minutes, institution risk reports/management information system reports, and for holding company supervisors supervisory reports provided to other regulators, among other things. This type of supervision allows for timely adjustments to the supervisory strategy of the examiners as conditions change within the institution. Bank examiners do not conduct a single annual full-scope examination of the institution. Rather, they conduct ongoing examinations that target specific areas at the institutions (target examinations) and annually issue an overall rating on the quality of risk management.[7]

Each regulator had a process to assess risk management systems. While each included certain core components, such as developing a supervisory plan and monitoring, the approach used and level of detail varied.

- The Federal Reserve's guidance consisted of a detailed risk assessment program that included an analytic framework for developing a risk management rating for holding companies. Unlike most bank regulatory examination guidance, this guidance is not yet publicly available. According to Federal Reserve officials, the primary purpose of the framework is to help ensure a consistent regulatory approach for assessing inherent risk and risk management practices of large financial institutions (the holding company) and make informed supervisory assessments. The Federal Reserve program for large complex banking organizations is based on a "continuous supervision" model that assigns a dedicated team to each institution. Those teams are responsible for completing risk assessments, supervisory plans, and annual assessments. The risk assessment includes an evaluation of inherent risk (credit, market, operational, liquidity, and legal and compliance) and related risk

[7]Depository institutions receive what is known as a CAMELS rating. The CAMELS rating is defined as Capital Adequacy-C, Asset Quality-A, Management-M, Earnings-E, Liquidity-L, and S-Sensitivity to Market Risk. The Federal Reserve issues what is known as a RFI/ C(D) rating. It is defined as Risk Management-R, Financial Condition-F, Potential impact of the parent company and nondepository subsidiaries on the subsidiary depository institutions-I, Composite Rating-C and Depository Institution-D. The D rating subcomponent is the primary banking rating. In late 2007, OTS changed its guidance related to the CORE competencies—Capital, Organization, Relationship, and Earnings. In a rule finalized on January 1, 2008, OTS changed the "R" to Risk Management.

management and internal controls. The risk assessment is often the starting point for the supervisory plan as well as a supporting document for the annual assessment.

The annual assessment requires the dedicated team to evaluate and rate the firm's risk management, its financial condition, and the potential impact of its non-depository operations on the depository institution. To apply the risk or "R" rating, the examiner must consider (1) board of director and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and management information system; and (4) internal controls for each of the risk areas.[8] The examiners then provide an overall "R" rating for the institution.

- OCC's onsite examiners assess the risks and risk management functions at large national banks using a detailed approach that is similar to that used by the Federal Reserve's examiners. The core assessment is OCC's primary assessment tool at the institutional level. According to OCC's guidance, its examiners are required to assess the quality, quantity, and overall direction of risks in nine categories (strategic, reputation, credit, interest rate, liquidity, price, foreign currency translation, transaction, and compliance). To determine the quality of risk management, OCC examiners assess policies, processes, personnel, and control systems in each category. This risk assessment is included in the examination report that is sent to the bank's board of directors. OCC also provides a rating based on the bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (the CAMELS rating), all of which can be impacted by the quality of a risk management system. OCC's supervisory

[8]According to Federal Reserve documentation, Board of Director and Senior Management Oversight evaluates the adequacy and effectiveness of its understanding and management of risk inherent in the BHC's activities, as well as the general capabilities of management. It also includes considerations of management's ability to identify, understand, and control the risk undertaken by the institution, to hire competent staff, and to respond to change in the institution's risk profile or innovations in the banking sector. Policies, Procedures, and Limits evaluates the adequacy of policies, procedures, and limits given the risk inherent in the activities of the consolidated organization and the organization's stated goals and objectives. The analysis may include a consideration of the adequacy of the institution's accounting and risk-disclosure policies and procedures. Risk monitoring and management information system reviews the assumption, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities. Internal controls and audits are evaluated relating to the accuracy of financial reporting and disclosure and the strength and influence, within the organization, of the internal audit team. The analysis will include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

strategy or plan for targeted examinations is developed from this Risk Assessment System.[9] Examiners can change a bank's ratings at any time if the bank's conditions warrant that change. Targeted examinations are a key component of OCC's oversight. Based on the materials we reviewed covering the last 2 years, OCC conducted 23 targeted examinations in 2007 and 45 in 2008 at a large national bank. These examinations focused on specific areas of risk management, such as governance, credit, and compliance.

- Recently revised OTS guidance requires its examiners to review large and complex holding companies to determine whether they have a comprehensive system to measure, monitor, and manage risk concentrations, determine the major risk-taking entities within the overall institution, and evaluate the control mechanisms in place to establish and monitor risk limits. OTS's recently revised guidance on assessing risk management includes a risk management rating framework that is similar to the Federal Reserve's. It includes the same risk management rating subcomponents—governance/board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems, and internal controls—and criteria that the Federal Reserve applies to bank holding companies. However, OTS considers additional risk areas, such as concentration or systemic risk. Starting in 2007, OTS used a risk matrix to document the level of 13 inherent risks by business unit. The matrix also includes an assessment of each unit's risk mitigation or risk management activities, including internal controls, risk monitoring systems, policies/procedures/limits, and governance. OTS began using the risk matrix to develop its supervisory plan. Based on our review of examination materials, OTS conducted targeted examinations on risk management in such areas as consumer lending and mortgage-backed securities.

In the last few years, the banking regulators have also conducted examinations that covered several large complex financial institutions on specific issues such as risk management (horizontal examinations). According to the Federal Reserve, horizontal examinations focus on a single area or issue and are designed to (1) identify the range of practices in use in the industry, (2) evaluate the safety and soundness of specific activities across business lines or across systemically important institutions, (3) provide better insight into the Federal Reserve's

[9]The Risk Assessment System is the assessment framework of the nine categories of risk and the risk management systems.

understanding of how a firm's operations compare with a range of industry practices, and (4) consider revisions to the formulation of supervisory policy. During the period of our review, the Federal Reserve completed several horizontal examinations on large, complex banking organizations, including stress testing and collateral management. According to Federal Reserve officials, examiners generally provide institutions with feedback that tells them generally how they are doing relative to their peers, and if any serious weaknesses were identified, these would be conveyed as well. With the Federal Reserve, OCC conducted a horizontal examination on advanced credit risk practices and OTS conducted a review across institutions for nontraditional mortgages and used the findings to issue supplemental guidance. According to an OCC official, the regulator uses the findings in horizontal reviews as a supervisory tool and to require corrective actions, as well as a means to discover information on bank practices to issue supplemental guidance.

Securities Regulators' Approaches to Assessing Risk Management Revolve around Regularly Scheduled Targeted Examinations

SEC and FINRA generally assess risk management systems of large broker-dealers using discrete, but risk-focused examinations. The focus of SEC and FINRA oversight is on compliance with their rules and the Securities and Exchange Act of 1934. Although SEC and FINRA are in continuous contact with large, complex institutions, neither SEC nor FINRA staff conduct continuous onsite monitoring of broker-dealers that involves an assessment of risks. FINRA's coordinator program is continuous supervision, albeit not on site. According to SEC and FINRA, however, they receive financial and risk area information on a regular basis from the largest firms and those of financial concern through the OCIE compliance monitoring program, the FINRA capital alert program, and regular meetings with the firms. To identify risks, they aggregate information from their officials and staff throughout the year to identify areas that may require special attention across all broker-dealers. SEC and FINRA conduct regularly scheduled target examinations that focus on the risk areas identified in their risk assessment and on compliance with relevant capital rules and customer protection rules. SEC's internal controls risk management examinations, which started in 1995, cover the top 15 wholesale and top 15 retail broker-dealers as well as a number of mid-sized broker-dealers with a large number of customer accounts. At the largest institutions, SEC conducts examinations every three years, while FINRA conducts annual examinations of all broker-dealers. According to Trading and Markets, the CSE program was modeled on the Federal Reserve's holding company supervision program, but continuous supervision was usually conducted off site by a small number of examiners, SEC did not rate risk management systems, nor use a detailed

risk assessment processes to determine areas of highest risk. During the CSE program, Trading and Markets staff concentrated their efforts on market and liquidity risks because the alternative net capital rule focused on these risks and on operational risk because of the need to protect investors. According to OCIE, their examiners focused on market, credit, operational, legal and compliance risks, as well as senior management, internal audit and new products. Because only five investment banks were subject to consolidated supervision by SEC, SEC staff believed it did not need to develop an overall supervisory strategy or written plans for individual institutions it supervised; however, OCIE drafted detailed scope memorandums for their target examinations. While no institutions are subject to consolidated supervision by SEC at this time, a number of broker-dealers are subject to the alternative net capital rule.

SEC and FINRA conduct horizontal or "sweep" examinations and, for example, have completed one for subprime mortgages. OCIE officials said that it had increased the number of these types of examinations since the current financial crisis began. Under the consolidated supervised entity program, Trading and Markets conducted several horizontal examinations aimed at discovering the range of industry practice in areas such as leveraged lending.

Banking Regulators Have a Variety of Tools to Address Risk Management Weaknesses

The banking regulators have developed guidance on how they should communicate their examination findings to help ensure that financial institutions take corrective actions. Bank regulators generally issue findings or cite weaknesses in supervisory letters or an annual examination report addressed to senior management of the financial institution. However, regulators also meet with institution management to address identified risk management weaknesses. Examples include:

- After a target examination, the Federal Reserve, OCC, OTS each prepare supervisory letters or reports of examination identifying weaknesses that financial institutions are expected to address in a timely manner. In addition to issues or findings, the Federal Reserve and OCC supervisory letters provided a specific timeframe for the institution to send a written response to the bank regulator articulating how the institution planned to address the findings. In these instances, for the files we reviewed, the institutions complied with the timeframes noted in the supervisory letter. These letters may be addressed to the board of directors or the CEO or as we found, the senior managers responsible for the program. For example, a Federal Reserve Bank addressed a recent targeted examination on a holding company's internal audit function to the chief auditor of the

holding company. Similarly, OCC addressed an examination of advanced risk management processes to a bank's chief credit officer. OTS also addressed some reports of target examinations to senior managers responsible for specific programs.

- In their supervisory letters, OCC sometimes identifies "Matters Requiring Attention," which instruct the bank to explain how it will address the matter in a timely manner. In its supervisory guidance, matters requiring attention include practices that deviate from sound governance, internal control and risk management principles that may adversely impact the bank's earning or capital, risk profile, or reputation if not addressed.[10] According to its guidance, OCC tracks matters requiring attention until they are resolved and maintains a record when these matters are resolved and closed out. OCC also includes recommendations to national banks in their supervisory letters. In addition, OCC will insert recommendations in their letters which are suggestions relating to how a bank can operate a specific program or business line more effectively.

- After the beginning of the financial crisis, the Federal Reserve issued revised examination guidance in July 2008 that established three types of findings: matters requiring immediate attention, matters requiring attention, and observations. Previously, each of the individual Federal Reserve Banks had its own approach to defining findings. Matters requiring attention and observations are similar to related practices followed by OCC. For matters requiring immediate attention, the matter is considered more urgent. According to their guidance, matters requiring immediate attention encompass the highest priority concerns and include matters that have the potential to pose significant risk to the organization's safety and soundness or that represent significant instances of noncompliance with laws and regulations.

- OTS examiners may list recommendations in the report, findings, and conclusions, but in the materials we reviewed examiners did not report these in a standard way. While members of the Board of Directors are required to sign the report of annual examination indicating that they have read the report, they are not required to submit a written response. The OTS Handbook Section 060 Examination Administration provides guidance on the use of "matters requiring board attention" or other lesser supervisory corrective actions that should be addressed in the

[10]OCC Memorandum, Matters Requiring Attention, August 8, 2005.

examination correspondence. According to OTS, matters requiring board attention and corrective actions are also tracked in its regulatory action system for follow up.

- For 2008, we reviewed one regulator's tracking report of matters requiring attention at one institution and found that only a small number of the 64 matters requiring attention relating to risk management and internal controls had been closed out or considered addressed by the end of January 2009. The examiners explained that some matters, such as institutions making adjustments to their technology framework can be time consuming. Another regulator told us that it does not track when institutions have implemented remedial actions.

- Because the banking regulators are generally on site and continuously monitoring large, complex institutions, examiners told us that a significant part of their efforts to improve risk management systems were undertaken through regularly scheduled meetings with senior management. According to Federal Reserve and OCC officials, these meetings allow opportunities for examiners to followup with management concerning actions that they expect the financial institutions to implement. A Federal Reserve examiner explained that several meetings were held with officials at a holding company concerning an internal control matter in order to help ensure that the institution was addressing the issue. For its complex and international organizations program, OTS directs its examiners to use regular meetings with senior management and periodic meetings with boards of directors and any relevant committees to effect change. OTS guidance indicates that examiners' regular meetings with senior management are designed to communicate and address any changes in risk profile and corrective actions. OTS also views annual meetings with the Board of Directors as a forum for discussing significant findings and management's approach for addressing them.

In addition to these tools, bank regulators' approval authorities related to mergers and acquisitions could be used to persuade institutions to address risk management weaknesses. For example, the Federal Reserve, OCC, and OTS are required to consider risk management when they approve bank or thrift acquisitions or mergers and could use identified weaknesses in this area to deny approvals. In addition, bank regulators have to approve the acquisition of bank charters and must assess management's ability to manage the bank or thrift charter being acquired.

SEC's Oversight Tools Are Aimed at Addressing Violations

If SEC's OCIE or FINRA examiners discover a violation of SEC or FINRA rules, the institution is required to resolve the deficiency in a timely manner. OCIE developed guidance on deficiency letters for examinations. According to SEC and FINRA staff, because SEC or FINRA rules do not contain specific requirements for internal controls, problems with internal controls generally are not cited as deficiencies. However, weaknesses in internal controls can rise to such a level as to violate other FINRA rules, such as supervision rules. Deficiencies and weaknesses are followed up on in subsequent examinations. OCIE's compliance audits require institutions to correct deficiencies and address weaknesses. OCIE staff told us that if the institutions do not address deficiencies in a timely manner, they may be forwarded to the enforcement division. For example, OCIE staff was able to discuss limit violations with one firm and required the firm to change their risk limit system to significantly reduce their limit violations—indicating senior management was taking steps to better oversee and manage their risks. Under the consolidated supervised entity program, SEC's Trading and Markets relied on discussions with management to effect change. For example, Trading and Market staff told us that they had discussions with senior management that led to changes in personnel.

Regulators Identified Weaknesses in Risk Management Systems before the Crisis but Did Not Fully Recognize the Threats They Posed

In the years leading up the financial crisis, some regulators identified weaknesses in the risk management systems of large, complex financial institutions. Regulators told us that despite these identified weaknesses, they did not take forceful action—such as changing their assessments—until the crisis occurred because the institutions reported a strong financial position and senior management had presented the regulators with plans for change. Moreover, regulators acknowledged that in some cases they had not fully appreciated the extent of these weaknesses until the financial crisis occurred and risk management systems were tested by events. Regulators also acknowledged they had relied heavily on management representations of risks.

Some Regulators Identified Weaknesses in Risk Management Systems in a Limited Number of Institutions but Did Not Take Forceful Actions to Address Them until the Crisis Began

In several instances, regulators identified shortcomings in institutions' oversight of risk management at the limited number of large, complex institutions we reviewed but did not change their overall assessments of the institutions until the crisis began in the summer of 2007.[11] For example, before the crisis one regulator found significant weaknesses in an institution's enterprisewide risk management system stemming from a lack of oversight by senior management. In 2006, the regulator notified the institution's board of directors that the 2005 examination had concluded that the board and senior management had failed to adequately oversee financial reporting, risk appetite, and internal audit functions. The regulator made several recommendations to the board to address these weaknesses. We found that the regulator continued to find some of the same weaknesses in subsequent examination reports, yet examiners did not take forceful action to require the institution to address these shortcomings until the liquidity crisis occurred and the severity of the risk management weaknesses became apparent. When asked about the regulator's assessment of the holding company in general and risk management in particular given the identified weaknesses, examiners told us that they had concluded that the institution's conditions were adequate, in part, because it was deemed to have sufficient capital and the ability to raise more. Moreover, the examiners said that senior management had presented them with plans to address the risk management weaknesses.

In another example, other regulators found weaknesses related to an institution's oversight of risk management before the crisis. One regulator issued a letter to the institution's senior management in 2005 requiring that the institution respond, within a specified time period, to weaknesses uncovered in an examination. The weaknesses included the following:

- The lack of an enterprisewide framework for overseeing risk, as specified in the COSO framework. The institution assessed risks (such as market or credit risks) on an individual operating unit basis, and was not able to effectively assess risks institutionwide.
- A lack of common definitions of risk types and of corporate policy for approving new products, which could ensure that management had reviewed and understood any potential risks.

[11]OTS does not have specific risk-based or leverage capital requirements for thrift holding companies but does require them to hold adequate capital pursuant to capital maintenance agreements.

- An institutional tendency to give earnings and profitability growth precedence over risk management.

In addition, the regulator recommended that senior management restructure the institution's risk management system to develop corporate standards for assessing risk. However, the regulator's assessment of the institution's risk management remained satisfactory during this period because senior management reported that they planned to address these weaknesses and, according to examiners, appeared to be doing so. Moreover, the examiners believed that senior management could address these weaknesses in the prevailing business environment of strong earnings and adequate liquidity. After earnings and liquidity declined during the financial crisis that began in 2007, the examiners changed their assessment, citing many of the same shortcomings in risk management that they had identified in 2005.

At one institution, a regulator noted in a 2005 examination report that management had addressed previously identified issues for one type of risk and that the institution had taken steps to improve various processes, such as clarifying the roles and responsibilities of risk assessment staff, and shortening internal audit cycles of high-risk entities in this area. Later in 2007, the regulator identified additional weaknesses related to credit and market risk management. Regulatory officials told us that weaknesses in oversight of credit and market risk management were not of the same magnitude prior to the crisis as they were in late 2007 and 2008. Moreover, examiners told us that it was difficult to identify all of the potential weaknesses in risk management oversight until the system was stressed by the financial crisis.

Some regulators told us that they had relied on management representation of risk, especially in emerging areas. For example, one regulator's targeted review risk relied heavily on management's representations about the risk related to subprime mortgages—representations that had been based on the lack of historical losses and the geographic diversification of the complex product issuers. However, once the credit markets started tightening in late 2007, the examiners reported that they were less comfortable with management's representations about the level of risk related to certain complex investments. Examiners said that, in hindsight, the risks posed by parts of an institution do not necessarily correspond with their size on the balance sheet and that relatively small parts of the institution had taken on risks that the regulator had not fully understood. Another regulator conducted a horizontal examination of securitized mortgage products in 2006 but relied

on information provided by the institutions. While the report noted that these products were experiencing rapid growth and that underwriting standards were important, it focused on the major risks identified by the firms and their actions to manage those risks as well as on how institutions were calculating their capital requirements.

Regulators Identified Weaknesses in Models Used to Calculate Risk but May Not Have Acted on These Findings

Regulators also identified weaknesses in the oversight and testing of risk models that financial institutions used, including those used to calculate the amount of capital needed to protect against their risk exposures and determine the valuation of complex products. Regulators require institutions to test their models so that the institutions have a better sense of where their weaknesses lie, and OCC developed guidance in 2000 related to model validation that other regulators consider to be the standard. OCC's guidance states that institutions should validate their models to increase reliability and improve their understanding of the models' strengths and weaknesses. The guidance calls for independent reviews by staff who have not helped to develop the models, instituting controls to ensure that the models are validated before they are used, ongoing testing, and audit oversight. The process of model validation should look not only at the accuracy of the data being entered into the model, but also at the model's assumptions, such as loan default rates.

Institutions use capital models as tools to inform their management activities, including measuring risk-adjusted performance, setting prices and limits on loans and other products, and allocating capital among various business lines and risks.[12] Certain large banking organizations have used models since the mid-1990s to calculate regulatory capital for market risk, and the rules issued by U.S. regulators for Basel II require that banks use models to estimate capital for credit and operational risks. The SEC's consolidated supervised entity program allowed broker-dealers that were part of consolidated supervised entities to compute capital requirements using models to estimate market and credit risk. In addition, institutions

[12]Economic capital models measure risks by estimating the probability of potential losses over a specified period and up to a defined confidence level using historical loss data. See GAO-07-253 *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework* (Washington, D.C.: February 15, 2007).

use models to estimate the value of complex instruments such as collateralized debt obligations (CDOs).[13]

Regulators identified several weaknesses related to financial institutions' oversight and use of risk models:

- One regulator found several weaknesses involving the use of models that had not been properly tested to measure credit risks, an important input into institutions' determinations of capital needed, but did not aggressively take steps to ensure that the firm corrected these weaknesses. In a 2006 letter addressed to the head of the institution's risk management division, the examiners reported deficiencies in models used to estimate credit risk, including lack of testing, a lack of review of the assumptions used in the models, and concerns about the independence of staff testing the models. The regulator issued a letter requiring management to address these weaknesses, but continued to allow the institution to use the models and did not change its overall assessment. Although the institution showed improvement in its processes, over time, in late 2007, examiners found that some of the weaknesses persisted. In late 2008, examiners closed the matter in a letter to management but continued to note concerns about internal controls associated with risk management.

- A horizontal review of credit risk models by the Federal Reserve and OCC in 2008 found a similar lack of controls surrounding model validation practices for assessing credit risks, leading to questions about the ability of large, complex institutions to understand and manage these risks and provide adequate capital to cushion against potential losses. For example, the review found that some institutions lacked requirements for model testing, clearly defined roles and responsibilities for testing, adequate detail for the scope or frequency of validation, and a specific process for correcting problems identified during validation.

- Before the crisis, another regulator found that an institution's model control group did not keep a complete inventory of its models and did not have an audit trail for models prior to 2000. The examiners said that they did not find these issues to be significant concerns. However, they were

[13]In a basic CDO, a group of loans or debt securities are pooled and securities are then issued in different tranches that vary in risk and return depending on how the underlying cash flows produced by the pooled assets are allocated. If some of the underlying assets defaulted, the more junior tranches—and thus riskier ones—would absorb these losses first before the more senior, less-risky tranches. Many CDOs in recent years largely consisted of mortgage-backed securities, including subprime mortgage-backed securities.

subsequently criticized for not aggressively requiring another institution to take action on weaknesses they had identified that were related to risk models, including lack of timely review, understaffing, lack of independence of risk managers, and an inability or unwillingness to update models to reflect the changing environment.

- Other regulators noted concerns about pricing models for illiquid instruments, but made these findings only as the crisis was unfolding. For example, in a 2007 horizontal review of 10 broker-dealers' exposure to subprime mortgage-related products, SEC and FINRA examiners found weaknesses in pricing assumptions in valuation models for complex financial products. They found that several of these firms relied on outdated pricing information or traders' valuations for complex financial transactions, such as CDOs. In some cases, firms could not demonstrate that they had assessed the reasonableness of prices for CDOs. Another regulator noted in a 2007 targeted examination that although management had stated that the risk of loss exposure from highly rated CDOs was remote, the downturn in the subprime mortgage market could mean that they would not perform as well as similarly rated instruments performed historically.

The Regulators Found That None of the Institutions We Reviewed Had Tested for the Effects of a Severe Economic Downturn Scenario

Because of the inherent limitations of modeling, such as the accuracy of model assumptions, financial institutions also use stress tests to determine how much capital and liquidity might be needed to absorb losses in the event of a large shock to the system or a significant underestimation of the probability of large losses. According to the Basel Committee on Banking Supervision, institutions should test not only for events that could lower their profitability, but also for rare but extreme scenarios that could threaten their solvency. In its January 2009 report, the Basel Committee emphasized the importance of stress testing, noting that it could (1) alert senior management to adverse unexpected losses, (2) provide forward-looking assessments of risk, (3) support enterprisewide communication about the firm's risk tolerance, (4) support capital and liquidity planning procedures, and (5) facilitate the development of risk mitigation or contingency plans across a range of stressed conditions.[14] Moreover, the report noted that stress testing was particularly important after long periods of relative economic and financial calm when companies might become complacent and begin underpricing risk.

[14]Basel Committee on Banking Supervision, Consultative Document: *Principles for Sound Stress Testing Practices and Supervision.* (Basel, Switzerland: January 2009).

We found that regulators had identified numerous weaknesses in stress testing at large institutions before the financial crisis. However, our limited review did not identify any instances in which an institution's lack of worst-case scenario testing prompted regulators to push forcefully for institutional actions to better understand and manage risks. A 2006 Federal Reserve horizontal review of stress testing practices at several large, complex banking institutions revealed that none of the institutions had an integrated stress testing program that incorporated all major financial risks enterprisewide, nor did they test for scenarios that would render them insolvent.. The review found that institutions were stress testing the impact of adverse events on individual products and business lines rather than on the institution as a whole. By testing the response of only part of the institution's portfolio to a stress such as declining home prices, the institution could not see the effect of such a risk on other parts of its portfolio that could also be affected. The review was particularly critical of institutions' inability to quantify the extent to which credit exposure to counterparties might increase in the event of a stressed market risk movement. It stated that institutions relied on "intuition" to determine their vulnerability to this type of risk. It also found that institutions' senior managers were confident in their current practices and questioned the need for additional stress testing, particularly for worst-case scenarios that they thought were implausible..

The 2006 review included some recommendations for examiners to address with individual institutions, and Federal Reserve officials told us that they met with institutions' chief risk officers to discuss the seriousness of the findings just before the crisis began. However, officials told us that the purpose of the review was primarily to facilitate the regulator's understanding of the full range of stress testing practices, as there was neither a well-developed set of best practices nor supervisory guidance in this area at the time. The regulatory officials also told us that these findings were used to inform guidance issued by the President's Working Group on assessing exposure from private pools of capital, including hedge funds.[15] However, this guidance focuses on testing the exposure to counterparty risks, such as from hedge funds, and not on testing the impact of solvency-threatening, worst-case scenarios. In

[15]See President's Working Group, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, February 22, 2007. The information from this horizontal review was later used in 2008 to analyze risk management practices after the crisis began in the *Senior Supervisors Group Observations on Risk Management Practices During the Recent Market Turbulence*.

hindsight, officials told us that the current crisis had gone beyond what they had contemplated for a worst-case scenario, and they said that they would probably have faced significant resistance had they tried to require the institutions to do stress tests for scenarios such as downgrades in counterparties' credit ratings because such scenarios appeared unlikely.

Other regulators raised concerns about stress testing at individual institutions, but we did not find evidence that they had effectively changed the firms' stress testing practices. In the materials we reviewed, one regulator recommended that the institution include worst-case scenarios in its testing. In a 2005 examination report, examiners noted a concern about the level of senior management oversight of risk tolerances. This concern primarily stemmed from lack of documentation, stress testing, and communication of firm risk tolerances and the extent to which these were reflected in stress tests. While the firm later took steps to document formal risk tolerances and communicate this throughout the firm, the recommendation related to stress testing remained open through 2008.

Another regulator required institutions to show that they conducted stress tests of the institution's ability to have enough funding and liquidity in response to certain events, including a credit downgrade or the inability to obtain unsecured, short-term financing. In addition, institutions were required to document that they had contingency plans to respond to these events. The regulator said that it specifically required institutions to conduct stress tests such as those based on historical events including the collapse of Long-Term Capital Management or the stock market decline of 1987. However, regulatory staff told us that the liquidity crisis of 2008 was greater than they had expected.

Regulators' Oversight of Institutions' Risk Management Systems Illustrates Some Limitations of the Current Regulatory System

In this and other work, we identified two specific shortcomings of the current regulatory system that impact the oversight of risk management at large, complex financial institutions. First, no regulator has a clear responsibility to look across institutions to identify risks to overall financial stability. As a result, both banking and securities regulators continue to assess risk management primarily at an individual institutional level. Even when regulators perform horizontal examinations across institutions, they generally do not use the results to identify potential systemic risks. Although for some period, the Federal Reserve analyzed financial stability issues for systemically important institutions it supervises, it did not assess the risks on an integrated basis or identify many of the issues that just a few months later led to the near failure of some of these institutions and to severe instability in the overall financial

system. Second, although financial institutions manage risks on an enterprisewide basis or by business lines that cut across legal entities, primary bank and functional regulators may oversee risk management at the level of a legal entity within a holding company. As a result, their view of risk management is limited or their activities overlap or duplicate those of other regulators including the holding company regulator.

Regulators Were Not Looking Across Groups of Institutions to Effectively Identify Risks to Overall Financial Stability

In previous work, we have noted that no single regulator or group of regulators systematically assesses risks to the financial stability of the United States by assessing activities across institutions and industry sectors.[16] In our current analysis of risk management oversight of large, complex institutions, we found that, for the period of the review (2006-2008), the regulators had not used effectively a systematic process that assessed threats that large financial institutions posed to the financial system or that market events posed to those institutions.

While the regulators periodically conducted horizontal examinations in areas such as stress testing, credit risk practices, and risk management for securitized mortgage products, these efforts did not focus on the stability of the financial system, nor were they used as a way to assess future threats to that system. The reports summarizing the results of these horizontal examinations show that the purpose of these reviews was primarily to understand the range of industry practices or to compare institutions rather than to determine whether several institutions were engaged in similar practices that might have a destabilizing effect on certain markets and leave the institutions vulnerable to those and other market changes, and that these conditions ultimately could affect the stability of the financial system.

Beginning in 2005 until the summer of 2007, the Federal Reserve made efforts to implement a systematic review of financial stability issues for certain large financial institutions it oversees and issued internal reports called *Large Financial Institutions' Perspectives on Risk*. With the advent of the financial crisis in the summer of 2007, the report was

[16]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009); *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Strategy*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004) and *Long-Term Capital Management, Regulators Need to Focus More Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

suspended; however, at a later time the Federal Reserve began to issue risk committee reports that addressed risks across more institutions. While we commend the Federal Reserve for making an effort to look systematically across a group of institutions to evaluate risks to the broader financial system, the *Perspectives of Risk* report for the second half of 2006 issued in April 2007 illustrates some of the shortcomings in the process. The report reviewed risk areas including credit, market, operational, and legal and compliance risk but did not provide an integrated risk analysis that looked across these risk areas—a shortcoming of risk management systems identified in reviews of the current crisis. In addition, with hindsight, we can see that the report did not identify effectively the severity and importance of a number of factors. For example, it stated that:

- There are no substantial issues of supervisory concern for these large financial institutions.
- Asset quality across the systemically important institutions remains strong.
- In spite of predictions of a market crash, the housing market correction has been relatively mild, and while price appreciation and home sales have slowed and inventories remain high, most analysts expect the housing market to bottom out in mid-2007. The overall impact on a national level will likely be moderate; however, in certain areas housing prices have dropped significantly.
- The volume of mortgages being held by institutions—warehouse pipelines—has grown rapidly to support collateralized mortgage-backed securities and CDOs.
- Surging investor demand for high-yield bonds and leveraged loans, largely through structured products such as CDOs, provided continuing strong liquidity that resulted in continued access to funding for lower-rated firms at relatively modest borrowing costs.
- Counterparty exposures, particularly to hedge funds, continue to expand rapidly.

With regard to the last point, a Federal Reserve examiner stated that the Federal Reserve had taken action to limit bank holding company exposures to hedge funds. The examiner noted that although in hindsight it was possible to see some risks that the regulators had not addressed, it was difficult to see the impact of issues they had worked to resolve.

When asked for examples of how the Federal Reserve had used supervisory information in conjunction with its role to maintain financial stability, a Federal Reserve official provided two examples that he believed illustrated how the Federal Reserve's supervisory role had influenced financial stability before the current financial crisis. First, the official said that the Federal Reserve had used supervisory information to improve the resilience of the private sector clearing and settlement infrastructure after the attacks on the World Trade Center on September 11, 2001. Second, it had worked through the supervisory system to strengthen the infrastructure for processing certain over-the-counter derivative transactions. Federal Reserve officials noted that financial stability is not the sole focus of safety and soundness supervision and that several mechanisms exist in which regulation plays a significant role with other areas of the Federal Reserve in assessing and monitoring financial stability. Federal Reserve regulators indicated that other Federal Reserve functions often consulted with them and that they provided information to these functions and contributed to financial stability discussions, working groups, and decisions both prior to and during the current crisis.

In October 2008, the Federal Reserve issued new guidance for consolidated supervision suggesting that in the future the agency would be more mindful of the impact of market developments on the safety and soundness of bank holding companies. The new guidance says, for instance, that the enhanced approach to consolidated supervision emphasizes several elements that should further the objectives of fostering financial stability and deterring or managing financial crises and help make the financial system more resilient. The guidance says that two areas of primary focus would be:

- activities in which the financial institutions play a significant role in critical or key financial markets that have the potential to transmit a collective adverse impact across multiple firms and financial markets, including the related risk management and internal controls for these activities, and

- areas of emerging interest that could have consequences for financial markets, including, for example, the operational infrastructure that underpins the credit derivatives market and counterparty credit risk management practices.

Primary Bank and Functional Regulators May Limit Their Oversight of Risk Management to Specific Legal Entities Such As Depository Institutions or Broker-Dealers

Some regulators have noted that the current practice of assessing risk management at the level of a depository institution or broker-dealer did not reflect the way most large, complex institutions manage their risks. Regulators noted that financial institutions manage some risks enterprisewide or by business lines that cross legal entity boundaries. The scope of regulators' supervisory authorities does not clearly reflect this reality, however. As set forth in the Gramm-Leach-Bliley Act, various regulators can have separate responsibilities for individual components of a large, complex financial institution. In addition, GLBA generally restricts the focus of holding company examinations to the holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of an affiliated bank. OCC examiners told us that it was difficult for them to assess a bank's market risk management because OCC focused on the national bank's activities, while the financial institution was managing risk across the bank and the broker-dealer. The examiners said that in some cases the same traders booked wholesale trades in the bank and in the broker-dealer and that the same risk governance process applied to both. Thus, both the primary bank regulator and the functional regulator were duplicating each other's supervisory activities. In addition, if initial transactions were booked in one entity, and transactions designed to mitigate the risks in that transaction were booked in another legal entity, neither regulator could fully understand the risks involved. While effective communication among the functional and primary bank regulators could address this limitation, securities regulators told us that they shared information with the Federal Reserve but generally did not share information with OCC.

OCC examination materials show that examiners sometimes assessed risks and risk management by looking at the entire enterprise. In addition, OCC examiners often met with holding company executives. In previous work, we noted the likelihood that OCC's responsibilities and activities as the national bank regulator overlap with the responsibilities and activities of the Federal Reserve in its role as the holding company regulator. We found in this review that this overlap continued to exist; however, we also continued to observe that OCC and the Federal Reserve share information and coordinate activities to minimize the burden to the institution.

Securities regulators face similar challenges in assessing risk management at broker-dealers. In a number of past reports, we have highlighted the challenges associated with SEC's lack of authority over certain broker-

dealer affiliates and holding companies.[17] FINRA officials also cited two examples of limitations on their efforts to oversee risk management within broker-dealers. First, they noted that FINRA's regulatory authority extended only to U.S. broker-dealers and that related transactions generally are booked in other legal entities. FINRA noted that the riskiest transactions were usually booked in legal entities located offshore. FINRA also noted that often inventory positions booked in the U.S. broker-dealer might hedge the risk in another affiliated legal entities. From time to time, FINRA has requested that the U.S. broker-dealer move the hedge into the broker-dealer to reduce the amount of the losses and protect the capital base of the broker-dealer. An SEC official noted that to take advantage of certain capital treatment the transaction and the hedge would both need to be booked in the broker-dealer. Second, FINRA officials noted that their view was limited because market risk policy is set at the holding company level.

In closing, I would like to reiterate a number of central themes that have appeared often in our recent work. While an institution's management, directors, and auditors all have key roles to play in effective corporate governance, regulators—as outside assessors of the overall adequacy of the system of risk management—also have an important role in assessing risk management. The current financial crisis has revealed that many institutions had not adequately identified, measured, and managed all core components of sound risk management. We also found that for the limited number of large, complex institutions we reviewed, the regulators failed to identify the magnitude of these weaknesses and that when weaknesses were identified, they generally did not take forceful action to prompt these institutions to address them. As we have witnessed, the failure of a risk management system at a single large financial institution can have implications for the entire financial system.

Second, while our recent work is based on a limited number of institutions, examples from the oversight of these institutions highlight the significant challenges regulators face in assessing risk management systems at large, complex institutions. While the painful lessons learned during the past year should bolster market discipline and regulatory authority in the short term, history has shown that as the memories of this crisis begin to fade, the hard lessons we have learned are destined to be repeated unless regulators are vigilant in good times as well as bad.

[17]GAO-09-216 and GAO/GGD-00-3.

Responsible regulation requires that regulators critically assess their regulatory approaches, especially during good times, to ensure that they are aware of potential regulatory blind spots. This means constantly reevaluating regulatory and supervisory approaches and understanding inherent biases and regulatory assumptions. For example, the regulators have begun to issue new and revised guidance that reflects the lessons learned from the current crisis. However, the guidance we have seen tends to focus on the issues specific to this crisis rather than on broader lessons learned about the need for more forward-looking assessments and on the reasons that regulation failed.

Finally, I would like to briefly discuss how our current regulatory framework has potentially contributed to some of the regulatory failures associated with risk management oversight. The current institution-centric approach has resulted in regulators all too often focusing on the risks of individual institutions. This has resulted and in regulators looking at how institutions were managing individual risks, but missing the implications of the collective strategy that was premised on the institution's having little liquidity risk and adequate capital. Whether the failures of some institutions ultimately came about because of a failure to manage a particular risk, such as liquidity or credit risks, these institutions often lacked some of the basic components of good risk management—for example, having the board of directors and senior management set the tone for proper risk management practices across the enterprise. The regulators were not able to connect the dots, in some cases because of the fragmented regulatory structure. While regulators promoted the benefits of enterprisewide risk management, we found that they failed to ensure that all of the large, complex financial institutions in our review had risk management systems commensurate with their size and complexity so that these institutions and their regulators could better understand and address related risk exposures.

This concludes my prepared statement. I would be pleased to answer any questions that you may have at the appropriate time.

Staff Contributions and Acknowledgments

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PREPARED STATEMENT OF ROGER T. COLE

DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 18, 2009

Chairman Reed, Ranking Member Bunning and members of the Subcommittee, it is my pleasure to appear today to discuss the state of risk management in the banking industry and steps taken by Federal Reserve supervisors to address risk management shortcomings at banking organizations.

In my testimony, I will describe the vigorous and concerted steps the Federal Reserve has taken and is taking to rectify the risk management weaknesses revealed by the current financial crisis. I will also describe actions we are taking internally to improve supervisory practices and apply supervisory lessons learned. This includes a process spearheaded by Federal Reserve Vice Chairman Donald Kohn to systematically identify key lessons revealed by recent events and to implement corresponding recommendations. Because this crisis is ongoing, our review is ongoing.

Background

The Federal Reserve has supervisory and regulatory authority over a range of financial institutions and activities. It works with other Federal and State supervisory authorities to ensure the safety and soundness of the banking industry, foster the stability of the financial system, and provide for fair and equitable treatment of consumers in their financial transactions. The Federal Reserve is not the primary Federal supervisor for the majority of commercial bank assets. Rather, it is the consolidated supervisor of bank holding companies, including financial holding companies, and conducts inspections of all of those institutions. As I describe below, we have recently enhanced our supervisory processes on consolidated supervision to make them more effective and efficient.

The primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the soundness of the company's depository institutions. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company's bank, securities, or insurance subsidiaries. The Federal Reserve is also the primary Federal supervisor of State-member banks, sharing supervisory responsibilities with State supervisory agencies. In this role, Federal Reserve supervisory staff regularly conduct onsite examinations and offsite monitoring to ensure the soundness of supervised State member banks.

The Federal Reserve is involved in both regulation—establishing the rules within which banking organizations must operate—and supervision—ensuring that banking organizations abide by those rules and remain, overall, in safe and sound condition. A key aspect of the supervisory process is evaluating risk management practices, in addition to assessing the financial condition of supervised institutions. Since rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors design policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and to assign supervisory ratings.

We are all aware that the U.S. financial system is experiencing unprecedented disruptions that have emerged with unusual speed. The principal cause of the current financial crisis and economic slowdown was the collapse of the global credit boom and the ensuing problems at financial institutions, triggered by the end of the housing expansion in the United States and other countries. Financial institutions have been adversely affected by the financial crisis itself, as well as by the ensuing economic downturn.

In the period leading up to the crisis, the Federal Reserve and other U.S. banking supervisors took several important steps to improve the safety and soundness of banking organizations and the resilience of the financial system. For example, following the September 11, 2001, terrorist attacks, we took steps to improve clearing and settlement processes, business continuity for critical financial market activities, and compliance with Bank Secrecy Act, anti-money laundering, and sanctions requirements. Other areas of focus pertained to credit card subprime lending, the growth in leveraged lending, credit risk management practices for home equity lending, counterparty credit risk related to hedge funds, and effective accounting controls after the fall of Enron. These are examples in which the Federal Reserve took aggressive action with a number of financial institutions, demonstrating that effec-

tive supervision can bring about material improvements in risk management and compliance practices at supervised institutions.

In addition, the Federal Reserve, working with the other U.S. banking agencies, issued several pieces of supervisory guidance before the onset of the recent crisis—taking action on nontraditional mortgages, commercial real estate, home equity lending, complex structured financial transactions, and subprime lending—to highlight emerging risks and point bankers to prudential risk management practices they should follow. Moreover, we identified a number of potential issues and concerns and communicated those concerns to the industry through the guidance and through our supervisory activities.

Supervisory Actions to Improve Risk Management Practices

In testimony last June, Vice Chairman Kohn outlined the immediate supervisory actions taken by the Federal Reserve to identify risk management deficiencies at supervised firms related to the current crisis and bring about the necessary corrective steps. We are continuing and expanding those actions. While additional work is necessary, we are seeing progress at supervised institutions toward rectifying issues identified amid the ongoing turmoil in the financial markets. We are also devoting considerable effort to requiring bankers to look not just at risks from the past but also to have a good understanding of their risks going forward.

The Federal Reserve has been actively engaged in a number of efforts to understand and document the risk management lapses and shortcomings at major financial institutions revealed during the current crisis. In fact, the Federal Reserve Bank of New York organized and leads the Senior Supervisors Group (SSG), which published a report last March on risk management practices at major international firms.[1] I do not plan to summarize the findings of the SSG report and similar public reports, since others from the Federal Reserve have already done so.[2] But I would like to describe some of the next steps being taken by the SSG.

A key initiative of the Federal Reserve and other supervisors since the issuance of the March 2008 SSG report has been to assess the response of the industry to the observations and recommendations on the need to enhance key risk management practices. The work of the SSG has been helpful, both in complementing our evaluation of risk management practices at individual firms and in our discussions with bankers and their directors. It is also providing perspective on how each individual firm's risk management performance compares with that of a broad cross-section of global financial services firms.

The continuation of the SSG process requires key firms to conduct self-assessments that are to be shared with the organization's board of directors and serve to highlight progress in addressing gaps in risk management practices and identify areas where additional efforts are still needed. Our supervisory staff is currently in the process of reviewing the firms' self assessments, but we note thus far that in many areas progress has been made to improve risk management practices. We plan to incorporate the results of these reviews into our future examination work to validate management assertions.

The next portion of my remarks describes the supervisory actions we have been taking in the areas of liquidity risk management, capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit risk, and commercial real estate. In all of these areas we are moving vigorously to address the weaknesses at financial institutions that have been revealed by the crisis.

Liquidity risk management

Since the beginning of the crisis, we have been working diligently to bring about needed improvements in institutions' liquidity risk management practices. One lesson learned in this crisis is that several key sources of liquidity may not be available in a crisis. For example, Bear Stearns collapsed in part because it could not obtain liquidity even on a basis fully secured by high-quality collateral, such as U.S. Government securities. Others have found that back-up lines of credit are not made available for use when most needed by the borrower.

These lessons have heightened our concern about liquidity and improved our approach to evaluating liquidity plans of banking organizations. Along with our U.S.

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[1] Senior Supervisors Group (2008). "Observations on Risk Management Practices during the Recent Market Turbulence" March 6, *www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.*

[2] President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, *www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.* Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, *www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.*

supervisory colleagues, we are monitoring the major firms' liquidity positions on a daily basis, and are discussing key market developments and our supervisory views with the firms' senior management. We also are conducting additional analysis of firms' liquidity positions to examine the impact various scenarios may have on their liquidity and funding profiles. We use this ongoing analysis along with findings from examinations to ensure that liquidity and funding risk management and contingency funding plans are sufficiently robust and that the institutions are prepared to address various stress scenarios. We are aggressively challenging those assumptions in firms' contingency funding plans that may be unrealistic.

Our supervisory efforts require firms to consider the potential impact of both disruptions in the overall funding markets and idiosyncratic funding difficulties. We are also requiring more rigor in the assessment of all expected and unexpected funding uses and needs. Firms are also being required to consider the respective risks of reliance on wholesale funding and retail funding, as well as the risks associated with off-balance sheet contingencies. These efforts include steps to require banks to consider the potential impact on liquidity that arises from firms' actions to protect their reputation, such as an unplanned increase in assets requiring funding that would arise with support given to money market funds and other financial vehicles where no contractual obligation exists. These efforts also pertain to steps banks must take to prepare for situations in which even collateralized funding may not be readily available because of market disruptions or concern about the health of a borrowing institution. As a result of these efforts, supervised institutions have significantly improved their liquidity risk management practices, and have taken steps to stabilize and improve their funding sources as market conditions permit.

In conducting work on liquidity risk management, we have used established supervisory guidance on liquidity risk management as well as updated guidelines on liquidity risk management issued by the Basel Committee on Banking Supervision last September—a process in which the Federal Reserve played a lead role. So that supervisory expectations for U.S. depository institutions are aligned with these international principles, the U.S. banking agencies plan to update their own interagency guidance on liquidity risk management practices in the near future. The new guidance will emphasize the need for institutions of all sizes to conduct meaningful cash-flow forecasts of their funding needs in both normal and stressed conditions and to ensure that they have an adequately diversified funding base and a cushion of liquid assets to mitigate stressful market conditions. Our supervisory efforts at individual institutions and the issuance of new liquidity risk management guidance come on top of broader Federal Reserve efforts outside of the supervision function to improve liquidity in financial markets, such as introduction of the Term Auction Facility and the Term Asset-Backed Securities Loan Facility.

Capital planning and capital adequacy

Our supervisory activities for capital planning and capital adequacy are similar to those for liquidity. We have been closely monitoring firms' capital levels relative to their risk exposures, in conjunction with reviewing projections for earnings and asset quality and discussing our evaluations with senior management. We have been engaged in our own analysis of loss scenarios to anticipate institutions' future capital needs, analysis that includes the potential for losses from a range of sources as well as assumption of assets currently held off balance sheet. We have been discussing our analysis with bankers and requiring their own internal analyses to reflect a broad range of scenarios and to capture stress environments that could impair solvency. As a result, banking organizations have taken a number of steps to strengthen their capital positions, including raising substantial amounts of capital from private sources in 2007 and 2008.

We have stepped up our efforts to evaluate firms' capital planning and to bring about improvements where they are needed. For instance, we recently issued guidance to our examination staff—which was also distributed to supervised institutions—on the declaration and payment of dividends, capital repurchases, and capital redemptions in the context of capital planning processes. We are forcefully requiring institutions to retain strong capital buffers-above the levels prescribed by minimum regulatory requirements—not only to weather the immediate environment but also to remain viable over the medium and long term.

Our efforts related to capital planning and capital adequacy are embodied in the interagency supervisory capital assessment process, which began in February. We are conducting assessments of selected banking institutions' capital adequacy, based on certain macroeconomic scenarios. For this assessment, we are carefully evaluating the forecasts submitted by each financial institution to ensure they are appropriate, consistent with the firm's underlying portfolio performance, and reflective of each entity's particular business activities and risk profile. The assessment of cap-

ital under the two macroeconomic scenarios being used in the capital assessment program will permit supervisors to ascertain whether institutions' capital buffers over the regulatory capital minimum are appropriate under more severe but plausible scenarios.

Federal Reserve supervisors have been engaged over the past few years in evaluating firms' internal processes to assess overall capital adequacy as set forth in existing Federal Reserve supervisory guidance. A portion of that work has focused on how firms use economic capital practices to assess overall capital needs. We have communicated our findings to firms individually, which included their need to improve some key practices, and demanded corrective actions. We also presented our overall findings to a broad portion of the financial industry at a System-sponsored outreach meeting last fall that served to underscore the importance of our message.

Firm-wide risk identification and compliance risk management

One of the most important aspects of good risk management is risk identification. This is a particularly challenging exercise because some practices, each of which appears to present low risk on its own, may combine to create unexpectedly high risk. For example, in the current crisis, practices in mortgage lending—which historically has been seen as a very low-risk activity—have become distorted and, consequently riskier, as they have been fueled by another activity that was designed to reduce risk to lenders—the sale of mortgage assets to investors outside the financial industry.

Since the onset of the crisis, we have been working with supervised institutions to improve their risk identification practices where needed, such as by helping identify interconnected risks. These improvements include a better understanding of risks facing the entire organization, such as interdependencies among risks and concentrations of exposures. One of the key lessons learned has been the need for timely and effective communication about risks, and many of our previously mentioned efforts pertaining to capital and liquidity are designed to ensure that management and boards of directors understand the linkages within the firm and how various events might impact the balance sheet and funding of an organization. We have demanded that institutions address more serious risk management deficiencies so that risk management is appropriately independent, that incentives are properly aligned, and that management information systems (MIS) produce comprehensive, accurate, and timely information.

In our 2006 guidance on nontraditional mortgage products, we recognized that poor risk management practices related to retail products and services could have serious effects on the profitability of financial institutions and the economy; in other words, there could be a relationship between consumer protection and financial soundness. For example, consumer abuses in the subprime mortgage lending market were a contributing cause to the current mortgage market problems. Here, too, we are requiring improvements. The Federal Reserve issued guidance on compliance risk management programs to emphasize the need for effective firm-wide compliance risk management and oversight at large, complex banking organizations. This guidance is particularly applicable to compliance risks, including its application to consumer protection, that transcend business lines, legal entities, and jurisdictions of operation.

Residential lending

Financial institutions are still facing significant challenges in the residential mortgage market, particularly given the rising level of defaults and foreclosures and the lack of liquidity for private label mortgage-backed securities. Therefore, we will continue to focus on the adequacy of institutions' risk management practices, including their underwriting standards, and re-emphasize the importance of a lender's assessment of a borrower's ability to repay the loan. Toward that end, we are requiring institutions to maintain risk management practices that more effectively identify, monitor, and control the risks associated with their mortgage lending activity and that more adequately address lessons learned from recent events.

In addition to efforts on the safety and soundness front, last year we finalized amendments to the rules under the Home Ownership and Equity Protection Act (HOEPA). These amendments establish sweeping new regulatory protections for consumers in the residential mortgage market. Our goal throughout this process has been to protect borrowers from practices that are unfair or deceptive and to preserve the availability of credit from responsible mortgage lenders. The Board believes that these regulations, which apply to all mortgage lenders, not just banks, will better protect consumers from a range of unfair or deceptive mortgage lending and advertising practices that have been the source of considerable concern and criticism.

Given escalating mortgage foreclosures, we have urged regulated institutions to establish systematic, proactive, and streamlined mortgage loan modification protocols and to review troubled loans using these protocols. We expect an institution (acting either in the role of lender or servicer) to determine, before proceeding to foreclosure, whether a loan modification will enhance the net present value of the loan, and whether loans currently in foreclosure have been subject to such analysis. Such practices are not only consistent with sound risk management but are also in the long-term interests of borrowers, lenders, investors, and servicers. We are encouraging regulated institutions, through government programs, to pursue modifications that result in mortgages that borrowers will be able to sustain over the remaining maturity of their loan. In this regard, just recently the Federal Reserve joined with other financial supervisors to encourage all of the institutions we supervise to participate in the Treasury Department's Home Affordable loan modification program, which was established under the Troubled Assets Relief Program.[3] Our examiners are closely monitoring loan modification efforts of institutions we supervise.

Counterparty credit risk

The Federal Reserve has been concerned about counterparty credit risk for some time, and has focused on requiring the industry to have effective risk management practices in place to deal with risks associated with transacting with hedge funds, for example, and other key counterparties. This focus includes assessing the overall quality of MIS for counterparty credit risk and ensuring that limits are complied with and exceptions appropriately reviewed. As the crisis has unfolded, we have intensified our monitoring of counterparty credit risk. Supervisors are analyzing management reports and, in some cases, are having daily conversations with management about ongoing issues and important developments. This process has allowed us to understand key linkages and exposures across the financial system as specific counterparties experience stress during the current market environment. Federal Reserve supervisors now collect information on the counterparty credit exposures of major institutions on a weekly and monthly basis, and have enhanced their methods of assessing this exposure.

Within counterparty credit risk, issues surrounding the credit default swap (CDS) market have been particularly pertinent. As various Federal Reserve officials have noted in past testimony to congressional committees and in other public statements, regulators have, for several years, been addressing issues surrounding the over-the-counter (OTC) derivatives market in general and the CDS market in particular. Since September 2005, an international group of supervisors, under the leadership of the Federal Reserve Bank of New York, has been working with dealers and other market participants to strengthen arrangements for processing, clearing, and settling OTC derivatives. An early focus of this process was on CDS. This emphasis includes promoting such steps as greater use of electronic-confirmation platforms, adoption of a protocol that requires participants to request counterparty consent before assigning trades to a third party, and creation of a contract repository that maintains an electronic record of CDS trades.

More recently, and in response to the recommendations of the President's Working Group on Financial Markets and the Financial Stability Forum, supervisors are working to bring about further improvements to the OTC derivatives market infrastructure. With respect to credit derivatives, this agenda includes: (1) further increasing standardization and automation; (2) incorporating an auction-based cash settlement mechanism into standard documentation; (3) reducing the volume of outstanding CDS contracts; and (4) developing well-designed central counterparty services to reduce systemic risks.

The most important potential change in the infrastructure for credit derivatives is the creation of one or more central counterparties (CCPs) for CDS. The Federal Reserve supports CCP clearing of CDS because, if properly designed and managed, CCPs can reduce risks to market participants and to the financial system. In addition to clearing CDS through CCPs, the Federal Reserve believes that exchange trading of sufficiently standardized contracts by banks and other market participants can increase market liquidity and transparency, and thus should be encouraged. In a major step toward achieving that goal, the Federal Reserve Board, on March 4, 2009, approved the application by ICE US Trust LLC (ICE Trust) to become a member of the Federal Reserve System. ICE Trust intends to provide central counterparty services for certain credit default swap contracts.

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[3] See *http://www.Federalreserve.gov/newsevents/press/bcreg/20090304a.htm.*

Commercial real estate

For some time, the Federal Reserve has been focused on commercial real estate (CRE) exposures. For background, as part of our onsite supervision of banking organizations in the early 2000s, we began to observe rising CRE concentrations. Given the central role that CRE lending played in the banking problems of the late 1980s and early 1990s, we led an interagency effort to issue supervisory guidance on CRE concentrations. In the 2006 guidance on CRE, we emphasized our concern that some institutions' strategic- and capital-planning processes did not adequately acknowledge the risks from their CRE concentrations. We stated that stress testing and similar exercises were necessary for institutions to identify the impact of potential CRE shocks on earnings and capital, especially the impact from credit concentrations.

Because weaker housing markets and deteriorating economic conditions have clearly impaired the quality of CRE loans at supervised banking organizations, we have redoubled our supervisory efforts in regard to this segment. These efforts include monitoring carefully the impact that declining collateral values may have on CRE exposures as well as assessing the extent to which banks have been complying with the interagency CRE guidance. We found, through horizontal reviews and other examinations, that some institutions would benefit from additional and better stress testing and could improve their understanding of how concentrations—both single-name and sectoral/geographical concentrations—can impact capital levels during shocks. We have also implemented additional examiner training so that our supervisory staff is equipped to deal with more serious CRE problems at banking organizations as they arise, and have enhanced our outreach to key real estate market participants and obtained additional market data sources to help support our supervisory activities. As a result of our supervisory work, risk management practices related to CRE are improving, including risk identification and measurement.

To sum up our efforts to improve banks' risk management, we are looking at all of the areas mentioned above—both on an individual and collective basis—as well as other areas to ensure that all institutions have their risk management practices at satisfactory levels. More generally, where we have not seen appropriate progress, we are aggressively downgrading supervisory ratings and using our enforcement tools.

Supervisory Lessons Learned

Having just described many of the steps being taken by Federal Reserve supervisors to address risk management deficiencies in the banking industry, I would now like to turn briefly to our internal efforts to improve our own supervisory practices. The current crisis has helped us to recognize areas in which we, like the banking industry, can improve.

Since last year, Vice Chairman Kohn has led a System-wide effort to identify lessons learned and to develop recommendations for potential improvements to supervisory practices. To benefit from multiple perspectives in these efforts, this internal process is drawing on staff from around the System. For example, we have formed System-wide groups, led by Board members and Reserve Bank Presidents, to address the identified issues in areas such as policies and guidance, the execution of supervisory responsibilities, and structure and governance. Each group is reviewing identified lessons learned, assessing the effectiveness of recent initiatives to rectify issues, and developing additional recommendations. We will leverage these group recommendations to arrive at an overall set of enhancements that will be implemented in concert. As you know, we are also meeting with Members of the Congress and other government bodies, including the Government Accountability Office, to consult on lessons learned and to hear additional suggestions for improving our practices.

One immediate example of enhancements relates to System-wide efforts for forward-looking risk identification efforts. Building on previous System-wide efforts to provide perspectives on existing and emerging risks, the Federal Reserve has recently augmented its process to disseminate risk information to all the Reserve Banks. That process is one way we are ensuring that risks are identified in a consistent manner across the System by leveraging the collective insights of Federal Reserve supervisory staff. We are also using our internal risk reporting to help establish supervisory priorities, contribute to examination planning and scoping, and track issues for proper correction. Additionally, we are reviewing staffing levels and expertise so that we have the appropriate resources, including for proper risk identification, to address not just the challenges of the current environment but also those over the longer term.

We have concluded that there is opportunity to improve our communication of supervisory and regulatory policies, guidance, and expectations to those we regulate.

This includes more frequently updating our rules and regulations and more quickly issuing guidance as new risks and concerns are identified. For instance, we are reviewing the area of capital adequacy, including treatment of market risk exposures as well as exposures related to securitizations and counterparty credit risk. We are taking extra steps to ensure that as potential areas of risk are identified or new issues emerge, policies and guidance address those areas in an appropriate and timely manner. And we will increase our efforts to ensure that, for global banks, our policy and guidance responses are coordinated, to the extent possible, with those developed in other countries.

One of the Federal Reserve's latest enhancements related to guidance, a project begun before the onset of the crisis, was the issuance of supervisory guidance on consolidated supervision. This guidance is intended to assist our examination staff as they carry out supervision of banking institutions, particularly large, complex firms with multiple legal entities, and to provide some clarity to bankers about our areas of supervisory focus. Importantly, the guidance is designed to calibrate supervisory objectives and activities to the systemic significance of the institutions and the complexity of their regulatory structures. The guidance provides more explicit expectations for supervisory staff on the importance of understanding and validating the effectiveness of the banking organization's corporate governance, risk management, and internal controls that are in place to oversee and manage risks across the organization. Our assessment of nonbank activities is an important part of our supervisory process to understand the linkages between depository and nondepository subsidiaries, and their effects on the overall risks of the organization.

In addition to issues related to general risk management at nonbank subsidiaries, the consolidated supervision guidance addresses potential issues related to consumer compliance. In this regard, in 2007 and 2008 the Board collaborated with other U.S. and State government agencies to launch a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations. This interagency initiative has clarified jurisdictional issues and improved information-sharing among the participating agencies, along with furthering its overarching goal of preventing abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

As stated earlier, there were numerous cases in which the U.S. banking agencies developed policies and guidance for emerging risks and issues that warranted the industry's attention, such as in the areas of nontraditional mortgages, home equity lending, and complex structured financial transactions. It is important that regulatory policies and guidance continue to be applied to firms in ways that allow for different business models and that do not squelch innovation. However, when bankers are particularly confident, when the industry and others are especially vocal about the costs of regulatory burden and international competitiveness, and when supervisors cannot yet cite recognized losses or writedowns, we must have even firmer resolve to hold firms accountable for prudent risk management practices. It is particularly important, in such cases, that our supervisory communications are very forceful and clear, directed at senior management and boards of directors so that matters are given proper attention and resolved to our satisfaction.

With respect to consumer protection matters, we have an even greater understanding that reviews of consumer compliance records of nonbank subsidiaries of bank holding companies can aid in confirming the level of risk that these entities assume, and that they assist in identifying appropriate supervisory action. Our consumer compliance division is currently developing a program to further the work that was begun in the interagency pilot discussed earlier. In addition to these points, it is important to note that we have learned lessons and taken action on important aspects of our consumer protection program, which I believe others from the Federal Reserve have discussed with the Congress.

In addition, we must further enhance our ability to develop clear and timely analysis of the interconnections among both regulated and unregulated institutions, and among institutions and markets, and the potential for these linkages and interrelationships to adversely affect banking organizations and the financial system. In many ways, the Federal Reserve is well positioned to meet this challenge. In this regard, the current crisis has, in our view, demonstrated the ways in which the Federal Reserve's consolidated supervision role closely complements our other central bank responsibilities, including the objectives of fostering financial stability and deterring or managing financial crises.

The information, expertise, and powers derived from our supervisory authority enhance the Federal Reserve's ability to help reduce the likelihood of financial crises, and to work with the Treasury Department and other U.S. and foreign authorities to manage such crises should they occur. Indeed, the enhanced consolidated super-

vision guidance that the Federal Reserve issued in 2008 explicitly outlines the process by which we will use information obtained in the course of supervising financial institutions—as well as information and analysis obtained through relationships with other supervisors and other sources—to identify potential vulnerabilities across financial institutions. It will also help us identify areas of supervisory focus that might further the Federal Reserve's knowledge of markets and counterparties and their linkages to banking organizations and the potential implications for financial stability.

A final supervisory lesson applies to the structure of the U.S. regulatory system, an issue that the Congress, the Federal Reserve, and others have already raised. While we have strong, cooperative relationships with other relevant bank supervisors and functional regulators, there are obvious gaps and operational challenges in the regulation and supervision of the overall U.S. financial system. This is an issue that the Federal Reserve has been studying for some time, and we look forward to providing support to the Congress and the Administration as they consider regulatory reform. In a recent speech, Chairman Bernanke introduced some ideas to improve the oversight of the U.S. financial system, including the oversight of nonbank entities. He stated that no matter what the future regulatory structure in the United States, there should be strong consolidated supervision of all systemically important banking and nonbanking financial institutions.

Finally, Mr. Chairman, I would like to thank you and the Subcommittee for holding this second hearing on risk management—a crucially important issue in understanding the failures that have contributed to the current crisis. Our actions, with the support of the Congress, will help strengthen institutions' risk management practices and the supervisory and regulatory process itself—which should, in turn, greatly strengthen the banking system and the broader economy as we recover from the current difficulties.

I look forward to answering your questions.

PREPARED STATEMENT OF TIMOTHY W. LONG

SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY AND CHIEF NATIONAL BANK EXAMINER

MARCH 18, 2009

Introduction

Chairman Reed, Ranking Member Bunning, and members of the Subcommittee, my name is Timothy Long and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to discuss the OCC's perspective on the recent lessons learned regarding risk management, as well as the steps we have taken to strengthen our supervision and examination processes in this critical area, and how we supervise the risk management activities at the largest national banking companies.

Your letter of invitation also requested our response to the findings of the GAO regarding the OCC's oversight of bank risk management. Because we only received the GAO's summary statement of facts on Friday night, we have not had an opportunity to thoroughly review and assess their full report and findings. Therefore, I will only provide some brief observations on their initial findings. We take findings and recommendations from the GAO very seriously and will be happy to provide Subcommittee members a written response to the GAO's findings once we have had the opportunity to carefully review their report.

Role of Risk Management

The unprecedented disruption that we have seen in the global financial markets over the last eighteen months, and the events and conditions leading up to this disruption, have underscored the critical need for effective and comprehensive risk management processes and systems. As I will discuss in my testimony, these events have revealed a number of weaknesses in banks' risk management processes that we and the industry must address. Because these problems are global in nature, many of the actions we are taking are in coordination with other supervisors around the world.

More fundamentally, recent events have served as a dramatic reminder that risk management is, and must be, more than simply a collection of policies, procedures, limits and models. Effective risk management requires a strong corporate culture and corporate risk governance. As noted in the March 2008 Senior Supervisors Group report on "Observations on Risk Management Practices During the Recent

Market Turmoil," companies that fostered a strong risk management culture and encouraged firm-wide identification and control of risk, were less vulnerable to significant losses, even when engaged in higher risk activities.[1]

While current economic conditions have brought renewed attention to risk management, it is during periods of expansionary economic growth when risk management can be most critical and challenging both for bankers and supervisors. Financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services. They must also be able to compete with firms that may be less regulated and with financial service companies across the globe. Failure to allow this competition risks ceding the prominent role that U.S. financial firms have in the global marketplace.

Banks are in the business of managing financial risk. Competing in the marketplace and allowing market innovation means that there will be times when banks lose money. There will also be times when, despite a less favorable risk/reward return, a bank will need to maintain a market presence to serve its customers and to retain its role as a key financial intermediary. These are not and should not be viewed as risk management failures. The job of risk management is not to eliminate losses or risk, but rather to ensure that risk exposures are fully identified and understood so that bank management and directors can make informed business decisions about the firm's level of risk.

In this regard, a key issue for bankers and supervisors is determining when the accumulation of risks either within an individual firm or across the system has become too high, such that corrective or mitigation actions are needed. Knowing when and how to strike this balance is one of the most difficult jobs that supervisors and examiners face. Taking action too quickly can constrain economic growth and impede credit to credit worthy borrowers; waiting too long can result in an overhang of risk becoming embedded into banks and the marketplace. Effective risk management systems play a critical role in this process.

Risk Management Lessons Learned

It is fair to ask what the banking industry and supervisors have learned from the major losses that have occurred over the past 18 months. The losses have been so significant, and the damage to the economy and confidence so great, that we all must take stock of what we missed, and what we should have done differently to make sure that we minimize the possibility that something like this happens again. Below are some of our assessments:

- ***Underwriting Standards Matter, Regardless of Whether Loans are Held or Sold***—The benign economic environment of the past decade, characterized by low interest rates, strong economic growth and very low rates of borrower defaults led to complacency on the part of many lenders. Competitive pressures drove business line managers to ease underwriting standards for the origination of credit and to assume increasingly complex and concentrated levels of risk. Increased investor appetite for yield and products, fueled by a global abundance of liquidity, led many larger banks to adopt the so-called "originate-to-distribute" model for certain commercial and leveraged loan products, whereby they originated a significant volume of loans with the express purpose of packaging and selling them to investors. Many of these institutional investors were willing to accept increasingly liberal repayment terms, reduced financial covenants, and higher borrower leverage on these transactions in return for marginally higher yields. Similar dynamics were occurring in the residential mortgage markets, where lenders, primarily non-bank lenders, were aggressively relaxing their underwriting standards.

Given the abundance of liquidity and willing investors for these loans, lenders became complacent about the risks underlying the loans. However, in the fall of 2007 the risk appetite of investors changed dramatically and, at times, for reasons not directly related to the exposures that they held. This abrupt change in risk tolerance left banks with significant pipelines of loans that they needed to fund as the syndicated loan and securitization markets shut down. Bankers and supervisors underestimated the rapidity and depth of the global liquidity freeze. A critical lesson, which the OCC and other Federal banking agencies noted in their 2007 Shared National Credit results, is that banking organizations should ensure that underwriting standards are not compromised by competitive pressures. The agencies warned that "consistent with safe and sound banking practice, agent banks should underwrite

[1] *See* Senior Supervisors Group Report, "Observations on Risk Management Practices," at *http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.*

funding commitments in a manner reasonably consistent with internal underwriting standards."[2]

- ***Risk Concentrations Can Accumulate Across Products and Business Lines and Must be Controlled***—Risk concentrations can arise as banks seek to maximize their expertise or operational efficiencies in a highly competitive business. Community banks can often develop significant concentrations as their lending portfolios tend to be highly concentrated in their local markets. For larger institutions, a key issue has been the ability to aggregate risk exposures across business and product lines and to identify risks that may be highly correlated. For example, many national banks underestimated their exposure to subprime mortgages because they did not originate them. Indeed, some senior bank management thought they had avoided subprime risk exposures by deliberately choosing to not originate such loans in the bank—only to find out after the fact that their investment bank affiliates had purchased subprime loans elsewhere to structure them into collateralized debt obligations. Because of inadequate communication within these firms, those structuring businesses were aggressively expanding activity at the same time that retail lending professionals in the bank were avoiding or exiting the business because of their refusal to meet weak underwriting conditions prevalent in the market. These failures were compounded when products, markets, and geographic regions that previously were looked to as a source of risk diversification became more highly correlated as contagion effects spread across the globe. Additionally, significant corporate acquisitions, especially if they were not consistent with the bank's business strategy and corporate culture, affected the institutions' financial well being, their risk positions and reputations, and placed significant strains on their risk management processes.
- ***Asset-Based Liquidity Provides a Critical Cushion***—There is always a tension of how much of a bank's balance sheet capacity should be used to provide a cushion of liquid assets—assets that can be readily converted to liquid funds should there be a disruption in the bank's normal funding markets or in its ability to access those markets. Because such assets tend to be low risk and, thus, low yielding, many banks have operated with very minimal cushions in recent years. These decisions reflected the abundance of liquidity in the market and the ease with which banks could tap alternative funding sources through various capital and securitization markets. Here again, when these markets became severely constrained, many banks faced significant short-term funding pressures. For some firms, these funding pressures, when combined with high credit exposures and increased leverage, resulted in significant strains and, in some cases, liquidity insolvency.
- ***Systemically Important Firms Require State-of-the-Art Infrastructure***—As noted in a number of visible cases during this period of market turmoil, a large firm's ability to change its risk profile or react to the changing risk tolerance of others is dependent on an extremely robust supporting infrastructure. The velocity with which information is transmitted across financial markets and the size, volume and complexity of transactions between market participants has been greatly expanded through technology advancements and globalization of markets. Failure to have sufficient infrastructure and backroom operations resulted in failed trades and increased counterparty exposures, increasing both reputation and credit risks.
- ***Need for Robust Capital Levels and Capital Planning Processes***—Although we are clearly seeing strains, the national banking system, as a whole, has been able to withstand the events of the past 18 months due, in part, to their strong levels of regulatory capital. The strong levels of capital in national banks helped to stabilize the financial system. National banking organizations absorbed many weaker competitors (*e.g.,* Bear Stearns, Countrywide, and WAMU). This relative strength is more apparent when compared to the highly leveraged position of many broker-dealers. Nonetheless, it is clear that both banks' internal capital processes and our own supervisory capital standards need to be strengthened to more fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm. In addition, capital planning and estimates of potential credit losses need to be more forward looking and take account of uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

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[2] *See* Joint Release, NR 2007–102 at: *http://www.occ.treas.gov/ftp/release/2007-102.htm*.

These findings are consistent with reports issued by the SSG's report on "Risk Management Practices," the Financial Stability Forum's (FSF) report on "Enhancing Market and Institutional Resilience," the Joint Forum's report on "Cross- Sectoral Review of Group-wide Identification and Management of Risk Concentrations," and the Basel Committee on Banking Supervision's consultative paper on "Principles for Sound Stress Testing Practices and Supervision."[3] Two common themes from these reports and other studies in which the OCC has actively participated are the need to strengthen risk management practices and improve stress testing and firm-wide capital planning processes. The reports also note several areas where banking supervisors need to enhance their oversight regimes. The recommendations generally fall into three broad categories: 1) providing additional guidance to institutions with regard to the risk management practices and monitoring institutions' actions to implement those recommendations; 2) enhancing the various aspects of the Basel II risk-based capital framework; and 3) improving the exchange of supervisory information and sharing of best practices.

OCC Supervisory Responses

The OCC has been actively involved in the various work groups that issued these reports, and we are taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations. I will focus on the three key areas identified by the Subcommittee: liquidity risk management, capital requirements, and enterprise-wide risk management.

Liquidity Risk Management

The sudden and complete shutdown in many traditional funding markets was not contemplated by most contingency funding plans. This period of market disruption has magnified the risks associated with underestimating liquidity risk exposures and improperly planning for periods of significant duress. The SSG report specifically noted that better performing firms carefully monitored their and on- and off-balance sheet risk exposures and actively managed their contingent liquidity needs. In April 2008, the OCC developed a liquidity risk monitoring program to standardize liquidity monitoring information across our large bank population and provide more forward looking assessments. We developed a template for the monthly collection of information about balance sheet exposures, cash-flow sources and uses, and financial market risk indicators. Our resident examiners complete this template each month and then work with our subject matter specialists in the Credit and Market Risk (CMR) division in Washington to produce a monthly report that summarizes the liquidity risk profile, based on levels of risk and quality of risk management, for 15 banking companies in our Large and Mid-size bank programs. These risk profiles provide a forward looking assessment of liquidity maturity mismatches and capacity constraints, both of which are considered early warning signals of potential future problems.

In September 2008, the Basel Committee on Banking Supervision (Basel Committee) issued a report on, "Principles for Sound Liquidity Risk Management and Supervision."[4] This report represents critical thinking that was done by supervisors in over 15 jurisdictions on the fundamental principles financial institutions and supervisors must adopt to provide appropriate governance of liquidity risk. OCC subject matter specialists in our CMR division were actively involved in the development of this important paper on risk management expectations, and are now contributing to the second phase of this work which is focused on identifying key liquidity metrics and benchmarks that may be valuable for enhancing transparency about liquidity risk at financial institutions. We are also working with the other U.S. Federal banking agencies to adapt and apply these key principles more broadly to all U.S. banking institutions through an interagency policy statement.

The OCC reviews bank liquidity on an ongoing basis and we have incorporated these valuable lessons into our evaluations. Our strategic bank supervision operating plan for 2009 directs examiners at our largest national banks to focus on

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[3] Senior Supervisors Group Report, "Observations on Risk Management Practices," at *http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf;* Financial Stability Forum, "Enhancing Market and Institutional Resilience," at *http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf;* Joint Forum, "Cross-sectoral review of group-wide identification and management of risk concentrations" at *http://www.bis.org/publ/joint19.htm;* and Basel Committee on Banking Supervision Report, "Sound principles for stress testing practices and supervision," at *http://www.bis.org/publ/bcbs147.htm.*

[4] *See* Basel Committee on Banking Supervision, "Principles for Sound Liquidity Management and Supervision," at *http://www.bis.org/publ/bcbs144.htm.*

banks' firm-wide assessments of their liquidity risk and the adequacy of their liquidity cushions (short-term liquid assets and collateralized borrowing capacity) to meet short and medium term funding needs, as well as on the effectiveness of their liquidity risk management, including management information systems and contingency funding plans.

Capital Requirements

The market turmoil has highlighted areas where the current Basel II capital framework needs to be strengthened. The OCC, through its membership on the Basel Committee and work with the FSF, has been actively involved in formulating improvements to the capital framework. Among the refinements recommended by the Basel Committee in its January 2009 consultative papers are higher capital requirements for re-securitizations, such as collateralized debt obligations, which are themselves comprised of asset-backed securities.[5] These structured securities suffered significant losses during the recent market turmoil. Other proposed changes to the Basel II framework would increase the capital requirements for certain liquidity facilities that support asset-backed commercial paper conduits.

In addition, the Basel Committee has proposed requirements for certain banks to incorporate default risk and credit migration risk in their value-at-risk models. These proposals are designed to better reflect the risks arising from the more complex, and less liquid, credit products that institutions now hold in their trading portfolios. The intention is also to reduce the extent of regulatory capital arbitrage that currently exists between the banking and trading books.

The January consultative paper that proposed enhancements to the Basel II framework would also strengthen supervisory guidance regarding Pillar 2, or the supervisory review process of Basel II. Specifically, the proposed supervisory guidance would address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitization activities; and incentives to manage risk and returns over the long-term.

More recently, following its meeting last week, the Basel Committee announced additional initiatives to strengthen capital in the banking system. These include introducing standards to promote the buildup of capital buffers that can be drawn down in periods of stress, as well as a non-risk-based capital measure like our leverage ratio.[6] Once the Basel Committee finalizes these and other changes to the Basel II framework, the OCC and other Federal banking agencies will jointly consider their adoption in the U.S. through the agencies' notice and comment process.

Enterprise Risk Management

As previously noted, the recent market turmoil has highlighted the importance of a comprehensive firm-wide risk management program. The SSG report advised that striking the right balance between risk appetite and risk controls was a distinguishing factor among firms surveyed in its study. Additionally, the FSF report noted that, "Supervisors and regulators need to make sure that the risk management and control framework within financial institutions keeps pace with the changes in instruments, markets and business models, and that firms do not engage in activities without having adequate controls."[7]

Proper risk governance was a key focus of guidance that the OCC, the SEC, and other Federal banking regulators issued in January 2007 on complex finance activities.[8] That guidance stressed the need for firms to have robust internal controls and risk management processes for complex structured finance transactions. The guidance emphasized the importance of a strong corporate culture that includes and encourages mechanisms that allow business line and risk managers to elevate concerns to appropriate levels of management and to ensure the timely resolution of those concerns. It also stressed the need to ensure appropriate due diligence at the front-end, before products are offered, to ensure that all risks have been appropriately considered and can be effectively identified, managed and controlled. At the OCC, approval of new or novel banking activities is predicated on the bank having sufficient risk management controls in place.

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[5] *See:* "Proposed enhancements to the Basel II framework," "Revisions to the Basel II Market Risk Framework," and "Guidelines for computing capital for incremental risk in the trading book," January 2009 at *http://www.bis.org/press/p090116.htm.*

[6] *See* "Initiatives on capital announced by the Basel Committee," March 12, 2009 at: *http://www.bis.org/press/p090312.htm.*

[7] *See* "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 2008 at: *http://www.fsforum.org/publications/r_0804.pdf.*

[8] *See:* OCC Bulletin 2007–1, "Complex Structured Finance Transactions" at *http://www.occ.gov/ftp/bulletin/2007-1.html.*

Assessing management's ability to effectively identify, measure, monitor, and control risk across the firm and to conduct effective stress testing is a key focus of our examination strategies for large national banks this year. Stress tests are a critical tool for effective enterprise-wide risk assessments. Such tests can help identify concentrations and interconnected risks and determine the adequacy of capital and liquidity. As with most other issues, the success of a stress testing program depends importantly on the support and sponsorship provided by senior management. In banks where risk management functions did not perform well, stress testing typically was a mechanical exercise. Management viewed stress tests as more of a "requirement" than an important risk management tool that could lead to internal discussions and debate about whether existing exposures constituted unacceptable risks.

In addition, many stress tests failed to fully estimate the potential severity and duration of stress events and to identify and capture risks across the firm. Often, stress tests would focus on a single line of business and/or use only historical statistical relationships. When designing a stress test, particularly after a prolonged period of abundant liquidity, low credit spreads and low interest rates, it is important to probe for weaknesses in the portfolio that may not be evident from historically based stress exercises. Expert judgment can help define scenarios to address the likely breakdown in normal statistical relationships, as well as feedback loops, in a crisis. Such scenario-based stress tests, often dismissed as implausible by business unit personnel, allow firms to shock multiple market factors (*e.g.,* interest rates credit spreads and commodity prices) simultaneously. Such stress tests are an important way to capture risks missed in traditional stress testing exercises, such as market liquidity risk and basis risk.

OCC's Supervision of Risk Management at Large National Banks

Let me now turn to how we apply and incorporate our perspective on risk management into the supervision of large national banks. The OCC is responsible for supervising over 1,600 banks, including some of the largest in the world that offer a wide array of financial services and are engaged in millions of transactions every day.

Pursuant to the provision of the Gramm Leach Bliley Act (GLBA), the OCC serves as the primary Federal banking regulator for activities conducted within the national bank charter and its subsidiaries, except for those activities where jurisdiction has been expressly provided to another functional supervisor, such as the Securities and Exchange Commission (SEC), for certain broker-dealer activities. Nonetheless, we work closely with the Federal Reserve Board, the SEC, and other appropriate regulators to help promote consistent and comprehensive supervision across the company.

The foundation of the OCC's supervisory efforts is our continuous, onsite presence of examiners at each of our 14 largest banking companies. These 14 banking companies account for approximately 89 percent of the assets held in all of the national banks under our supervision. The resident examiner teams are supplemented by subject matter specialists in our Policy Division and PhD economists from our Risk Analysis Division trained in quantitative finance.

Our Large Bank program is organized with a national perspective. It is highly centralized and headquartered in Washington, and structured to promote consistent uniform coordination across institutions. The onsite teams at each or our 14 largest banks are led by an Examiner-In-Charge (EIC), who reports directly to the Deputy Comptrollers in our Large Bank Supervision Office in Washington, DC. The Large Bank Deputies are in ongoing communication with the EICs, in addition to holding monthly calls and quarterly face-to-face meetings with all EICs. To enhance our ability to identify risks and share best practices across the large bank population, we have established a program of examiner network groups in Large Banks. There are eight main network groups (Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk and Compliance) and numerous subgroups. These groups facilitate sharing of information, concerns and policy application among examiners with specialized skills in these areas. The EICs and leadership teams of each of the network groups work closely with specialists in our Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to emerging issues.

All of this enables the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors. Nonetheless, given the volume and complexity of bank transactions, it is not feasible to review every transaction in each bank, or for that matter, every single product line or bank

activity. Accordingly, we focus on those products and services posing the greatest risk to the bank through risk-based supervision.

Resident examiners apply risk-based supervision to a broad array of risks, including credit, liquidity, market, compliance and operational risks. Supervisory activities are based upon supervisory strategies that are developed for each institution that are risk-based and focused on the more complex banking activities. Although each strategy is tailored to the risk profile of the individual institution, our strategy development process is governed by supervisory objectives set forth annually in the OCC's bank supervision operating plan. Through this operating plan, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concerns. With the operating plan as a guide, EICs develop detailed strategies that will direct supervisory activities and resources for the coming year. Each strategy is reviewed by the appropriate Large Bank Deputy Comptroller. Our risk-based supervision is flexible, allowing strategies to be revised, as needed, to reflect the changing risk profile of the supervised institutions. We have a Quality Assurance group within our Large Bank program that selects strategies to review as part of a supervisory program review to ensure reasonableness and quality supervision.

Our supervisory goal is to ensure banks have sound risk governance processes commensurate with the nature of their risk-taking activities. Risk management systems must be sufficiently comprehensive to enable senior management to identify and effectively manage risk throughout the firm. Therefore, examinations of our largest banks focus on the overall integrity and effectiveness of risk management systems.

The first step in risk-based supervision is to identify the most significant risks and then to determine whether a bank has systems and controls to identify and manage those risks. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. This is accomplished through our supervisory process which involves a combination of ongoing monitoring and targeted examinations. The purpose of our targeted examinations is to validate that risk management systems and processes are functioning as expected and do not present any significant supervisory concerns. Our supervisory conclusions, including any risk management deficiencies, are communicated directly to bank senior management. Thus, not only is there ongoing evaluation, but there is also a process for timely and effective corrective action when needed. To the extent we identify concerns, we "drill down" to test additional transactions.

These concerns are then highlighted for management and the Board as "Matters Requiring Attention" ("MRAs") in supervisory communications. Often these MRAs are line of business specific, and can be corrected relatively easily in the normal course of business. However, a few MRAs address more global concerns such as enterprise risk management or company-wide information security. We also have a consolidated electronic system to monitor and report outstanding MRAs. Each MRA is assigned a due date and is followed-up by onsite staff at each bank. If these concerns are not appropriately addressed within a reasonable period, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

Our supervision program includes targeted and on-going analysis of corporate governance at our large national banks. This area encompasses a wide variety of supervisory activities including:

- Analysis and critique of materials presented to directors;
- Review of board activities and organization;
- Risk management and audit structures within the organization, including the independence of these structures;
- Reviews of the charters, structure and minutes of significant decisionmaking committees in the bank;
- Review of the vetting process for new and complex products and the robustness of new product controls; and
- Analysis of the appropriateness and adequacy of management information packages used to measure and control risk.

It is not uncommon to find weaknesses in structure, organization, or management information, which we address through MRAs and other supervisory processes described above. But more significantly, at some of our institutions what appeared to be an appropriate governance structure was made less effective by a weak corporate culture, which discouraged credible challenge from risk managers and did not hold lines of business accountable for inappropriate actions. When the market disruption occurred in mid 2007, it became apparent that in some banks, risk management

lacked support from executive management and the board to achieve the necessary stature within the organization, or otherwise did not exercise its authority to constrain business activities. At institutions where these issues occurred, we took strong supervisory actions, and we effected changes in personnel, organization and/or processes.

Just as we adjust our strategies for individual banks, we also make adjustments to our overall supervisory processes, as needed. And of course we are adjusting our supervisory processes to incorporate the lessons we have learned during this period of extreme financial distress. For example, recent strategy guidance prepared by our Large Bank network groups and issued by Large Bank senior management increases our focus on:

- Risk concentrations across the enterprise;
- Refinancing risk arising from illiquidity in credit markets and changes in underwriting standards that limit the ability of many borrowers to refinance debt as originally intended;
- Collections, recovery and loss mitigation programs;
- Decision modeling;
- Liquidity contingency planning;
- Allowance for loan and lease loss adequacy;
- Capital buffers and stress assessments; and
- Syndication and other distribution processes and warehouse/pipeline controls.

Our supervisory activities at individual banks are often supplemented with horizontal reviews of targeted areas across a group of banks. These horizontal reviews can help us to identify emerging risks that, while not posing a significant threat to any one institution could, if not corrected, pose more system-wide implications for the industry. For example, reviews of certain credit card account management practices several years ago revealed that as a result of competitive pressures, banks were reducing minimum payments required from credit card customers to the point where many consumers could simply continue to increase their outstanding balances over time with no meaningful reduction in principal. We were concerned that these competitive pressures could mask underlying deterioration in a borrower's condition and could also result in consumers becoming over-extended. Because of the highly competitive nature of this business, we recognized that we needed to address this problem on a system-wide basis and as a result, worked with the other Federal banking agencies to issue the 2003 guidance on Credit Card Account Management Practices.[9]

In addition to the aforementioned liquidity monitoring data we have begun collecting, we have also initiated loan level data collection from our major banks for residential mortgages, home equity loans, large corporate credits, and credit card loans. This data is being used to enhance our horizontal risk assessments in these key segments and offers a tool for examiners to benchmark their individual institution against the industry.

More recently, in early 2008 we began developing a work plan to benchmark our largest national banks against the risk management "best practices" raised in various reports issued by the President's Working Group (PWG), SSG, FSF, and Basel Committee. OCC staff developed a template for our examining staff to collect information to conduct this benchmarking exercise and we shared this with our colleagues at the PWG and SSG. In the interest of expanding the pool of firms and expediting the collection of risk management information, agency principals elected to use the SSG as the forum for undertaking the risk management assessment. In December 2008, a self-assessment template was sent to 23 globally active financial firms and the completed self-assessments are now in the process of being collected and shared among the participating agencies. These self-assessments will be supplemented with interviews at selected firms to discuss the status of addressing risk management deficiencies already identified and also probe for further information on emerging issues that may not yet be evident.

To summarize, the goal of our supervision is to ensure that banks are managed in a safe and sound manner, to identify problems or weaknesses as early as possible and to obtain corrective action. Through our examinations and reviews, we have directed banks to be more realistic in assessing their credit risks; to improve their valuation techniques for certain complex transactions; to raise capital as market op-

[9] *See* OCC Bulletin 2003–1, "Credit Card Lending: Account Management and Loss Allowance Guidance," at *http://www.occ.gov/ftp/bulletin/2003-1.doc.*

portunities permit; to aggressively build loan loss reserves; and to correct various risk management weaknesses.

As previously noted, we have a staff of specialists who provide on-going technical assistance to our onsite examination teams. Our Risk Analysis Division includes 40 PhD economists and mathematicians who have strong backgrounds in statistical analysis and risk modeling. These individuals frequently participate in our risk management examinations to help evaluate the integrity and empirical soundness of banks' risk models and the assumptions underlying those models. Our policy specialists assist by keeping abreast of emerging trends and issues within the industry and the supervisory community. Staffs from our CMR, Operational Risk, and Capital Policy units have been key participants and contributors to the ongoing work of the SSG, FSF, PWG and Basel Committee.

In 2008, we established a Financial Markets Group within the agency and tasked them with the build-out of a market intelligence program. Their mission is to look around corners, to seek out early warning signs of emerging and/or systemic risk issues. This team is comprised of highly experienced bank examiners and subject matter specialists hired from the industry, and they spend considerable time meeting with bank investors, bank counterparties, bank competitors, bank analysts, and other relevant stakeholders. Their work is discussed with members of the OCC's senior management team on a bi-weekly basis, or more frequently when needed, and discussed in detail with the OCC's National Risk Committee members, who represent all lines of bank supervision within the OCC, as well as our legal and economics teams.

Coordination with Other Supervisors

Successful execution of our supervisory priorities requires an effective working relationship with other supervisors, both domestically and internationally. The events of the past 18 months highlight the global nature of the problems we are facing and the need for global responses.

The OCC has taken a significant leadership role in the interagency work underway to address risk management issues raised during this period of market turmoil. Comptroller Dugan is an active member of the PWG and also serves as the Chair of the Joint Forum. In that capacity, he has sponsored critical work streams to address credit risk transfer, off-balance sheet activities and reliance on credit rating agencies. The Joint Forum work not only builds transparency about how large, financial conglomerates manage critical aspects of risk management, but it also serves as a vehicle for identifying risk management "best practices."

Close coordination with our supervisory colleagues at the other banking agencies, as well as the securities agencies, has proven beneficial for all parties—firms, supervisors and policymakers. One example where this is evident has been the cooperative work among major market players and key regulators (the New York Federal Reserve Bank, the Federal Reserve Board, the OCC, the SEC, and other key global regulators) to strengthen the operational infrastructure and backroom processes used for various over-the-counter (OTC) derivative transactions. This is another example where a collective effort was needed to address problems where there was not a clear incentive for any individual firm to take corrective action. As a result of these efforts, we have seen material improvements in the reduction of unconfirmed trades across all categories of OTC derivatives, with the most notable reduction in the area of credit derivatives, where the large dealers have reduced by over 90 percent the backlog of credit derivatives confirmations that are outstanding by more than 30 days.

GAO Report

As I noted in my introduction, we received the GAO's draft statement of findings on Friday night and, as requested, provided them with summary comments on those draft findings on Monday morning. Once we receive the GAO's final report, we will give careful consideration to its findings and any recommendations therein for improvement in our supervisory processes. We will be happy to share our conclusions and responses with the Subcommittee.

As I have described in my testimony, the OCC has a strong, centralized program for supervising the largest national banks. But clearly, the unprecedented global disruptions that we have witnessed across the credit and capital markets have revealed risk management weaknesses across banking organizations that need to be fixed and we are taking steps to ensure this happens. In this regard, it is important to recognize that risk management systems are not static. These systems do and must evolve with changes in markets, business lines, and products. For example, improving and validating risk models is an ongoing exercise at our largest institutions. Therefore it should not be surprising that we routinely have outstanding

MRAs that direct bank management to make improvements or changes to their risk models and risk management practices. This is an area where we continuously probe to look for areas of improvement and best practices. As I described earlier, we have systems in place to monitor and track these MRAs and, when we determine that the bank is not making sufficient progress to address our concerns, we can and do take more forceful action. However, unless we believe the model deficiency is so severe as to undermine the bank's safety and soundness, we will allow the bank to continue to use the model as it makes necessary refinements or adjustments. Given the iterative process of testing and validating risk models, it simply is not realistic to suggest that a bank suspend its operations or business whenever it needs to make enhancements to those processes.

One of the GAO's major findings is that institutions failed to adequately test for the effects of a severe economic downturn scenario. As I have discussed, we agree that the events of the past 18 months have underscored the need for improved and more robust stress testing. Banks' stress tests need to more fully incorporate potential interconnection risks across products, business lines and markets, and evaluate such exposures under extreme tail-events. The OCC was actively involved in developing the January 2009 report issued by the Basel Committee cited by the GAO. Indeed, many of the findings and recommendations in that report were drawn from our findings and work in our large banking institutions. We will be working with these institutions to ensure that they incorporate those recommendations into their stress testing processes.

Conclusion

The events of the past 18 months have highlighted and reinforced the need for effective risk management programs and revealed areas where improvements are needed. I believe the OCC and the banking industry are taking appropriate steps to implement needed changes. I also believe that these events have demonstrated the strength of the OCC's large bank supervision program. Throughout the recent market turmoil, our resident examination staffs at the largest institutions have had daily contact with the business and risk managers of those institutions' funding, trading, and lending areas to enable close monitoring of market conditions, deal flow and funding availability. Their insights and on-the-ground market intelligence have been critical in helping to assess appropriate policy and supervisory responses as market events have continued to unfold. Indeed, I believe that the OCC's large bank supervision program, with its centralized oversight from Washington D.C., and highly experienced resident teams of bank examiners and risk specialists, is the most effective means of supervising large, globally active financial firms.

Statement Required by 12 U.S.C. § 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

PREPARED STATEMENT OF SCOTT M. POLAKOFF

ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

MARCH 18, 2009

I. Introduction

Good afternoon Chairman Reed, Ranking Member Bunning and members of the Subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on how the Federal financial regulators conduct oversight of risk management. I appreciate the opportunity to familiarize the Subcommittee with several critical risk management areas and how OTS has revised its supervisory oversight based on lessons learned. I also appreciate the opportunity to comment on the state of risk management in the financial services industry and OTS's recommendations for improving regulatory oversight and cooperation.

In my testimony, I will discuss critical risk management areas that led to the failure or near-failure of an array of financial institutions. I will provide examples of the lessons learned and the actions that OTS has taken to revise industry and examiner guidance to ensure effective and efficient regulation. I will also describe risk management areas that warrant close supervision and provide OTS's perspective on how to proceed. My discussion will focus on five primary risk areas that played roles in the economic crisis: concentration risk, liquidity risk, capital adequacy, loan loss provisioning and fair value accounting.

II. Overview of OTS-regulated Entities

I would like to begin with an overview of the thrift industry. At the end of 2008, OTS supervised 810 savings associations with total assets of $1.2 trillion and 463 holding company enterprises with approximately $6.1 trillion in U.S. domiciled consolidated assets. The majority of savings associations (97.2 percent) exceed well capitalized regulatory standards with combined assets that represent 95.3 percent of industry aggregate assets.

Recent increases in problem assets have resulted primarily from the housing market downturn and rising unemployment. In December 2008, troubled assets (noncurrent loans and repossessed assets) rose to 2.52 percent of assets, up from 1.66 percent a year ago. The current level of troubled assets is the highest since the early 1990s, when it reached 3.74 percent; however, the composition is quite different. While one- to four-family mortgage loans are traditionally lower-risk, they currently account for about 72 percent of the thrift industry's troubled assets. Economic problems are spreading to commercial real estate (nonresidential mortgage, multifamily and construction loans), which now account for 20 percent of the troubled assets. In contrast, 68 percent of troubled assets in 1990 were commercial real estate loans. One- to four-family mortgages accounted for 23 percent of troubled assets.

The prominence of residential mortgage loans among troubled assets requires a strong commitment to effective loan modification programs. OTS is collaborating with the Office of the Comptroller of the Currency to produce a quarterly Mortgage Metrics Report that analyzes performance data of first-lien residential mortgage loans serviced by federally regulated savings associations and national banks. The agencies are finalizing the report for the fourth quarter of 2008. The goal is to provide a comprehensive picture of mortgage servicing activities of the industry's largest mortgage servicers. This report includes data on mortgage delinquency rates, home retention actions and foreclosures. The fourth quarter report will include granular information to measure the effectiveness of loan modifications and new data on the affordability and sustainability of loan modifications.

Preliminary analysis from the fourth quarter Mortgage Metrics Report indicates that credit quality continues to deteriorate, resulting in increased delinquencies and early payment defaults. However, home retention efforts, including loan modifications and payment plans, continue to increase. The fourth quarter report analyzes modifications based on four categories of payment modification. The two categories that lower the borrower's monthly payment are the most successful in improving affordability and sustainability. Servicers have increased use of these types of loan modifications, which is leading to fewer foreclosures.

The number of problem thrifts has risen over the past year. OTS defines problem institutions as those with the two lowest composite safety-and-soundness exam ratings of "4" or "5." There were 26 problem thrifts representing 3.2 percent of all thrifts at the end of the year. This is more than double from year-end 2007, when OTS reported 11 problem institutions. One common measurement of capital strength in an unstable economic period is the ratio of tangible common equity capital to tangible assets. The ratio is stable for savings associations, measuring 7.61 percent at the end of 2008. This measurement remains close to the 9-year average of 7.70 percent.

Focusing attention on core earnings is another method to assess the strength of insured depository institutions while eliminating volatile items. Core earnings measures exclude one-time events such as branch sale gains or acquisition charges. They also exclude charges for provisions for loan losses, which is a major reason for the losses by savings associations. The thrift industry's operating earnings remained stable and measured 1.39 percent of average assets in 2008. This is consistent with operating earnings of 1.37 percent and 1.34 percent for 2007 and 2006, respectively. Although a focus remains on problem banks and the deteriorating mortgage market, the vast majority of insured financial institutions maintain solid capital, sufficient loan loss reserves, stable operating earnings and effective risk management.

III. Critical Risk Areas

OTS has learned multiple lessons during this economic cycle and has used this knowledge to refine and improve its regulatory program. The agency conducts independent internal failed bank reviews for savings associations placed in receivership and generates a series of recommended actions to supplement and improve its regulatory oversight. Upon finalizing each review, senior managers distribute internal guidance identifying lessons learned to improve examiners' focus on critical risk management areas. OTS also committed to implementing the recommendations derived from the Material Loss Review reports from the Office of the Inspector General. The agency has made substantial progress in implementing recommended actions to improve regulatory oversight.

The OTS closely monitors—in some cases participates in—and responds to risk management recommendations by the Senior Supervisors Group report on Risk Management Practices, the Financial Stability Forum's report on enhancing market and institutional resilience, the Basel Joint Forum's report on the identification and management of risk concentrations, and the Government Accountability Office report on regulatory oversight of risk management systems. The agency reviews these reports and integrates their findings when revising regulatory guidance and examination programs. OTS participated on the Joint Forum working group that produced the report on risk concentrations. Several of the report's recommendations derive from OTS's expertise in supervising or regulating financial institutions ranging from community banks to international conglomerates. All of the Federal banking agencies are members of the international Basel Committee on Banking Supervision, which comprises banking supervisors worldwide. The Basel Committee on Banking Supervision provides an international forum to collaborate and improve the quality of bank supervision.

Managing compliance with consumer protection laws is also a critical element of effective enterprise risk management and is a focus of OTS's supervisory oversight of risk management. OTS requires sound compliance risk management programs in all savings associations. Excessive compliance risk can harm consumers, diminish a savings association's reputation, reduce its franchise value and limit its business opportunities. It can also expose a financial institution to supervisory enforcement action and litigation.

OTS expects the sophistication of a savings association's risk management program to be appropriate for the size and complexity of the financial institution. OTS places responsibility on a financial institution's Board of Directors for understanding, prescribing limits on and monitoring all risk areas. Traditionally, financial institutions have managed their operations by organizational unit or legal entity rather than from a holistic, enterprise-wide risk management perspective. However, financial institutions are shifting their focus toward enterprise-wide risk management structures. This transition from a silo-based risk management function to horizontal risk management across business lines is an appropriate evolution. One of the lessons of the current crisis and a key recommendation of each of the risk management reports mentioned above is that financial institutions must be aware of how risk concentrations and business activities interrelate throughout the organization. Regulators, in turn, must identify weaknesses in enterprise risk management and ensure that boards of directors take prompt action to correct the deficiencies.

OTS communicates refinements in its supervisory program to examiners, Chief Executive Officers, Board members and industry groups through examination handbooks, official correspondence, outreach meetings, and other internal and external issuances. Based on the knowledge we have gained through horizontal reviews of OTS-regulated financial institutions, cooperation with domestic and international financial regulators, routine examination and supervision of savings associations and their holding companies, and failed bank reviews, the agency has identified several key risk management areas for discussion.

Concentration Risk

Poorly managed concentration risk contributed significantly to the deterioration in performance of several OTS-regulated problem banks. Concentrations are groups of assets or liabilities that have similar characteristics and expose a financial institution to one or more closely related risks. OTS defines a concentration as an asset, liability, or off-balance sheet exposure that exceeds 25 percent of the association's core capital, plus allowances for loan and lease losses. The agency encourages its examiners to use discretion in identifying higher-risk assets or liabilities that may not meet this threshold, but still pose a concentration risk. OTS also encourages financial institutions' Boards of Directors to approve limits and monitor concentrations based on their exposure relative to Tier 1 capital and allowances for loan and lease losses.

Concentrations pose risk because the same economic, political, geographic, or other factors can negatively affect the entire group of assets or liabilities. The financial industry and the regulatory community have learned a valuable lesson about the risk exposure of asset, liability and off-balance sheet concentrations. Institutions with concentrations need to manage the risk of individual assets or liabilities, as well as the risk of the whole group. For example, an institution may have a portfolio of prudently underwritten loans located in a single geographic location. The geographic concentration exposes otherwise prudent loans to the risk of loss because a single regional economic event can expose the entire portfolio to losses. If the institution does not appropriately manage its geographic lending activity through size, sector and counterparty limits, then it has heightened risk exposure. Management

should regularly evaluate the degree of correlation between related assets or liabilities, and establish internal guidelines and concentration limits that control the institution's risk exposure.

The Basel Committee on Banking Supervision Joint Forum's paper on concentration risk surveyed and summarized concentration risk management among financial conglomerates. While its focus was on financial conglomerates, the principles of concentration risk it identified are applicable to all financial institutions. It suggests that concentration risk has three elements. The first element of concentration risk is materiality. Financial institutions must identify whether the risk concentration can produce losses that threaten their health or ability to maintain their core operations. They must also determine whether an interruption in the concentrated business activity would lead to a material change in their risk profile. The second element is the identification of single, or closely related, drivers of risk that may affect each part of the institution differently. Effective risk management requires that the impact of these drivers be integrated into any analysis to assess the overall risk exposure of the institution. The third element is that risk concentrations arise not just in assets, but also in liabilities, off-balance sheet items, or through the execution or processing of transactions.

OTS captures each of these elements in its supervisory program and requires examiners to document concentrations of assets, liabilities and off-balance sheet activity in each comprehensive examination report. The agency is acutely aware of the risk that a concentration can pose to an institution, whether the concentration arises from a business strategy, a product type, or a funding program. OTS guidelines recommend establishing limits based on a ratio of the asset, liability, or off-balance sheet item to core capital and allowances for loan and lease losses. In many cases, OTS places limitations on the amount of assets, liabilities, or other activities that expose the institution to concentration risk. Firms should also have additional capital as a buffer against the larger loss potential that a concentration can present. The agency also has expectations that savings associations with high concentration risk establish robust risk management practices to identify, measure, monitor and control the risk.

A key concentration risk that OTS identified in the current crisis is the risk exposure of warehouse and pipeline loans in financial institutions that engage in an originate-to-sell business model during stressful market events. In response, OTS updated its one- to four-family real estate lending examination handbook in September 2008. The agency also distributed a letter to Chief Executive Officers outlining revised recommendations for monitoring and managing the level of pipeline, warehouse and credit-enhancing repurchase exposure for mortgage loans originated for sale to nongovernment sponsored purchasers. In the letter, OTS states that any concentration that exceeds 100 percent of Tier 1 capital will receive closer supervisory review. This revised guidance was in response to the lessons learned from recent bank failures and a horizontal review of all OTS institutions to assess the examination and supervision of mortgage banking activity.

Another example of the regulatory expectations for concentration risk management is the 2006 guidance on managing commercial real estate concentration risk. The guidance applied to savings associations actively engaged in commercial real estate (CRE) lending, especially those that are entering or rapidly expanding CRE lending. The guidance states that institutions should perform a self-assessment of exposure to concentration risk. They should continually monitor potential risk exposure and report identified concentration risk to senior management and the board of directors. The guidance also recommends implementing risk management policies and procedures to monitor and manage concentration risk based on the size of the portfolio and the level and nature of concentrations.

The OTS expects savings associations to continually assess and manage concentration risk. OTS conducts quarterly monitoring of savings associations' investments to determine compliance with portfolio limitations and to assess each association's exposure to concentration risk. An institution should hold capital commensurate with the level and nature of its risk exposure. Accordingly, savings associations with mortgage banking or commercial real estate concentration exposure should assess the credit risk, operational risk and concentration risk of those business activities. In assessing the adequacy of an institution's capital, OTS also considers management expertise, historical performance, underwriting standards, risk management practices and market conditions.

By the nature of the thrift charter, savings associations are required to hold a concentration in real estate mortgage or consumer lending-related assets. OTS-regulated savings associations are subject to two distinct statutory restrictions on their assets, which contribute to this inherent concentration in mortgage lending. The first is a requirement that thrifts hold 65 percent of their assets in qualified thrift

investments. This ensures that thrifts maintain a focus on mortgage and retail consumer lending activities. The second set of restrictions includes limitations on the ability of savings associations to engage in specific lending activities, including consumer, commercial and small business lending.

Although there is merit for maintaining restrictions to ensure that savings associations focus on mortgage and retail consumer and community lending activities consistent with the purpose of the thrift charter, certain asset restrictions contradict the purpose of the charter and compromise safety and soundness. For example, savings associations have no limits on credit card lending, an unsecured lending activity, but are limited to 35 percent of their assets in secured consumer lending activities. This has the clearly unintended effect of promoting unsecured consumer lending activities over secured consumer lending. Similarly, the existing 20 percent of assets limit on small business lending discourages thrifts from pursuing business activities that could diversify their lending operations and credit risk.

The OTS has offered several legislative proposals to address these shortcomings, while maintaining the thrift charter's focus on consumer and community lending. These increases would strengthen OTS-regulated institutions by further diversifying their business lines and would increase the availability of credit in local communities. Small business lending is a key to economic growth and recovery, particularly in low- and moderate-income areas.

Liquidity Risk

Another risk management area that requires additional focus is liquidity risk. OTS and the other U.S. banking agencies published interagency guidance that required institutions to develop a comprehensive liquidity risk management program. As articulated in this interagency guidance, a sound liquidity risk management program includes clearly written policies, well-defined responsibilities, strong management information systems, sound forecasting and analysis, thoughtful contingency planning, scenario analyses, and diversification and management of funding sources.

Recent events illustrate that liquidity risk management at many insured depository institutions needs improvement to comply with this guidance. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, insufficient cash-flow projections and a lack of viable contingency funding plans. The current crisis also identified areas where it is necessary to strengthen supervisory guidance and oversight. In mid 2007, the secondary mortgage markets began showing signs of stress as investor appetite for non-conforming mortgages greatly diminished. Many large institutions that relied on the originate-to-distribute model were trapped by the speed and magnitude of market liquidity evaporation. As the size of their mortgage warehouse ballooned, lenders and depositors became increasingly concerned about the financial health and long-term viability of these organizations. Those institutions that had a strong contingency funding strategy were able to find temporary relief until they could develop longer-term solutions.

OTS is working with the other U.S. banking agencies to issue updated interagency guidance on funding liquidity risk management. The revised guidance will incorporate the recent lessons learned and the liquidity guidance issued by the Basel Committee on Banking Supervision. As part of this guidance, the agencies will reiterate the need for diversified funding sources, stress testing and an unencumbered cushion of highly liquid assets that are readily available and are not pledged to payment systems or clearing houses. This increased emphasis on high-quality liquid assets is important because many firms had a misconception about the extent to which decreases in market and funding liquidity are mutually reinforcing. As market liquidity erodes, so does the availability of funding. The regulatory agencies plan to release the revised guidance with a notice for public comment the first half of 2009.

OTS is also strengthening its examination and supervision of savings associations with high-risk business models or reliance on volatile funding sources. In some cases, OTS is obtaining daily liquidity monitoring reports from financial institutions to identify cash in-flows and out-flows and the availability of unpledged collateral. We are also stressing the need for institutions to test the actual availability of lines of credit and to work actively with their respective Federal Home Loan Banks to ensure sufficient borrowing capacity. OTS is also conducting a review of liquidity risk management to identify best practices and issue guidance to savings associations. The agency is using the review to develop additional liquidity metrics as a tool for examiners to use to identify institutions with developing liquidity problems.

Capital Adequacy

OTS and the other Federal banking agencies agree that capital adequacy is a central component of safe and sound banking. Capital absorbs losses, promotes public confidence and provides protection to the deposit insurance fund. It provides a financial cushion for a financial institution to continue operating during adverse events. OTS has learned important lessons about how the capital adequacy rules work in a broad economic downturn and when financial systems are stressed primarily because of systemic events, including the deterioration in values of entire asset classes.

This crisis underscores the critical importance of prudent underwriting for every loan. The risk of home loans varies depending upon factors, such as the loan-to-value, borrower creditworthiness, loan terms and other underwriting factors. Yet the risk-based capital requirements do not adequately address the varying levels of risk in different types of home loans. The existing risk-based capital rules treat almost all home loans as having similar risk and assign most of them a 50 percent risk weight, which effectively requires $4 of capital for every $100 dollars of asset value. A more sensitive risk-based capital framework with meaningful risk drivers should encourage Federal depositories to make fewer higher-risk mortgage loans, or to support higher-risk lending activity with a more realistic capital cushion.

Among the capital tools available to a supervisor in an environment of financial stress is the early intervention authority under Section 38 of the Federal Deposit Insurance Act, known as Prompt Corrective Action (PCA). The purpose of PCA statutory authority was to require and enable supervisory intervention before an institution becomes critically undercapitalized. PCA is triggered by an institution's capital category, as defined in 12 USC § 1831o and 12 CFR Part 565. Depending on an institution's PCA capital category, the statute automatically imposes certain restrictions and actions. The restrictions begin once an institution falls below the well-capitalized category. In addition to the automatic restrictions, there are other discretionary PCA actions. The expectation is that banking agencies must apply progressively significant restrictions on operations as an institution's capital category declines.

To be effective, supervisory intervention must be timely when an institution is experiencing a rapid and severe deterioration in its financial condition. However, because PCA is linked to declining capital categories, we have learned that its utility is limited in a liquidity crisis, particularly when the crisis is widespread. We have witnessed severe and rapid declines in the financial condition of well or adequately capitalized institutions that were precipitated by an inability to meet rapid, sustained deposit outflows or other cash and collateral demands. In the current crisis, PCA has not been an effective supervisory tool because its triggers for supervisory action are capital-driven. Extraordinary liquidity demands typically do not produce the gradual erosion of capital envisioned by PCA. It is possible to modernize the PCA framework to link the PCA system to other risk areas.

Liquidity and funding problems can stem from a lack of investor confidence in an institution's financial condition. In the current environment, this may also stem from a lack of confidence in balance sheets of financial institutions and a belief that there is insufficient transparency. While institutions report well-capitalized ratios, investors are questioning the value of those ratios under extreme financial stress when it is difficult to value assets. Some have also questioned the quantity and quality of capital and the validity of capital buffers in stressful periods. The economic crisis demonstrates the interrelationship of portfolio risk, liquidity, risk-based capital rules and PCA. The Agencies will continue to review our rules in light of these lessons learned.

OTS and the other Federal banking agencies finalized the Basel II advanced capital adequacy rules, which establish a capital requirement that increases proportionally with loan risk. The advanced rules are mandatory only for the largest financial institutions in the United States, in part due to the complexity of measuring risk and assigning commensurate capital requirements, often requiring a models-based approach. Due to this complexity, implementation of the advanced Basel II rules will take several years.

The Agencies have also developed a proposal for a standardized risk-based capital adequacy framework that is simpler than the advanced rule, yet more risk sensitive than the existing framework for home mortgages. If this voluntary framework is finalized in its current form, no one knows how many institutions would adopt it, but most of the banking industry would likely not choose it. The Agencies proposed these new standardized rules in 2008, but based on recent lessons learned, the proposal needs further improvement. OTS supports expanding the risk-based capital refinements in the proposed rule and extending capital modernization to all Federal depositories.

In designing the Basel II capital adequacy framework, the Basel Committee intended for Basel II to be a "living framework." As part of its strategic response to address weaknesses revealed by the financial market crisis, the Basel Committee has reviewed the Basel II capital adequacy framework and has developed and published for comment a series of proposed enhancements to strengthen the framework. The Basel Committee has also just announced it is developing a combination of measures to strengthen the level of capital in the banking system to increase resilience to future episodes of economic stress. It plans to introduce standards to increase capital buffers for stress events and to strengthen the quality of bank capital. The Committee also announced that it would review the regulatory minimum level of capital to arrive at a higher level than the current Basel II framework. OTS and the other Agencies continue our work with other Basel Committee members to evaluate the financial crisis and refine our rules.

Loan Loss Provision

Another area that deserves attention because of the rapid deterioration in credit quality is the adequacy of allowances for loan and lease losses (ALLL). Economic weakness and uncertainty of the timing of the economic recovery require elevated levels of loan loss reserves. Savings associations responded to this environment and outlook by significantly bolstering their ALLL. In the fourth quarter, savings associations added $8.7 billion to loan loss provisions, bringing the total additions to a record $38.7 billion for the year. These substantial loan loss provisions increased the ratio of loss reserves to total loans and leases 63 percent, from 1.10 percent 1 year ago to 1.79 percent at the end of 2008.

Because financial institutions build loan loss reserves through charges to earnings, these substantial loss provision expenses are driving industry net losses. The large provision for losses in the fourth quarter resulted in a net loss of $3 billion, or an annualized return on average assets (ROA) of negative 1.02 percent. The record annual provision drove the industry's loss to a record for all of 2008 of $13.4 billion, or an ROA of negative 1.00 percent. Loss provisioning will continue to dampen industry earnings until home prices stabilize, job market losses slow and the employment outlook improves.

On September 30, 2008, OTS issued guidance to its examiners and other supervision staff members about the allowance for loan losses. The purpose of the guidance was to highlight best practices for savings associations. This guidance discussed inflection points, or periods of increasing or decreasing losses, the use of lagging data when loss rates change quickly, and validation methods that rely on leading data rather than historical loss experience.

Institutions rely on the 2006 interagency guidance, *"Interagency Policy Statement on the Allowance for Loan and Lease Losses* and supplemental *Questions and Answers on Accounting for Loan and Lease Losses,"* to manage loan loss provisions. This guidance uses the Generally Accepted Accounting Principles' incurred loss model for assessing losses and establishing reserves. When there is a significant economic downturn following an extended period of positive economic performance, the incurred loss model may result in insufficient loan loss allowances and the need for substantial increases. OTS supports refining the current accounting model to one based on expected credit losses for the life of the loan. An expected loss model will result in more robust allowances throughout the credit cycle to absorb all expected charge-offs as they occur over the life of the loan, without regard to the economic environment. The expected loss model would not eliminate pro-cyclicality, but it would allow for earlier recognition of loan losses.

Fair Value Accounting

Many have blamed the current economic crisis on the use of "mark-to-market" accounting. Some assert that this accounting model contributes to pro-cyclicality or a downward spiral in asset prices. The theory is that as financial institutions write down assets to current market values in an illiquid market, those losses reduce regulatory capital. In order to increase regulatory capital ratios, those institutions deleverage by selling assets into stressed, illiquid markets. This triggers a cycle of additional sales at depressed prices and results in further write-downs by institutions holding similar assets.

The term "mark-to-market" can be misleading. Thrifts carry less than 5 percent of their assets at market value, with gains and losses recognized in earnings and regulatory capital. These include trading assets, derivatives and financial instruments for which the thrift has voluntarily elected the fair-value option. We believe it is appropriate to report these assets at fair value because financial institutions manage them, or should manage them, on a fair-value basis.

Fair value accounting requires the recognition in earnings and regulatory capital of significant declines in the fair value of investment securities, including mortgage backed securities. Fair value determinations are more challenging when the markets are illiquid. Financial institutions find it difficult to determine fair value because there is a lack of trades of identical or similar securities. The result is that institutions must rely on models and assumptions to estimate fair value. The OTS supports disclosure of the assumptions used to estimate fair value. Increased transparency would improve confidence in the fair value adjustment.

The Securities and Exchange Commission (SEC), in its *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting,* stated that fair value accounting did not play a meaningful role in bank failures in 2008. The SEC staff concluded that U.S. bank failures resulted from growing probable credit losses, concerns about asset quality and, in certain cases, eroding lender and investor confidence. The report also concluded that for the failed banks that did recognize sizable fair-value losses, the reporting of these losses was not the reason the bank failed.

OTS believes that refining fair value accounting is a better approach than suspending it. It is possible to improve the accounting standards to respond to both those who insist fair value accounting should continue and those that call for its suspension.

The most significant fair value issue facing savings associations relates to non-trading investment securities. Non-trading investment securities are those the institution designates as available-for-sale or held-to-maturity. The concept of "other-than-temporary impairment" (or OTTI) is the primary area of concern. Accounting standards call for different impairment (loss) recognition models, based on whether an asset is a loan or a security. Loan impairment reflects only credit losses. The measure of impairment of debt securities is fair value. In the current market, fair value can include recognition of significant additional losses because of illiquidity and other non-credit losses that may be temporary. This discrepancy, although largely overlooked in the past, is at the center of the debate about fair value accounting because the non-credit components of fair value losses in some cases represent the majority of the loss amount.

OTS supports an alternative to the current mark-to-market accounting model that is gaining recognition through recent roundtable discussions on accounting standards. The Center for Audit Quality recommended this alternative approach to the SEC in its November 13, 2008 letter responding to the SEC's study of mark-to-market accounting. The proposed alternative would identify and clarify the components of fair value and improve the application and practice of the fair value accounting standards. Fair value estimates incorporate numerous observable data, such as the credit worthiness and paying capacity of the debtor, changes in interest rates and the volume of market liquidity.

Under the proposed alternative accounting treatment, financial institutions would continue to report impaired investment securities at fair value. They would separate impairment losses into two components: credit and non-credit. They would continue to report the credit component as a reduction of earnings, but they would report the noncredit component as a direct reduction of equity. The significant result of this alternative accounting treatment is that only the credit loss portion would immediately reduce regulatory capital. It would also mitigate the effects of temporary market volatility on earnings. The non-credit component would result in a direct reduction in equity, but would not reduce earnings or regulatory capital unless the institution sells the security and realizes the loss. The credit component consists of probable declines in expected cash-flows. These declines represent a loss of contractual or estimated cash-flows anticipated by an investor, and should reduce earnings and regulatory capital immediately.

OTS believes that this recommendation to recognize the credit loss component of the OTTI impairment through earnings improves the application of the fair value accounting standards. This improvement in the accounting standards will align the recognition of impairment for loans and securities more closely. Financial institutions already record an allowance for loan loss based only on the credit impairment. Because many investment securities held by financial institutions are mortgage- or asset-backed securities, it is reasonable to use a similar model to recognize losses on debt securities.

Investor panic to sell certain investments immediately rather than take a longer-term view of their underlying value has exacerbated current market conditions. The desire to stop the decline in fair value fuels these sales because of the current OTTI accounting requirements. Bifurcation of the fair value components will permit investors to take a longer-term view of investments, by only recognizing declines in expected cash-flows in earnings. Other components of fair value adjustments will be

reported in a separate section of equity. When markets return to normalized activity, financial institutions can recover these components.

IV. Regulatory Restructuring

Lessons learned on risk management are helping to guide OTS's position on regulatory restructuring. The events of the past several years have reinforced the need for a review of the framework for the regulatory oversight of financial services firms of all types. The importance of ensuring consistent regulation for similar products regardless of the issuer or originator has become evident, whether the product is a mortgage loan or a complex commercial instrument. One of the goals of creating a new framework should be to ensure scrutiny of all bank products, services and activities. There should be consistent regulation and supervision of every entity that provides bank-like products, services and activities, whether or not it is an insured depository institution. The "shadow bank system," where bank or bank-like products are offered by nonbanks, should be subject to the same rigorous standards as banks.

As one element of regulatory modernization, OTS recommends subjecting unevenly regulated or under-regulated mortgage brokers and independent mortgage companies to the same regulatory, supervisory and enforcement regime as insured institutions offering the same products.

Another important element in regulatory modernization is establishing a systemic risk regulator. OTS endorses establishing a systemic risk regulator with broad regulatory and monitoring authority of companies whose failure or activities could pose a risk to financial stability. Such a regulator should be able to access funds, which would present options to resolve problems at these institutions. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities and insurance.

V. Conclusion

Effective enterprise risk management, commensurate with the size and complexity of a financial institution's operations, is paramount. The lessons learned from this economic cycle support this conclusion. A holistic approach to identifying, assessing and managing risk is relevant not only for financial institutions, but also for the regulatory environment. The interdependency of each risk area warrants a comprehensive solution from financial institutions and the agencies that regulate them.

Thank you, Mr. Chairman, Ranking Member Bunning and members of the Subcommittee for the opportunity to testify on risk management and the steps that OTS is taking to adjust its examinations based on the lessons learned during the economic crisis.

Concentration risk, liquidity risk, capital adequacy, allowances for loan and lease losses and fair value accounting are critical areas where risk management deficiencies contributed to the recent turmoil. OTS is committed to refining and improving its oversight to ensure that financial institutions adopt stronger risk management programs.

PREPARED STATEMENT OF ERIK SIRRI

DIRECTOR, DIVISION OF TRADING AND MARKETS,
SECURITIES AND EXCHANGE COMMISSION

MARCH 18, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee:

I am pleased to have the opportunity today to testify concerning the insights gained from the SEC's long history of regulating the financial responsibility of broker-dealers and protecting customer funds and securities.

The turmoil in the global financial system is unprecedented and has tested not only the resiliency of financial institutions, but also the assumptions underpinning many financial regulatory programs. I have testified previously that the deterioration in mortgages spread to the capital markets through securitization, and to related derivative and insurance products. The knock-on effects broadened and deepened beyond those entities that deal in mortgages and mortgage-related financial products, including investment and commercial banks, insurance companies, and government sponsored enterprises, and finally to operating companies.

Market participants relied on the thriving securitization process to disperse risk and provide more private capital raising and investing opportunities for investors, but as we have learned that process did not eliminate or, in many cases, even re-

duce risk. Ultimately, the growing size and dispersion of risk, combined with deteriorating markets, has made clear to regulators the need for greater transparency and stronger risk management controls for financial institutions of all kinds. I believe, however, that hearings such as this one, where supervisors reflect on and share their experiences from this past year will enhance our collective efforts to continue to improve the risk management oversight of complex financial institutions.

The CSE Program and BD Financial Responsibility

Some changes in the capital markets and the broader economy have presented new challenges that are rightly the subject of Congressional review, notwithstanding the current regulatory system's long record of accomplishment. The point is, we don't need to start from scratch. Instead, we should build on and strengthen what has worked, while taking lessons from what hasn't worked in order to adjust the current system to update our regulatory system to fit modern market practices, products, and conditions.

Beginning in 2004, the SEC supervised five entities with large U.S. securities firms as subsidiaries on a consolidated basis, specifically, Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns. For such firms, known as consolidated supervised entities or "CSEs," the Commission oversaw not only the U.S. registered broker-dealer, but also the holding company and all affiliates on a consolidated basis. The registered broker-dealers that were the core regulated entities within the CSE groups were supervised by staff both at the SEC and at the primary self-regulatory organization (SRO), FINRA—a system akin to bank supervision at the depository institution level as well as the holding company level. It should be noted that the U.S. broker-dealer subsidiaries of the CSE firms at all times during this credit crisis remained solvent and adequately capitalized.

The CSE program was designed to be broadly consistent with Federal Reserve oversight of bank holding companies. Of note, the use of the Basel Standard to regulate holding companies of the broker dealer did not result in a diminution of capital at the broker-dealer. First, broker-dealers had to maintain a minimum of $5 billion tentative net capital to qualify for the calculation. Although phrased as an early warning level, the "5 billion" was and remained a hard limit. No firm fell below this requirement. The CSE regime was also tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflected the reliance of securities firms on fair value, and where possible, mark-to-market accounting as a critical risk and governance control.[1] Second, the CSE program requirements as to liquidity are explained below. Whereas commercial banks may use insured deposits to fund their businesses and have access to the Federal Reserve as a backstop liquidity provider, the CSE firms were prohibited, under SEC rules, from financing their investment bank activities with customer funds or fully paid securities held in a broker-dealer. Moreover, the SEC had no ability to provide a liquidity backstop to CSEs.

The CSE program had five principal components: First, CSE holding companies were required to maintain and document a system of internal controls that had to be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission staff examined the implementation of these controls. Third, CSEs were monitored for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs were required to compute a capital adequacy measure at the holding company level that is consistent with standards set forth by the Basel Committee on Banking Supervision (Basel Committee). Finally, CSEs were required to perform stress tests on the liquidity computation and maintain significant liquidity pools at the holding company, for use in any regulated or unregulated entity within the group without regulatory restriction.

To monitor the implementation of firms' internal controls, the CSE program leveraged the firms' internal audit functions, among other things. Our staff met regularly with internal auditors to review and explore issues identified by their risk assessment and audit program. The Commission's rules for CSEs required internal auditors to review the functioning of major governance committees and all internal risk control functions and represent in writing to the SEC annually that this work has been done, with the results presented to the external auditor and the audit committee of the Board of Directors. Also, as circumstances required, or as risk management issues arose, senior officers of the SEC met with CEOs, CFOs, and other members of the firm's senior management to raise issues for focus and resolution.

The CSE program also included examination of and monitoring for key risk control areas, in particular market, credit, liquidity, and operational risk. The holding

[1] Hereafter the terms "fair value" and "mark-to-market" are used interchangeably.

company was required to provide the Commission on a periodic basis with extensive information regarding its capital and risk exposures, including market, credit, and liquidity risk. SEC staff met monthly with CSE firm risk managers and other personnel to review and discuss this information.

Two fundamental components of the CSE program deserve special attention: capital and liquidity. In electing to operate under the CSE program, the holding company was required, among other things, to compute on a monthly basis its group-wide capital in accordance with the Basel standards. CSEs were expected to maintain an overall Basel capital ratio at the consolidated level of not less than the Federal Reserve Bank's 10 percent "well-capitalized" standard for bank holding companies. CSEs were also required to file an "early warning" notice with the SEC in the event that certain minimum thresholds, including the 10 percent capital ratio, were breached or were likely to be breached. Commission rules for CSEs permitted the parent holding company to calculate its capital adequacy using an approach consistent with either of the two Basel standards, adopted by the Basel Committee.

Investment banks relied on the ongoing secured and unsecured credit markets for funding, rather than customer deposits; therefore liquidity and liquidity risk management were of critical importance. In particular, the Commission's rules required CSEs to maintain funding procedures designed to ensure that the holding company had sufficient stand-alone liquidity to withstand the complete loss of all sources of unsecured funding for at least 1 year. In addition, with respect to secured funding, these procedures incorporated a stress test that estimated what a prudent lender would lend on an asset under stressed market conditions (*e.g.,* a haircut). Another premise of this liquidity planning was that any assets held in a regulated entity were unavailable for use outside of the entity to deal with weaknesses elsewhere in the holding company structure, based on the assumption that during the stress event, including a tightening of market liquidity, regulators in the U.S. and relevant foreign jurisdictions would not permit a withdrawal of capital. Thus, the liquidity pool at the holding company was comprised of unencumbered liquid assets.

Beginning immediately in the wake of the Bear Stearns sale to JPMorgan Chase, the SEC broadly strengthened liquidity requirements for CSE firms. The Division of Trading and Markets, working with the Federal Reserve, implemented substantially more rigorous approaches to supervision of liquidity levels and liquidity risk management. We developed scenarios that were much more severe, including denial of access to short-term unsecured funding. Those more stringent scenarios assumed limited access to the Fed's discount window or other liquidity facilities, although in fact such facilities became available to the major investment banks. As a matter of prudence, the investment banks were urged to maintain capital and liquidity at levels far above what would be required under the standards themselves.

The SEC scrutinized the secured funding activities of each CSE firm, and advised the establishment of additional term funding arrangements and a reduction of dependency on "open" and "overnight" transactions. We also focused on the so-called matched book, a significant focus of secured funding activities within investment banks. We monitored closely potential mismatches between the "asset side," where positions are financed for customers, and the "liability side" of the matched book, where positions are financed by other financial institutions and investors. Also, we discussed with CSE senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

Observations and Lessons

The Bear Stearns and Lehman Brothers' experience as well as the continuing financial distress and government support of commercial banks and insurance companies has challenged a number of assumptions held by the SEC. We are working with other regulators to ensure that the proper lessons are derived from these experiences, and changes will continue to be made to the relevant regulatory processes to reflect those lessons. Long before the CSE program existed, the SEC's supervision of investment banks recognized that capital is not synonymous with liquidity that a firm could be highly capitalized—that is, it can have far more assets than liabilities—while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets—cash, and high-quality instruments such as U.S. Treasury securities that can be used as collateral to meet its financial obligations as they arise.

The CSE program built on this concept and required stress testing and substantial liquidity pools at the holding company to allow firms to continue to operate normally in stressed market environments. But what neither the CSE regulatory approach nor most existing regulatory models have taken into account was the possibility that secured funding, even that backed by high-quality collateral such as U.S.

Treasury and agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectation that secured funding, would be available in any market environment, albeit perhaps on less favorable terms than normal.

Thus, one lesson from the SEC's oversight of CSEs—Bear Stearns in particular—is that no parent company liquidity pool can withstand a "run on the bank." Supervisors simply did not anticipate that a run-on-the-bank was indeed a real possibility for a well-capitalized securities firm with high quality assets to fund. Given that the liquidity pool was sized for the loss of unsecured funding for a year, such a liquidity pool would not suffice in an extended financial crisis of the magnitude we are now experiencing, where firms are taking significant writedowns on what have become illiquid assets over several quarters while the economy contracts. These liquidity constraints are exacerbated when clearing agencies seize sizable amounts of collateral or clearing deposits to protect themselves against intraday exposures to the firm. Thus, for financial institutions that rely on secured and unsecured funding for their business model, some modification, such as government backstop emergency liquidity support, may well be necessary to plug a liquidity gap on an interim basis, to guarantee assets over the longer term, or to provide a capital infusion. Indeed, as we have seen, such facilities can be necessary even for deposit-taking institutions. The role of the government in providing any such backstop liquidity should be carefully circumscribed, and the effects on incentives considered.

Another lesson relates to the need for supervisory focus on the concentration of illiquid assets held by financial firms, particularly in entities other than a U.S. registered broker-dealer. Such monitoring is relatively straightforward with U.S. registered broker-dealers, which must disclose illiquid assets on a monthly basis in financial reports filed with their regulators. Also, registered U.S. broker-dealers must take capital charges on illiquid assets when computing net capital. As a result, illiquid assets often are held outside the registered U.S. broker-dealer in other legal entities within the consolidated entity. So, for the consolidated entity, supervisors must be well acquainted with the quality of assets on a group wide basis, monitor the amount of illiquid assets, and drill down on the relative quality of such illiquid assets.

We currently inquire, through FINRA, about the amount of Level 3 assets at broker-dealers, but such information must be known with specificity about affiliates in the group as well. A thorough understanding of illiquid assets would be a more useful measure of financial health than a leverage metric that is broadly applied across a complex financial institution. The SEC has noted on numerous occasions that leverage tests are not accurate measures of financial strength, especially in firms with a sizable matched book or derivatives business. Leverage ratios do not account for the risk or liquidity of the underlying assets or associated hedging positions. Therefore, leverage ratios can overstate or understate actual risk due to leverage. For example: a 10-1 leverage ratio involving Treasury bills involves little risk of loss; however, the same 10-1 leverage ratio applied to uncollateralized loans would be extremely risky, and would not be prudent in a broker-dealer. The same could be said of repo transactions involving treasuries versus mortgages. Rather than rely on such overly simplistic measures of risk, regulators of financial firms have gone to great lengths to develop capital rules that are risk sensitive and act as limiters on the amount of risk that can be taken on by a firm.

While the SEC knew the importance of supervisory focus on illiquid assets, I do not believe any regulator truly understood that market perception of the integrity of the financial statements, which involves both the amount of illiquid assets and the valuation of such assets, could erode so precipitously and ignite a run on a securities firm. This brings me to a related point—and lesson.

A knowledge of illiquid assets also requires supervisors to review valuation thoroughly, and understand how mark-to-market (MTM) is executed within the firm—with a particular focus on the strength of control processes, the independence of the price verification function, and the disclosures made by the firm on its valuation processes. The challenges of valuing illiquid or complex structured products should not cast doubt on the process of marking-to-market, however. In fact, marking-to-market is part of the solution. This is another lesson from the events of 2008.

MTM informs investment bank senior managers of trading performance and asset price and risk factor volatilities, supports profit and loss (p/l) processes and hedge performance analyses, facilitates the generation and validation of risk metrics, and enables a controlled environment for risk-taking In short, the MTM process helps ensure consistency between p/l reporting, hedging, and risk measurement. Without this, discipline across these activities would be more difficult to maintain and risk management would be significantly weaker. The act of marking-to-market provides

necessary information and can impose discipline on risk-taking and risk management.

At securities firms and elsewhere, to protect the accuracy and integrity of the financial institution's books and records and to support the CFO's attestation concerning the fair value of the firm's inventory as of a certain date, an independent group of financial controllers verifies monthly that traders' marks are accurate and unbiased. Once the price verification is completed, summary mark review reports are provided to senior managers at investment banks which provides insight into the composition of the portfolio, as different methods signal different degrees of liquidity, complexity or model risk. Internally, one of the primary aims of the control function performed by price verification is to reduce the risk of a position or portfolio being mis-marked. Obviously, this risk rises with the degree of subjectivity that may be applied to a given mark or position (and gets multiplied by the exposure). Given its critical contribution to the integrity of valuation and books and records, supervisors must engage fully in understanding the price verification controls at financial institutions, ensure that it is well-resourced, has independent authority to push back on the business line valuations, and is in ready communication with and has the active support and involvement of firm senior management.

Recent events have proven the limitations of certain risk metrics such as Value-at-Risk (VaR) and the necessity of rigorous stress testing of financial models. VaR, among other things, assumes certain historical correlations, which may be inapplicable during times of extreme stress. In addition, VaR does not measure liquidity or concentration risk. Therefore, a lesson learned is while VaR and other risk metrics may be useful during normal market conditions, risk managers and supervisors must recognize their imbedded limitations and assumptions and plan accordingly. That is, supervisors and risk managers must supplement their usage with stress testing that incorporates not only likely economic scenarios, but also low probability, extreme events. In addition, the market-wide failure to appreciate and measure the market risk of mortgage-related assets, including structured credit products, has shown that the Basel market risk standards as then in force were not adequate. Each is in need of serious improvement.

Another important lesson is that critical financial and risk management controls cannot just exist on paper. They must be staffed appropriately and well-resourced. Whether a supervisory program maintains staff onsite at regulated entities, or engages in frequent in-person meetings, the quality of the program must combine an ability to focus and follow up on risk management issues as they develop with an ability to gain the attention of senior management of the firm. Within the firm, senior management must engage with firm risk managers and support them as an independent function. Firm boards of directors must participate actively in setting the risk appetite of the firm, hold senior management accountable for following the board's direction on risk taking, and force management to take action, as appropriate. For instance, risk managers should have some degree of authority over trading decisions, and any decision by senior management to deviate from their recommendations should be documented and reviewed by the board.

One final observation relates to the challenges any single regulator has in overseeing an entity—in the SEC's case, sizable broker-dealers—that reside within a complex institution with multiple material affiliates, regulated or not, in numerous countries. Any regulator must have an ability to get information about the holding company and other affiliates, particularly about issues and transactions that could impact capital and liquidity. For instance, whether directed by a holding company supervisor here or abroad, a poorly capitalized and not very liquid affiliate could require infusions from the parent and become the source of financial weakness for the entire organization. This could occur while the registered U.S. broker-dealer is well-capitalized and liquid. As was true in the case of Lehman Brothers, the bankruptcy filing of a material affiliate has a cascading effect that can bring down the other entities in the group. Also, in some instances, affiliates try to involve the well-capitalized broker-dealer in their business in a manner that is not prudent. For these reasons, and to protect the broker-dealer and its customer assets, the SEC would want, not only to be consulted before any such liquidity drain occurs at the parent, but to have a say, likely in coordination with other interested regulators, in the capital and liquidity standards the holding company must maintain. Our experience last year with the failure of Lehman's UK broker-dealer, and the fact that the U.S. registered broker-dealers were well-capitalized and liquid throughout the turmoil, has redoubled our belief that we must rely on and protect going forward the soundness of the regulatory regime of the principal subsidiaries. Nothing in any future regulatory regime, or systemic regulator, should operate to weaken the regulatory standards of these subsidiaries.

Having learned all of these lessons, we at the SEC are focusing on how best to deploy our broker-dealer expertise in a new regulatory paradigm. As Congress considers the financial services regulatory structure, we believe that regulatory expertise should be recognized and deployed efficiently. For a certain set of large broker-dealer holding companies that are not affiliated with banks, the SEC supports a program that would permit us to also set capital standards at the holding company level (perhaps, in consultation with a holding company supervisor, if any), and to obtain financial information about, and examine, the holding company and material affiliates. Such broker-dealer holding companies may also have an emergency liquidity provider (not the SEC). The SEC would determine the universe of broker-dealer holding companies that would be subject to parent company capital standards. The remaining broker-dealer holding companies not affiliated with banks would be subject to material affiliate reporting requirements, similar to the reporting regime under Section 17(h) of the Exchange Act.

Given the recent dialog about systemic regulation, I must note that our experience with the bankruptcy filing of a foreign affiliate of Lehman Brothers has demonstrated the innate difficulties of any multijurisdictional approach to regulation. While cross border coordination and dialog is important, jurisdictions nonetheless have unique bankruptcy and financial regulatory regimes—and creditors wherever they are located shall always act in their own interest during a crisis. Thus, a U.S. liquidity provider might be faced with the difficult choice of guaranteeing the assets of the holding company globally, or else risk creditors exercising their rights against foreign affiliates or foreign supervisors acting to protect the regulated subsidiaries in their jurisdictions, either of which could trigger bankruptcy of the holding company. These are thorny issues that Congress should consider carefully.

GAO Review of Regulators' Oversight of Risk Management Systems

I want, finally, to mention that, recently, we were provided a copy of the GAO's draft Review of Regulators' Oversight of Risk Management Systems. Based on our review of that draft, I can make a few personal observations. First, I appreciate the work that GAO did to review the supervision of financial institutions' risk management programs across the various regulators and find GAO's observations about those programs helpful. I can also make a few comments about the draft of GAO's review of regulators' oversight of risk management systems at various financial institutions. Staff of the Division of Trading and Markets has discussed these and other comments on the draft directly with GAO staff.

The GAO draft states that banking regulators (the Federal Reserve, OCC, and OTS) use a combination of supervisory activities, including informal tools and examination-related activities to assess the quality of institutional risk management systems. It then describes the securities regulators' approach as revolving around regularly scheduled target examinations. This is not, however, an apt description of the SEC's CSE risk management supervisory program. We believe it is important to stress that SEC's supervision included continuous monitoring throughout the year of the CSEs for which we were the consolidated supervisor. While SEC staff conducted formal meetings with firms on a regular schedule (*e.g.,* monthly risk meetings), SEC staff had continuous contact with the firm. These formal meetings were supplemented by additional follow-up meetings to discuss issues further. This often led to further monitoring by staff and, if warranted, included cross-firm reviews conducted by SEC monitoring staff and later SEC inspection staff for CSEs. We also received regular risk, financial, and liquidity reporting from the CSE firms, including some information on a daily basis. Particularly with respect to the liquidity reporting, we had frequent discussions, often daily or weekly, with the firms' treasurers during much of 2007 and 2008. In addition, during times of extreme market stress we had on-site coverage as well. While not continuously onsite, the SEC's approach was one of continuous supervision, a point not evident in the draft GAO report.

SEC staff's continuous supervision was directly aimed at addressing risk management weaknesses. While we fully understand that SEC's process for ensuring that firms take corrective action was not as formal as some of the banking regulators, the substance was the same. There have been many instances in which, based on our supervisory approach, firms made changes to their risk management to address weaknesses that the SEC highlighted.

We concur in the GAO's observation that although financial institutions manage risks on an enterprise basis or by business lines that cut across legal entities, functional regulators may oversee risk management at the legal entity level, resulting in a view of risk management that is limited or in overlap in efforts by regulators. Under the CSE program, the SEC continued its focus on the functionally regulated entity—the broker-dealer—but also assessed risk management wherever imple-

mented within the holding company structure. This is necessary in order to gain an accurate assessment of the effectiveness of these risk management controls.

Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM ROGER T. COLE

Q.1. How many banks have asked to return TARP funds officially? Unofficially?

A.1. As of April 22, 2009, the Federal Reserve had been informed by Treasury Department staff of 16 companies that had formally asked to return TARP funds.

Q.2. Have you told any banks that they cannot return TARP funds?

A.2. The Federal Reserve has established a uniform process to analyze and respond to requests to redeem TARP funds by bank holding companies and State member banks. This process includes consideration of the following elements:

- Whether the redemption request raises any question about the company's ability to maintain appropriate capital levels over the next one to two years, even assuming worsening economic conditions.
- Whether the holding company will still be able to serve as a source of financial and managerial strength to its subsidiary bank(s) after the redemption.
- The level and composition of capital, earnings, asset quality, the allowance for loan and lease losses (ALLL), and liquidity, among other factors.
- Whether management's capital planning projections are appropriate given the current financial condition and risk profile of the organization.
- Expectations for communication with management and/or the Federal banking regulator of the subsidiary bank(s) as needed.

At this time, the Federal Reserve has not denied the request of any banking organization to return TARP funds. However, there have been some informal inquiries from organizations involved in the Supervisory Capital Assessment Program (CAP) stress test regarding returning funds they received from the TARP Capital Purchase Program. We have communicated to these institutions that such requests will not be considered, and should not be formally submitted, until the CAP stress test process has been completed.

Q.3. What is the process to return TARP funds? Do they just mail it back to Secretary Geithner?

A.3. Institutions must formally notify the Treasury of their intention to return TARP funds. Treasury staff then notifies the appropriate banking agency of the request and the agency then completes an analysis of the request (as detailed above) and indicates to Treasury whether they object to the repayment Treasury staff has asked that this analysis process be completed within two weeks, if possible. If the appropriate Federal banking agency notifies Treasury staff that it has no objection to the repayment, the Treasury Department immediately contacts the requesting company and coordinates the details and scheduling of the redemption with the issuer. This includes coordinating the exchange of both cash and securities, as well as the redemption of warrants, if applicable.

Q.4. If a bank asked to return TARP funds, why would they be denied?

A.4. As detailed in the responses to questions 2 and 5, those supervisory agencies may object to a request to repay the TARP funds if such repayment would raise questions about the adequacy of capital at a supervised institution and its ability to operate in a safe and sound manner.

Q.5. What provision of law would justify a regulator or treasury denying a bank's request to return TARP funds?

A.5. Capital plays a critical role in ensuring the safety and soundness of a banking organization. For this reason, Federal banking laws and regulations have long provided the Federal banking agencies several important tools to ensure that banking organizations maintain strong capital levels and that an organization's capital is not depleted through redemptions or similar transactions in a manner or amount that would have materially adverse consequences on the organization's financial condition or resources. For example, under the "prompt corrective action" provisions of the Federal Deposit Insurance Act (12 U.S.C. 1831o) (FDI Act), all insured depository institutions are prohibited without their Federal banking agency permission from redeeming capital if the institution would be undercapitalized as a result of the redemption. The Federal banking laws, also expressly require that an insured bank obtain the approval of its Federal banking regulator to redeem its equity capital,[1] such as the preferred equity generally issued by banks in exchange for TARP funds.

The risk-based capital rules applicable to bank holding companies (BHCs) directs BHCs to consult with the Federal Reserve before redeeming any equity or other capital instrument included as certain components of regulatory capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base.[2] Certain BHCs also must provide the Federal Reserve with notice prior to making a redemption that would reduce a BHC's consolidated net worth by 10 percent or more.[3]

In addition, Federal law provides the Federal banking agencies important enforcement tools to ensure that banking organizations remain safe and sound, including by maintaining adequate capital. For example, under section 8 of the FDI Act, a Federal banking agency may impose a cease-and-desist order on a banking institution requiring the institution to take corrective actions if the institution engages in an unsafe or unsound practice.[4] The International Lending Supervision Act also provides that a Federal banking agency may issue a directive to a banking institution that fails to maintain capital at or above the level required by its Federal banking regulator, which may require the institution to submit

[1] 12 U.S.C. 56 and 59 (national banks and extended to State member banks by 12 U.S.C. 324); 12 U.S.C. 1828(i)(l) (State nonmember banks).

[2] *See* 12 CFR part 225, Appendix A, section II, (iii).

[3] 12 CFR 225.4(b)(1). *See* Board SR Letter 09–04. "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies" for a description of the standards applied by the Federal Reserve in evaluating a BHC's capital position.

[4] *See* 12 U.S.C. 1818(b).

and adhere to plan acceptable to the agency describing the institution's plan for restoring its capital.

Q.6. What changes, if any, to the law would have to be made to prevent a regulator from forcing a bank to keep TARP funds?

A.6. As discussed above, Congress has provided the Federal banking agencies several important tools to ensure that redemptions of capital by a banking organizations do not materially weaken a banking organization or cause it to be in an unsafe or unsound condition. To prevent a regulator from taking steps to prevent a banking organization from redeeming TARP capital when necessary to protect the financial health of the organization, Congress would have to provide that the safety and soundness laws and regulations discussed in question 1 shall not prevent or restrict a banking organization from redeeming TARP capital. Moreover, Congress would need to adopt a law that specifically prevents the Federal banking agencies from taking any action under section 8 of the FDI Act to prevent a bank from making redemptions even if the redemption is determined to be an unsafe or unsound practice or would result in the institution being undercapitalized in violation of law.

Q.7. What would be possible negative implications of allowing any bank/company to give back TARP funds at their discretion?

A.7. As discussed above, depending on the current and projected condition of a TARP recipient, the immediate repayment of TARP funds could result in capital levels that are inadequate to support the risk of loss at the banking institution and result in an unsafe and unsound condition.

Q.8. Do the regulators have the necessary authority to deal with the consequences of TARP funds being returned over regulator objections?

A.8. If a banking organization were to redeem the capital instruments issued to the TARP over a regulator's objections, and such action constituted an unsafe or unsound practice or violated any law or regulation, the appropriate Federal banking agency would have a range of options under the FDI Act to address the infraction.[5] For example, the banking organization's Federal banking regulator could impose a cease-and-desist order on the organization under section 8 of the FPI Act. Such an order could require the bank to take steps to correct or remedy the acts or practices giving rise to the order. The regulator also could impose civil money penalties on the organization if it violated a law or regulation, failed to comply with a cease and desist order imposed by the regulator, or engaged in a recklessly unsafe or unsound practice.

The "prompt corrective action" provisions also require the appropriate Federal banking agency to take prompt correction action to resolve capital issues at insured depository institutions. The statute requires the Federal banking agencies to establish capital requirements for the institutions they regulate together with measures of when the institution would be considered well-capitalized, adequately capitalized, undercapitalized, or significantly under-

[5] *See* 12 U.S.C. 1818.

capitalized under those standards. If an insured depository institution is undercapitalized, the statute lays out the steps that must be taken by the institution and the relevant agency to address the capital deficiency. Moreover, the statue provides that if the appropriate Federal banking agency determines that an insured depository institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, the agency may reclassify the institution's capitalization status to the next lower category and impose requirements on that institution in accordance with its revised capitalization status. For example, if a bank were considered adequately capitalized and is engaged in an unsafe or unsound practice, the bank's Federal banking regulator could reclassify the bank as undercapitalized. As a result the bank, among other things, would not be allowed to redeem equity securities, would have to submit an acceptable capital restoration plan to its regulator, and could be subject to restrictions on its asset growth.[6]

A bank that is significantly undercapitalized or is undercapitalized and fails to submit a satisfactory capital restoration plan also could be subject to a range of requirements or restrictions under the prompt corrective action provisions of the FDI Act, such as a recapitalization plan imposed by its regulator or restrictions on activities, transactions with affiliates, interest rates paid, or asset growth, or other similar restrictions that address the bank's capital situation.

Q.9. Are you requiring banks to hold capital above the statutory definition of well capitalized, and if so why? Anecdotal reports indicate that examiners are requiring an additional 200 basis points of capital on top of the well capitalized requirements—is that true, if so why?

A.9. It has been longstanding policy that banking institutions are expected to hold capital commensurate with their overall risk profiles. Regulatory capital requirements are designed to establish a minimum level of capital that is relatively comparable across institutions, and are limited in their ability to reflect an institution's full risk profile. Accordingly, all banking institutions need to understand their risks and hold capital commensurate with those risks—at levels above regulatory minimums—to ensure overall capital adequacy.

With respect to the composition of capital, supervisory expectations are outlined in the BHC Supervision Manual:

> The Board's long-standing view is that common equity (that is, common stock and surplus and retained earnings) should be the dominant component of a banking organization's capital structure and that organizations should avoid undue reliance on capital elements that do not form common equity. Common equity allows an organization to absorb losses on an ongoing basis and is permanently available for this purpose. Further, this element of capital best allows organizations to conserve resources when they are under stress because it provides full discretion as to the amount and timing of dividends and other distributions. Consequently, common equity is the basis on which most market judgments of capital adequacy are made.

Q.10. What are you communicating to the examination force on these issues of TARP repayment and capital requirements? Please provide any relevant documents or training materials related to

[6] *See* 12 U.S.C. 1831o.

how your agency is instructing examiners to treat capital. In H.R. 1, Congress has said the TARP money can be repaid, please provide information which documents how your agency is getting that legal change out into the field.

A.10. The Federal Reserve has developed written guidelines for Reserve Bank staff to follow and a Redemption Request Decision Memo for Reserve Banks to complete when processing and analyzing redemption requests. The guidelines require Reserve Bank staff to analyze the sufficiency of an institution's capital planning process and capital levels and ensure that any approvals that may be required under Federal or State law or regulation are received before the redemption can proceed. The guidelines and Redemption Request Decision Memo were provided to the Reserve Bank TARP CPP contacts on March 13, 2009, and have been modified as appropriate as experience has been gained with the redemption process. The redemption analysis guidelines are consistent with longstanding Federal Reserve policies addressing the assessment of capital adequacy and the redemption of material amounts of capital and direct examiners to consider the factors outlined in SR letter 09–4, Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies, when evaluating redemption requests.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM TIMOTHY W. LONG

Q.1. How many banks have asked to return TARP funds officially? Unofficially?

A.1. As of April 23, 2009, six national banks have officially asked to return their CPP TARP funds. Four of those banks, Old National Bancorp, Sun Bancorp, First Merit Corporation, and TCF Financial Corporation have repaid their funds. We do not have a mechanism to track banks that may be considering or asking unofficially to return TARP funds. However, based on inquiries we have received from national banks about the process for returning TARP funds, we estimate that the total number, as of April 23, is probably fewer than 15. We would caution, however, that participation and interest in the TARP CPP program has become very fluid in the past month as an increasing number of banks have withdrawn their CPP applications either before or after they received preliminary approval from Treasury to receive TARP funding. Based on these trends, a greater number of banks could ultimately decide to attempt to return their TARP funding.

Q.2. Have you told any banks that they cannot return TARP funds?

A.2. As of April 23, we have not told any national banks who have inquired that they cannot repay their TARP CPP funds. Any requests that we would receive from the largest TARP recipients (those with assets over $100 billion) that are currently undergoing a comprehensive forward looking assessment (stress tests) would be considered after the completion of the assessment analysis.

Q.3. What is the process to return TARP funds? Do they just mail it back to Secretary Geithner?

A.3. Banks wishing to repay their TARP CPP funds have been instructed to notify Treasury at *CPPRedemption@do.treas.gov* and their primary Federal regulator of their desire to redeem their securities. Banks will need to follow their primary Federal banking regulators' existing guidelines governing reductions of capital. Once the appropriate Federal banking regulator notifies Treasury that the regulator has no objection, Treasury will work with the bank to schedule the bank's repayment. It is our understanding that Treasury is executing repayment requests on a weekly basis.

For national banks that have a holding company, the Federal Reserve Board will be the regulator that formally provides consent to Treasury. This is because the TARP securities were issued and funds injected at the holding company level. The OCC and Federal Reserve, however, are closely coordinating on any such requests.

In cases where TARP CPP funds have been down-streamed to a national bank, OCC approval will likely be needed to allow the bank to reduce capital, pursuant to 12 CFR 5.46 and 12 USC 59, or to pay a dividend in excess of the amount allowed under 12 USC 60(b).

Q.4. If a bank asked to return TARP funds, why would they be denied?

A.4. This determination will be made based on the condition of the bank and the amount of capital it has in relation to the risks it confronts. For example, there could be cases where a bank's condition has deteriorated significantly since its receipt of TARP CPP funds and where repayment of those funds could impair the bank's safety and soundness or would trigger the capital provisions of the Prompt Corrective Action regime (12 CFR 6, 12 USC 1831o).

Q.5. What provision of law would justify a regulator or treasury denying a bank's request to return TARP funds?

A.5. As noted above, under Prompt Corrective Action, the banking agencies are required to take increasingly severe supervisory actions should a bank's capital levels fall below specified regulatory minimums. Those requirements are specified in section 38 of the Federal Deposit Insurance Act, 12 USC 1831o, and OCC implementing regulations, 12 CFR 6. In such cases, the agencies may deny a bank's request to return TARP funds until and unless it developed and implemented an effective capital restoration plan. More generally, if repayment would result in capital levels that are inconsistent with the bank's overall risk profile or with other OCC directives to the bank, such as an individual minimum capital requirement under 12 CFR 3.15 due to the bank's risk profile, or the terms of a cease and desist order under 12 USC 1818(b), the OCC may require additional actions or commitments from bank management before repayment would be allowed.

Q.6. What challenges, if any, to the law would have to be made to prevent a regulator from forcing a bank to keep TARP funds?

A.6. As described in our answers above, if the OCC objected to a bank's repayment of TARP funds, our objection would be based on supervisory concerns about capital adequacy or safety and soundness. To override those concerns, Congress would have to provide in statute that the OCC could not exercise the safety and sound-

ness authorities the law currently provides (including the statutes mentioned in our answers to Questions 3 and 5) to preclude the repayment of TARP funds, regardless of the effect that repayment would have on the bank's ability to meet its capital requirements, on its financial condition, or on its safety and soundness. The clear downside of such an approach is that it would deprive the OCC of the tools it currently has to ensure that repayment of TARP funds does not welcome a national bank's condition or adversely affect its safety and soundness.

Q.7. What would be possible negative implications of allowing any bank/company to give back TARP funds at their discretion?

A.7. We would be concerned about cases in which a TARP repayment would cause a bank to become undercapitalized or otherwise reduce capital to a level that is inconsistent with its risk profile, thus threatening its on-going viability and its ability to meet the credit needs of its community.

Q.8. Do the regulators have the necessary authority to deal with the consequences of TARP funds being returned over regulator objections?

A.8. We do not anticipate this will be an issue as Treasury will be requesting a "no objection" from the appropriate Federal banking agency before allowing an institution to repay its TARP CPP funds.

Q.9. Are you requiring banks to hold capital above the statutory definition of well capitalized, and if so why? Anecdotal reports indicate that examiners are requiring an additional 200 basis points of capital on top of the well capitalized requirements—is that true, if so why?

A.9. The OCC and other Federal banking agencies have long stressed that the regulatory risk-based and leverage capital ratios (12 CFR 3) are minimums and that banks are expected to hold capital commensurate with the level and nature of all risks. As noted in 12 CFR 3, Appendix A, section 1(b)(1), " . . . since this measure [risk-based capital ratio] addresses only credit risk, the 8 percent minimum ratio should not be viewed as the level to be targeted, but rather as a floor. The final supervisory judgment on a bank's capital adequacy is based on an individualized assessment of numerous factors, including those listed in 12 CFR 3.10." Among the factors listed in 12 CFR 3.10 are: banks with significant exposures due to the risks from concentrations of credit; banks exposed to a high volume or, particularly severe, problem loans; banks that are growing rapidly, either internally, or through acquisitions; or banks exposed to a high degree of asset depreciation.

Many banks currently have substantial concentrations in various commercial real estate segments, have been involved in recent mergers, or have experienced recent asset depreciation that warrant capital levels above the risk-based capital regulatory minimums.

Q.10. What are you communicating to the examination force on these issues of TARP repayment and capital requirements? Please provide any relevant documents or training materials related to how your agency is instructing examiners to treat capital. In H.R. 1, Congress has said the TARP money can be repaid, please pro-

vide information which documents how your agency is getting that legal change out into the field.

A.10. We issued internal guidance to our examiners on the TARP program, including requests for repayment of TARP funds, on March 26, 2009. A copy of those materials is attached.

Our general guidance to examiners on capital and dividends can be found in:

- The Interagency "Uniform Financial Institutions Rating System," where capital adequacy is one of the component "CAMELS" rating assigned to every financial institution. (See Appendix A in "Bank Supervision Process" booklet of the Comptroller's Handbook (*http://www.occ.gov/handbook/banksup.pdf*).) and
- The "Large Bank Supervision," "Community Bank Supervision," and "Capital Accounts and Dividends" booklets of the Comptroller's Handbook. Copies can be found at: *http://www.occ.gov/handbook/lbs.pdf*; *http://www.occ.gov/handbook/cbsh2003intro.pdf*; and *http://www.occ.gov/handbook/Capital.pdf.*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM SCOTT POLAKOFF

Q.1. How many banks have asked to return TARP funds officially? Unofficially?

A.1. As of May 5 2009, OTS has received official requests by five institutions [1] to return TARP funds received as part of the Capital Purchase Program (CPP). Also as of May 5, 2009, OTS has received one unofficial notice from an institution that may return its CPP funds.

Q.2. Have you told any banks that they cannot return TARP funds?

A.2. No. OTS, as of May 5, has not informed any institutions under its supervision that they cannot return TARP funds.

Q.3. What is the process to return TARP funds? Do they just mail it back to Secretary Geithner?

A.3. An institution that would like to redeem its CPP investment will notify its primary regulator of its desire to redeem. The institution also notifies Treasury at *CPPRedemption@do.treas.gov*. After receiving the institution's notice, Treasury and the institution's primary regulator will consult about the request. When all consultations have been completed, Treasury will contact the institution to discuss the redemption request. Details of the redemption and completion of all necessary documentation will be handled by the institution's original Treasury counsel.

Please refer to the link below for the Treasury's listing of Frequently Asked Questions (FAQs) addressing Capital Purchase Program (CPP) redemptions. The linked-to document is also included

[1] The word institutions as used in this letter may refer to both thrifts and thrift holding companies.

with this letter as an attachment. *http://www.treasury.gov/press/releases/reports/CPP-FAQs.pdf.*

Q.4. If a bank asked to return TARP funds, why would they be denied?

A.4. An institution's request to return TARP CPP funds may be denied by its primary regulator if the repayment of the TARP CPP funds would result in insufficient capital and/or liquidity to support the operations of a thrift holding company or in an unsafe and unsound financial condition for its subsidiary thrift.

Q.5. What provision of law would justify a regulator or treasury denying a bank's request to return TARP funds?

A.5. The OTS's primary statutory authority is the Home Owners' Loan Act (HOLA). HOLA provided the OTS with authority to impose capital requirements on thrifts as well as supervisory and enforcement authority to contain and resolve problem institutions. The OTS may deny a TARP repayment request if it determines that the repayment would result in an insufficient level of capital and/or liquidity necessary to support the operations of either the thrift holding company or its subsidiary thrift.

Q.6. What changes, if any, to the law would have to be made to prevent a regulator from forcing a bank to keep TARP funds?

A.6. The Home Owners' Loan Act includes a specific section, section 10(f), that requires notice to OTS before a savings association subsidiary of a savings and loan holding company may pay a dividend to its holding company. There is also a specific restriction on dividends under the prompt corrective action statute in the Federal Deposit Insurance Act (generally, a dividend may not be paid if it causes a savings association to become undercapitalized). In addition, OTS has consistently taken the position that it has the authority to object to a dividend by a savings association based on safety and soundness grounds. In order to ensure that the agency could not object on any basis to a dividend by a savings association in connection with a redemption TARP securities, the HOLA would need to be amended to provide "The Director, notwithstanding any safety and soundness concerns regarding a savings association, and notwithstanding any other provision of law, may not object to a dividend by a savings association to the extent the dividend is declared in connection with a redemption of TARP securities."

Q.7. What would be possible negative implications of allowing any bank/company to give back TARP funds at their discretion?

A.7. If an institution is allowed to return TARP funds at its discretion, without obtaining its primary regulator's approval, the possible negative implications could include a resulting insufficient level of capital and/or liquidity necessary to support the operations of either the thrift holding company or its subsidiary thrift.

Q.8. Do the regulators have the necessary authority to deal with the consequences of TARP funds being returned over regulator objections?

A.8. We consider this to be a hypothetical question because an OTS-supervised institution may not presently return TARP funds over the objection of the OTS. Institutions supervised by the other

Federal banking regulatory agencies are likewise subject to the approval of their relevant primary regulator for returning TARP funds.

If an institution is allowed to return TARP funds over the objection of its primary regulator, the possible negative implications could include a resulting insufficient level of capital and/or liquidity necessary to support the operations of either the thrift holding company or its subsidiary thrift. In the event of such an undesired outcome, the OTS has the supervisory authority to direct the institution to address its resulting weakened condition and to correct it.

Q.9. Are you requiring banks to hold capital above the statutory definition of well capitalized, and if so why? Anecdotal reports indicate that examiners are requiring an additional 200 basis points of capital on top of the well capitalized requirements—is that true, if so why?

A.9. The OTS expects its supervised thrifts to maintain capital buffers above the minimum defined amount necessary to be well-capitalized, and also expects its supervised holding companies to maintain prudent levels of capital necessary to support their operations. The OTS does not direct its examiners to require institutions to maintain a "one-size-fits-all" amount of additional capital above the minimum defined amount necessary to be well-capitalized.

Q.10. What are you communicating to the examination force on these issues of TARP repayment and capital requirements? Please provide any relevant documents or training materials related to how your agency is instructing examiners to treat capital. In H.R. 1, Congress has said the TARP money can be repaid, please provide information which documents how your agency is getting that legal change out into the field.

A.10. The OTS's Regional Supervisory Staff reviews each institution's request to repay its CPP investment and recommends approval or denial of the request to OTS Washington. OTS Washington makes the final decision to approve or deny each institution's request and then informs Treasury of its decision.

The process that the OTS follows in its decision to approve or deny an institution's CPP repayment request is completed outside of the OTS's examination process. Regardless of the OTS's decision on the repayment request, examiners follow required review procedures that are necessary to determine the capital adequacy of the institution. Please refer to the website link below for the OTS's Examination Handbook section on Capital. The linked-to document is also included with this letter as an attachment. *http://files.ots.treas.gov/422319.pdf.*

February 26, 2009

FAQs addressing Capital Purchase Program (CPP) changes under the American Recovery and Reinvestment Act of 2009

Can my bank redeem its CPP investment under terms other than those specified in the original transaction documents?

Yes. This answer applies to all CPP participants, irrespective of funding dates but this does not apply to participants in the Capital Assistance Program, announced on February 25, 2009.

If my bank determines that it would like to redeem its CPP investment, what is the process?

Please notify your primary regulator of your desire to redeem. Also, please notify Treasury at CPPRedemption@do.treas.gov. After receiving your notice, Treasury and your primary regulator will consult about the request. When all consultations have been completed, we will contact you to discuss the redemption request. Details of the redemption and completion of all necessary documentation will be handled by your original UST counsel.

What does the consultation with my primary regulator involve?

Treasury is working with the four federal banking agencies to determine what factors are involved in the consultation.

Can my bank redeem part of its CPP investment at this time?

CPP participants wishing to repay part of its CPP investment must pay a minimum of 25% of the issue price of the preferred.

Where should my bank send the money?

It is important that you go through the process noted above to get detailed transfer instructions to make sure that all payments are attributed correctly.

Can my bank purchase the warrants at the time we redeem Treasury's investment?

Yes. This right is given under Section 4.9 of the Securities Purchase Agreement, which permits the issuer to repurchase the warrants at "fair market value" as defined in the agreement, which details the procedure for determining this value. Treasury will work with you to facilitate the repurchase process. Your warrants cannot be sold to an investor until you have had an opportunity to repurchase them.

If my bank does not purchase the warrants at this time, what happens to them?

If your bank does not choose to exercise its option to repurchase the warrants, Treasury will attempt to liquidate registered warrants as soon as possible.

My bank participated in CPP under the private company transaction documents, and the warrants we issued to Treasury were exercised immediately upon closing. Can we redeem the warrant preferred shares at the same time we redeem the original preferred investment?

Yes.

When my bank repays Treasury's investment, are we responsible for unpaid dividends?

Yes. In the case of the cumulative senior preferred, you must pay any accrued and unpaid dividends. In the case of the non-cumulative senior preferred, you must pay accrued and unpaid dividends for the current dividend period, regardless of whether any dividends are actually declared for that period.

Capital Stock and Ownership

This Section of the Handbook presents information concerning the following:

- Mutual organization.
- Mutual holding companies.
- Stock organization.
- Types of capital stock.
- Conversions from mutual to stock organization.
- Securities and Exchange Commission (SEC) reporting requirements for publicly traded companies.
- Insider stock trading.
- Change in control.
- Divestiture of control.
- Contributed capital.
- Savings and loan holding companies.
- Capital distributions.
- Loans by savings associations on its own stock.
- Employee stock ownership plans (ESOPs).

LINKS
Program
Appendix A

MUTUAL ORGANIZATION

Savings associations organized as mutual institutions issue no capital stock and therefore have no stockholders. Mutual savings associations build capital almost exclusively through retained earnings. Mutual savings associations may receive pledged deposits and issue mutual capital certificates and

subordinated debentures, however, mutuals rarely use these capital forms. When a new mutual savings association organizes, certain founding members pledge savings for the time required for the new mutual to build-up capital and operate profitably.

Background

The first savings associations appeared in the United States in the first half of the nineteenth century. Savings banks first appeared in Boston and Philadelphia in 1816. The first savings association was in 1831 in Frankford, Pennsylvania, now part of the city of Philadelphia. All thrift type institutions were originally mutual institutions. All federal savings associations were in mutual form from 1933 until 1974, when Congress amended the Home Owners' Loan Act (HOLA) to permit the conversion of federal mutual savings associations to stock form. The Garn-St. Germain Depository Institutions Act of 1982 first authorized the direct chartering of federal stock savings associations.

Mutual savings associations initially were organized by individuals and groups for the common good of working class individuals and families who lacked the financial service facilities necessary for the accumulation of capital through savings plans and access to credit for housing needs. These mutual associations greatly expanded in number and location throughout the nineteenth and early twentieth centuries. They generally were small associations, although some eventually grew to substantial size, mostly in the larger cities. Although a substantial number of mutual associations migrated to stock form savings associations through conversion since the mid-1970s, there remain a substantial core of mutual associations. As of September 2003, there were over 300 mutual savings associations under OTS supervision and several hundred more state chartered savings banks under FDIC supervision. These mutual savings associations, while generally smaller than the stock associations, carry on the basic mission of the founders of the thrift movement. The mutual savings associations remain close to their communities and the immediate needs of their localities for basic banking services for the citizens. In general, mutual savings associations often tend to have higher capital levels, somewhat lower earnings, and high quality assets.

Ownership of Mutual Savings Associations

The concept of ownership in mutual savings associations resulted in extensive discussion and subsequent litigation. The courts have determined that mutual account holders have only a contingent interest in the surplus of mutual savings associations in the event of liquidation. In the first case to challenge the newly adopted conversion regulations of the Federal Home Loan Bank Board, York v. Federal Home Loan Bank Board, the court concluded that conversion to a federal stock organization did not deprive the mutual depositors of property rights.

Members Rights of a Federal Mutual Savings Association

The federal mutual charter grants certain rights to mutual members, which give them some control over the affairs of the savings association. All holders of the savings association's savings, demand, and other authorized accounts are members of the savings association. The ability to exercise control over a mutual savings association by its members, however, is not coextensive with the rights of stockholders

of ordinary corporations, although there are similarities. The members of a federal mutual savings association have the right to:

- Vote.
- Amend the charter.
- Amend the bylaws.
- Nominate and elect directors.
- Remove directors for cause.
- Request special meetings.
- Communicate with other members.
- Inspect the corporate books and records.
- Share pro rata in the assets of the savings association following liquidation.

In enacting the Home Owners' Loan Act (HOLA) Congress generally left to the OTS (or its predecessor, the FHLBB) the authority to determine when a mutual savings association's members have voting rights. Except for provisions relating to the conversion of a federal mutual to stock form, there is no statutory requirement that federal mutual savings associations' members have voting rights. Although the charter of a federal mutual savings association does grant such rights, it does not specify a member vote for all significant corporate transactions.

In practice, members delegate voting rights and the operation of federal mutual savings associations through the granting of proxies typically given to the board of directors (trustees) or a committee appointed by a majority of the board.

Mutual Holding Companies

In 1987, Congress authorized mutual savings associations and savings banks to reorganize themselves in a holding company structure, in which the holding company is owned by the mutual members. The purpose of this new structure was to afford all FSLIC or FDIC-insured mutual thrifts the opportunity to raise capital in an amount less than that required in a full mutual-to-stock conversion, while retaining the mutual ownership base. A mutual holding company reorganization permits an institution to raise incremental amounts of capital, provided that the mutual holding company retains a majority interest in the subsidiary savings association.

The Mutual Holding Company regulation implements § 10(o) of HOLA. Part 575 authorizes a mutual holding company to engage in capital raising activities. A mutual holding company's subsidiary savings

association may issue up to 49.9 percent of its stock to persons other than the mutual holding company.

Alternatively, a mutual holding company (MHC) may create a new subsidiary stock holding company (SHC) that would exist between the MHC and its savings association in a three-tier corporate structure. The SHC, like a stock savings association subsidiary, must issue at least a majority of its shares to the MHC and could issue up to 49.9 percent of its shares to the public. The SHC must own 100 percent of the shares of the savings association subsidiary.

On August 9, 2002, OTS issued a Final Rule based on the Gramm-Leach-Bliley Act. OTS changed the activities limitations for MHC's to mirror those applicable to financial holding companies. These changes enhance the MHC structure as an alternative to full conversion for mutual savings associations.

Stock Organization

Section 552.2-1 outlines the process for organizing a federal stock savings association. Stock organization means that management decisions are subject to shareholder vote and scrutiny. Stock savings associations must hold annual meetings of shareholders subject to regulatory requirements. These requirements appear in § 552.6 or applicable state law and/or § 14 of the Securities Exchange Act of 1934 (Exchange Act). Savings associations that convert to stock form face shareholder scrutiny and increased public disclosure requirements if they become a public reporting company under that act.

Capital Stock

Capital stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest in the savings association. One or more individuals or any business entity such as a partnership, a trust, or a corporation may own the stock.

Common Stock

Common stock represents all the basic rights of ownership. Common stockholders exercise their basic rights in proportion to the shares owned. These rights include the following:

- The right to vote for the directors.
- The right to share in dividends declared by the board of directors.
- The right to share in the distribution of cash or other assets, after payment of creditors, in the event of liquidation of the savings association.

Savings associations may value capital stock on their books at a stated par value. A savings association will assign a nominal par value if the stock does not have a par value. Savings associations account for amounts paid in excess of the par value as additional paid-in capital.

The market value of shares does not coincide with par values. The market price reflects many factors, including the following:

- Overall economic conditions.
- Financial health of the savings association.
- Liquidity of the stock.
- Competition.
- Dividend policies.
- Growth potential.
- Market saturation in financial institution issues (supply and demand).

A savings association may list its shares on an organized exchange, or trade them over the counter (OTC). A savings association may act as its own registrar and transfer agent. If the savings association has 500 or more stockholders, the savings association must adhere to the SEC regulations when performing transfer agent functions.

Among the records a stock savings association must maintain is a (registrar's) list of stockholders. The list should include the following information:

- Name of holder.
- Address.
- Number of shares owned.
- Date acquired.
- Certificate number(s) held.
- Amount and type of dividend paid each stockholder.

It is important to promptly record transfers of shares to new owners. Savings associations, periodically, should reconcile the stockholder ledger with the general ledger control account and the stock certificate book.

Preferred Stock

Preferred stock carries certain preferences, such as a prior claim on dividends, over common stock. Often preferred stock conveys no voting rights, or only limited voting rights, to the holders. The

articles of incorporation (charter) govern special rights of a preferred stock issue. The chartering authority may also regulate stockholders' rights.

Whether preferred stock is includable in regulatory or generally accepted accounting principles (GAAP) capital depends on its permanence as a funding source. The status of preferred stock as part of capital also depends on whether redemption of the stock is required to occur only upon the liquidation or termination of the savings association. Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation.

Although forms of permanent perpetual preferred stock exist, other preferred stock contains defined redemption terms and consequently it is not as permanent or long term a funding source as common stock.

Savings associations not subject to federal securities laws financial reporting requirements may make financial reports using Thrift Financial Report (TFR) instructions and rely on OTS capital regulations. Under 12 CFR Part 567 (Capital), savings associations include noncumulative perpetual preferred stock in core capital (§567.5(a)(1)(ii)). Savings associations include cumulative perpetual preferred stock in supplemental capital (§567.5(b)(1)(i)). Supplemental capital also may include certain redeemable preferred stock and subordinated debt issued under OTS regulations and memoranda. Eligibility for such instruments to qualify as part of regulatory capital depends on the timing of the redemption and other contractual characteristics. See 12 CFR § 563.81, Issuance of subordinated debt securities and mandatorily redeemable preferred stock.

Subchapter S Corporations

Subchapter S Corporations generally receive pass-through tax treatment for federal income tax purposes. The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code that allows financial institutions, and their parent holding companies, to elect Subchapter S Corporation status under the Code. The savings association must meet the following criteria:

- Shareholders may only be individuals, certain estates, and trusts.
- There may be no more than 75 shareholders and they must all consent to the election of S Corporation status.
- There must be only one class of stock.
- The savings association must use (or convert to) the specific charge-off method in accounting for bad debts for tax purposes.
- The savings association must use a calendar year, unless IRS grants permission to use some other year.

A Subchapter S holding company may wholly (but not partially) own a savings association that is a Subchapter S Corporation. Thus, holding companies and their wholly owned depository institution subsidiaries are both eligible for S Corporation status.

Savings associations may voluntarily or involuntarily lose their S Corporation status. Although there is no penalty or direct tax for a termination, either a voluntary or an involuntary loss may have adverse effects on a savings association's capital. For example, revocations may adversely affect an association, because the association may need to re-establish deferred tax accounts, which may reduce capital.

Ability to Raise Capital

If an S Corporation needs to raise capital, its initial efforts will often focus on selling additional common stock to its existing stockholders to preserve its tax status. If existing stockholders are unable or unwilling to properly capitalize the savings association, the association will normally offer to sell common stock to Subchapter S eligible investors who consent to the tax election. The association should seek to limit the increase in the number of its stockholders to stay within the 75-shareholder limit for S Corporation.

S Corporation stockholders customarily sign shareholder agreements that prevent them from selling stock or otherwise transferring their stock to ineligible stockholders. These agreements typically require a shareholder who wishes to sell stock to first offer the shares to the other existing stockholders before offering the shares to any other party. As a prerequisite to purchasing an S Corporation's stock, a new investor must agree to sign the shareholder agreement.

If the association cannot successfully increase its capital through these means, it may pursue other potential investors who may cause the association to lose its Subchapter S election. Alternatively, the association may have to issue a second class of stock that will result in an involuntary termination of its election. In either case, the association would not incur any tax penalties because of its return to C Corporation status. Therefore, an association's tax status as an S Corporation does not prevent it from raising additional capital.

Stock Conversion

For mutual savings associations, conversion to stock form is another avenue available to raise capital in the equity market.

To facilitate the conversion process, management may contract for the services of attorneys, accountants, appraisers, and conversion managers who have conversion experience. Savings associations record conversion sales proceeds after deduction of conversion expenses. In smaller offerings, conversion expenses may amount to over ten percent of the equity raised.

Following is a description of various types of conversions. See Part 563b for additional information.

Standard Conversion

A standard conversion offers a funding source for savings associations. In this form, eligible account holders receive nontransferable, pro-rated subscription rights to purchase the stock of the converting savings association before the public offering. Savings associations sell shares of the converting institution not purchased by persons with subscription rights either in a public offering through an underwriter or by the savings association in a direct community offering.

Submission of a conversion plan according to Part 563b, Subpart A, is the first requirement before effecting a standard conversion. The resulting savings association must comply with the capital standards of Part 567. The accounting used for acquiring assets and liabilities in a standard conversion is generally historical cost of the acquired savings association (pooling-of-interest accounting).

Supervisory Conversion

A supervisory conversion permits savings associations that fail to meet specified capital levels to raise additional capital without government assistance. The resulting savings association must be a viable entity under Part 563b, Subpart B.

Any significantly undercapitalized SAIF-insured savings association will qualify for a supervisory conversion unless OTS determines otherwise. OTS may permit, on a case-by-case basis, an undercapitalized savings association to undertake a supervisory conversion if the savings association can demonstrate that a standard conversion is not feasible.

A savings association may accomplish a supervisory conversion through a public or nonpublic offering (that is, the sale of the savings association's securities issued in the conversion directly to a person or persons) or merger/conversion.

A majority of the board of directors of the converting savings association must adopt a plan of supervisory conversion that is in accordance with Part 563b. The members of the savings association shall have no rights of approval or participation in the conversion or rights to the continuance of any legal or beneficial ownership interest in the converted savings association.

Merger Conversion

A merger conversion occurs when an existing stock institution or holding company acquires a converting mutual savings association. The converting mutual exchanges its stock for stock of the acquirer. OTS limits merger conversions to cases involving financially weak savings associations. OTS will also consider requests for waivers from this general policy for very small institutions, such as those with assets under $25 million, for whom a standard conversion is not a viable option.

Review of Exchange Act and Securities Offering Filings

Under §12(i) of the Exchange Act, OTS has the powers, functions, and duties vested in the SEC to administer and enforce several sections of the Exchange Act for savings associations. The applicable

sections are §§ 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the Exchange Act and §§ 302, 303, 304, 306, 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act. OTS is the securities regulator for all HOLA federal charters (both SAIF and BIF members that have registered securities with OTS). In addition, OTS is the securities regulator for state chartered savings associations that have registered securities with OTS. The FDIC is the comparable regulator for all BIF-insured, state chartered savings banks. The securities of savings and loan associations are exempt from registration under § 3(a)(5) of the Securities Act of 1933. OTS has promulgated 12 CFR Part 563g to require federal savings associations to register issuances of securities that are not otherwise exempt from registration.

A savings association may become subject to reporting obligations under the Exchange Act in one of three ways:

- Section 12(b) of the Exchange Act requires the registration of any class of a savings association's securities registered on a national securities exchange.
- Exchange Act rules generally require that each savings association with 500 or more shareholders and $5 million or more in assets register its equity securities under the Exchange Act. Savings associations may satisfy this requirement by filing Form 10 with OTS. Also, savings associations may voluntarily register securities not otherwise requiring registration by filing Form 10 with OTS.
- Section 563b.530(a) generally requires savings associations converting from the mutual to the stock form to register the class of securities issued in the conversion under the Exchange Act. Savings associations may not deregister such securities for three years.

Each savings association, not otherwise required to report under the Exchange Act, has special responsibilities relating to filing of offering circulars with the Business Transactions Division (BTD). Section 563g.2 provides that no savings association may offer or sell any security unless the offer or sale includes an effective offering circular. Part 563g provides for the declaration of effectiveness of such offering circulars. If BTD declares an offering circular effective pursuant to Part 563g, savings associations must make filings pursuant to § 563g.18 with OTS. Savings associations must make these filings for at least the first year during which the offering circular becomes effective. These filings consist of periodic and current reports on Forms 10-K, 10-Q, 10-KSB, 10-QSB, and 8-K, as § 13 of the Exchange Act may require. The duty to file reports under § 563g.18 is automatically suspended for any fiscal year under the following condition:

- If at the beginning of the fiscal year, (other than the fiscal year the offering circular became effective) the securities of each class to which the offering circular relates are held of record by less than 300 persons.

In certain circumstances, an exemption from the filing requirements is available. Savings associations must file offering circulars required under Part 563g with both BTD and the appropriate regional office.

Currently, only a limited number of savings associations have a class of securities registered under the Exchange Act. They are subject to Exchange Act current and periodic reporting requirements and rules governing a wide range of activities. Such activities include proxy solicitations, tender offers, and the acquisition of securities by officers, directors, and significant shareholders.

BTD and the Accounting Policy Division (APD) review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. The applicable OTS regulations are 12 CFR Parts 563b, 563c, 563d, and 563g.

The regional offices are responsible for timely review of filings of savings associations and holding companies for information of supervisory concern. Regional staff should alert BTD or APD to disclosure problems noted during these reviews. For a more detailed discussion of the Washington and Regional Processing of Exchange Act Filings, refer to Appendix A.

Description of Filings

The Annual Report (Form 10-K or Form 10-KSB)

Savings associations must file this report after the close of a fiscal year.

The Quarterly Report (Form 10-Q or Form 10- QSB)

Savings associations must file this report for each fiscal quarter (except the fourth quarter).

Forms 10-KSB and 10-QSB are public filings filed by a small business under SEC Regulation S-B. Under Regulation S-B, a small business filer is generally defined as a company that meets all of the following criteria:

- It has revenues of less than $25,000,000.
- It is a U.S. or Canadian filer.
- The entity is not an investment company.
- The parent corporation is also a small business filer if the entity is a majority owned subsidiary.

A company is not a small business filer if it has a public float (the aggregate market value of the filers outstanding securities held by the non affiliates) of $25,000,000 or more.

The Annual and Quarterly Reports provide specific financial information regarding the savings association as well as management's discussion of the savings association's financial condition. The reports also include a description of matters voted on by securities holders, and other relevant matters as required by the applicable form and regulations.

The Annual Report is due 90 days after the savings association's fiscal year end, and the Quarterly Report is due 45 days after the fiscal quarter end. If a savings association qualifies as an accelerated filer, the Annual and Quarterly Reports are due on an accelerated basis. As defined by the SEC, an accelerated filer is a domestic reporting company that has a common equity public float of at least $75 million that meets the following conditions:

- It has been subject to the Exchange Act's reporting requirements for at least 12 calendar months.
- It previously filed at least one annual report.
- The entity is not eligible to use forms 10-KSB and 10-QSB.

The following chart sets forth the transition filing deadlines for the Annual and Quarterly Reports:

For fiscal years ending on or after	Form 10-K deadline after fiscal year end	Form 10-Q deadline after fiscal quarter end
December 15, 2002	90	45
December 15, 2003	75	45
December 15, 2004	60	40
December 15, 2005	60	35

The Current Report (Form 8-K)

Savings associations must file this report with OTS when one of the following events occurs and within the following time frames:

- Any changes in control of the savings association - 15 days.
- Acquisition or disposition of assets (of a significant amount other than in the ordinary course of business) - 15 days.
- Placing of the savings association in receivership or conservatorship - 15 days.
- Any change in the savings association's certifying accountant - 5 days.
- Occurrence of other events the savings association deems to be materially important to security holders - no time frame, but within a reasonable time.
- Resignation of directors - 5 days.
- A change in fiscal year - 15 days.

Beneficial Ownership Reports

The Initial Statement of Beneficial Ownership (Form 3)

Persons who fall into any of the categories listed below must file a Form 3 with OTS within ten days after achieving such status.

- Officers (regardless of whether they own any securities).
- Directors (regardless of whether they own any securities).
- Beneficial owners of ten percent or more of any class of the savings association's equity securities.

A Statement of Change in Beneficial Ownership of Equity Securities (Form 4)

Previous filers of Form 3 must file Form 4 when a change occurs in the nature or amount of the person's beneficial ownership of the savings association's equity securities. Filers must file Form 4 within ten days after the end of the month in which a change occurs.

Annual Statement of Changes in Beneficial Ownership (Form 5)

Report annually, within 45 days of the end of the fiscal year, any other small changes in ownership.

Reports of Beneficial Ownership (Schedule 13D and Schedule 13G)

Shareholders must file Schedule 13D within ten days of the acquisition of beneficial ownership of more than five percent of any class of equity securities. Any material change in the facts of the statement requires that the shareholder promptly (generally within two business days of the material change) file an amendment.

Mutual funds and other institutions that invest funds or manage portfolios for beneficial owners must file Schedule 13G. Filers must file Schedule 13G within 45 days after the end of the calendar year.

Shareholders must file 13D and 13G reports with the savings association, OTS, each exchange where the savings association's securities trade, or to the National Association of Securities Dealers, Inc. (NASD) if the National Association of Securities Dealers Automated Quotation System (NASDAQ) quotes the stock.

In reviewing Forms 3, 4, and 5 and Schedules 13D and 13G, BTD attorneys watch for issues related to Part 574, the potential for hostile takeovers, and possible trading on insider information. You should be alert to these possibilities and alert appropriate OTS staff to relevant information.

Other Types of Beneficial Ownership

Persons may own directly any stock held in their own name, or the stock may be held by a bank, broker, or nominee in "street name" for their account. Under the convention of holding shares in street name, a broker executes the trade and holds the stock in the name of the brokerage firm or a nominee. The savings association, through the shareholder (registrar's) ledger, is unaware of the individual initiating the transaction. There are no rules governing the disclosure of ownership held in street name except for the threshold reporting requirements described above.

Persons are the beneficial owners of any stock that they have the right to acquire through the exercise of presently exercisable options, including options granted through a stock option plan. Indirect beneficial ownership includes stock held in the name of another person if, because of an agreement or relationship, a person obtains benefits substantially equivalent to those of ownership. Such benefits include the right to receive income and the right to control transfer of the stock. For example, a person generally is the beneficial owner of stock in the following situations:

- Stock held by certain family members, such as a spouse or minor children.
- Stock owned as trustee, where the person or members of the person's immediate family have a vested interest in the income or principal of the trust.
- Stock held in trust for which the person is a beneficiary.
- Stock owned by a partnership of which the person is a member.
- Stock owned by a corporation that the person controls.

Proxy and Information Statements

Exchange Act Regulations 14A and 14C require the filing of preliminary copies of all proxy statements, other soliciting materials, and Information Statements. Savings associations must file this material with OTS at least ten calendar days prior to the date of first sending or giving such information to shareholders unless the materials relate to the merger or acquisition of the savings association. Savings associations must file definitive copies of the above materials with OTS no later than the date of sending or giving such information to shareholders.

In certain circumstances, savings associations must provide an Information Statement that contains the information specified by Regulation 14C under the Exchange Act. In those instances where a savings association plans corporate action, the Exchange Act requires the filing of an Information Statement. The Information Statement may relate to an annual meeting, a special meeting instead of an annual meeting, or a written consent instead of either an annual or special meeting that includes election of directors. This is a requirement even where there is no solicitation of proxies. The corporate action may occur either at a meeting of the savings association's security holders or by written authorization or consent of such holders.

Annual Report to Shareholders

Savings associations must mail to shareholders copies of the Annual Report to Shareholders. Savings associations mail the Annual Report to Shareholders with, or subsequent to the mailing of, either proxy solicitation material or an Information Statement.

INSIDER STOCK TRADING

There are substantive limitations on the ability of savings association directors, officers, and ten percent shareholders to trade in the savings association's stock. Generally, any profit realized from any purchase and sale or sale and purchase of the savings association's stock within a six-month period (short swing trade) is subject to recapture. Either the savings association or the savings association's stockholders by filing suit on its behalf (15 USC § 16(b)) may seek recapture. The rule provides a rigorous guard against misuse of confidential information by insiders.

Furthermore, the Exchange Act generally prohibits directors, officers, and ten percent stockholders from making any short sale of their savings association's stock. That is, any sale of stock that the seller does not then own. The Exchange Act also requires that directors, officers, and 10 percent stockholders deliver to buyers within 20 days any stock they sell. Alternatively, the Exchange Act requires the depositing in the mail within 5 days any stock sold by directors, officers, and 10 percent stockholders.

In addition, Rule 10b-5 under the Exchange Act (17 CFR § 240.10b-5) prohibits a person from trading any stock using material inside information. Inside information refers to material information not available to the public in general. The rule also prohibits a person in possession of material nonpublic information from selectively disclosing this information to others (tipping) and generally bars the tippees (persons who may have received such nonpublic information) from trading on such a tip. Information is material for this purpose if a reasonable investor would consider it important in reaching an investment decision or would attach actual significance to the information in making the decision. Thus, savings association officers, directors, and others in possession of material inside information must not trade in the savings association's stock until the information is available to the investing public. Managers must not make any disclosures of material information to selected persons without concurrently releasing the information to the public.

CHANGE IN CONTROL

Regulators have concerns about the control of a savings association's voting rights because a change in control may influence the direction and operating policies of the savings association. No person may acquire control of a savings association through a purchase, assignment, transfer, pledge, or other disposition of voting rights of such savings association without OTS approval. This includes the individual acting directly or indirectly, or through or in concert with one or more other persons.

Companies that seek to acquire direct or indirect control of a savings association must also seek OTS approval pursuant to § 10(e) of the HOLA before the acquisition of control. Companies may act in

concert with individuals or other companies to acquire control of a savings association. OTS rules on acquisition of control of savings associations are in 12 CFR Part 574. See Applications Handbook Section 310, Change of Control and Section 320, Rebuttals of Control for a more detailed discussion of changes of control, rebuttals of control, and acting in concert.

Section 563.181 contains special notification requirements that apply whenever a change occurs in the outstanding voting rights that will result in control (or a change in control) of any mutual savings association. The president or other chief executive officer must report such facts to the OTS. They should file the report within 15 days of their knowledge of such change.

Section 563.183 requires the savings association to file a report whenever there is a change in control of any savings association or holding company and there is also a change or replacement of the chief executive officer within a specified time.

The president or other chief executive officer must file a report when a change in control of a savings association or holding company occurs concurrently with, or within 60 days after or 12 months before, a change or replacement of the chief executive officer. (A change in control also mandates filing Form 8-K for a savings association or holding company subject to public reporting requirements of the Exchange Act.)

The president or other chief executive officer must report to OTS whether a change in ownership or other change in the outstanding voting rights under §§ 563.181 or 563.183 will result in control or a change in control of the savings association or holding company. Section 574.4 outlines the conditions under which an acquirer possesses control. The regulation also includes conclusive control determinations.

Section 563.181(c) states the conditions that will require a report from a mutual savings association president or CEO when there is a solicitation of voting rights of the savings association. If a solicitation is of a continuing nature, it is necessary to file a report only when the solicitation begins. The report should indicate the continuing nature of the solicitation. No further reporting is necessary unless or until there is a change in the solicitor.

The president or CEO of the savings association or the holding company should file the report required under 12 CFR §§ 563.181 and 563.183. Under 12 CFR § 516.1(c), they should send an original and two copies to the regional office.

Savings associations must provide a business plan with each of the following applications:

- Approval of change in control of a stock savings association.
- Change in control of a mutual savings association.
- Change in or replacement of the chief executive officer.

Willful violations of §§ 563.181 and 563.183 may be subject to harsh enforcement action, including civil money penalties. If you discover such activity, you should remind savings associations and savings and

loan holding companies of these reporting requirements. Savings associations and savings and loan holding companies are to resolve any doubt regarding the necessity of filing by submission of a report.

Regulatory Considerations

Divestiture of Control

Section 567.13 requires that any acquiror subject to a capital maintenance obligation must give prior written notice to OTS if the acquiror proposes a divestiture of the savings association.

After receiving the notice, OTS has 90 days to conduct an examination of the savings association. OTS determines the extent of any capital deficiency and communicates the results to the acquiror. If the examination indicates that no deficiency exists, the acquiror may divest control of the savings association upon receiving written notice of the examination results.

If a capital deficiency does exist, any acquiror subject to a capital maintenance agreement may only divest a savings association if they provide OTS with a capital infusion agreement. Such an agreement must provide that the acquiror will infuse the savings association with the amount necessary to remedy the deficiency. Further, the acquiror must arrange for payment, satisfactory to OTS, or otherwise satisfy the deficiency. If the acquiror provides OTS with a satisfactory agreement before the completion of an examination made to determine the extent of any capital deficiency, it may proceed to divest control. Also, the acquiror must arrange for payment, satisfactory to OTS, to ensure payment of any deficiency. Alternatively, the acquiror may immediately satisfy the deficiency.

Contributed Capital

Savings associations may accept without limit the following capital contributions:

- Cash.
- Cash equivalents.
- Other high quality, marketable assets provided they are otherwise permissible for the savings association.

Savings associations may accept other forms of contributed capital if the association receives prior OTS Regional Director approval. In considering whether to approve a contribution of capital, the Regional Director will consider the following criteria:

- The assets are separable and capable of being sold apart from the savings association or from the bulk of the savings association's assets.

- The savings association has established an independent market value of the assets and demonstrated that such assets are likely to hold their market value in the future or that the association has established a process for periodic, independent revaluation of the assets.
- The savings association has demonstrated that a market exists for the assets.
- The transaction is in compliance with the requirements of 12 CFR § 563.41.
- The financial condition and adequacy of capital of the savings association.

Generally, the Regional Director will not approve noncash capital contributions that do not meet the above criteria or that constitute more than 25 percent of capital prior to the proposed conversion, unless good cause is demonstrated.

Noncash capital contributions in connection with permission to organize applications or applications under 12 CFR Part 559 will be evaluated pursuant to the criteria established for those application reviews.

Savings and Loan Holding Companies

OTS regulation, 12 CFR § 584.1, requires savings and loan holding companies to file Form H-(b)11 with the appropriate regional office.

Holding companies with securities registered with the SEC under the Exchange Act must attach certain SEC filings to the H-(b)11. For example, the H-(b)11 must include the following information:

- Proxy material filed with the SEC.
- The annual report on Form 10-K.
- Current reports filed on Form 8-K.
- Any prospectus filed in connection with the public offering of securities.
- SEC reports not excluded by request of the OTS regional office.

Capital Distributions

A savings association is permitted to make a distribution of cash or other property subject to 12 CFR § 563.140. Whether a savings association must file a notice or application with OTS depends on whether the capital distribution falls within certain criteria. Section 12 CFR 563, Subpart E - Capital Distributions provides guidance on capital distributions by a savings association. Federal Deposit Insurance Corporation Improvement Act (FDICIA) § 38 prohibits an insured institution from taking certain actions if, as a result, the institution would fall within any of the three undercapitalized capital categories. The prohibited actions include the following:

- Declare any dividends.
- Make any other capital distribution.
- Pay a management fee to a controlling person.

See 12 CFR § 565.4(b) and Examination Handbook Section 120, Capital Adequacy, for guidance regarding the capital categories.

A savings association permitted to make a capital distribution under the prompt corrective action regulations may do so in accordance with 12 CFR Part 563. The capital distribution regulation incorporates FDICIA's capital distribution requirements and imposes other limitations comparable to those applicable to national banks.

Subchapter S Distributions

Distributions by a Subchapter S Corporation are dividends for regulatory purposes, including prompt corrective action. This includes distributions intended to cover a shareholder's personal tax liability for the shareholder's proportionate share of the taxable income of the institution.

OTS may restrict such distributions to shareholders in amount or prohibit them in some instances. There may be some cases where the amount of dividends that shareholders would need to receive to pay their personal income taxes would exceed the amount of dividends allowable under 12 CFR Part 563, Subpart E - Capital Distributions. It is also possible for an association to be generating taxable income in a period when the association is reporting a loss or nominal income for financial reporting purposes. This situation can arise, for example, when an association takes a large provision for loan losses because of credit quality problems but has not yet charged off specific loans.

Loans by Savings Association on Its Own Stock

Pursuant to The Financial Regulatory Relief and Economic Efficiency Act of 2000 (FRREEA), OTS now prohibits savings associations from making loans or discounts on the security of the shares of their own capital stock. Since repayment of the loan may require the association to take title to the collateral and remarket it, OTS considers such action an unsafe and unsound practice, particularly for an association that cannot easily remarket its stock. Prior to FRREEA, OTS did not prohibit savings associations from making loans on its own stock.

The statute allows a savings association to make a loan or discount on the security of the shares of its own capital stock if it acquires the stock to prevent loss upon a debt previously contracted for in good faith. Savings associations may also take their own stock as additional collateral in "work-out" situations. This provides lenders with greater security against default and enhances the safe and sound operations of a lender. Savings associations may own or acquire shares to reduce capital.

EMPLOYEE STOCK OWNERSHIP PLANS

It is customary for a significant holder of a savings association's shares to be an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan. The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 describe an ESOP as a stock bonus plan, or combination stock bonus and money purchase pension plan. ESOPs invest primarily in an employer's stock, generally by using tax deductible contributions made to the ESOP under the terms of the plan. Other pension plans normally limit the amount of the plan's assets allowable for investment in the employer's securities.

Federal legislation encourages the use of ESOPs to help achieve two major objectives:

- Broadening stock ownership of corporations by employees.
- Providing corporations with an additional source of capital funds.

A plan and trust are the vehicles used to establish an ESOP. The trustee is typically a financial institution. There are over 100 savings associations with trust powers. A savings association with trust powers can be the trustee for its own ESOP and the ESOPs of other employers.

After the establishment of the plan and the trust, the employer periodically contributes to the ESOP. The ESOP uses the contributions to purchase stock of the employer and to pay administrative and other expenses.

A common form of this type of benefit plan is the leveraged ESOP, whereby the sponsoring company forms a tax-qualified ESOP trust. The ESOP then borrows funds from a lending institution to acquire shares of the employer's stock. The stock may consist of outstanding shares, Treasury shares, or newly issued shares.

The debt of the ESOP is usually collateralized by the pledge of the stock to the lender. Also, there is either a guarantee or a commitment from the employer to make future contributions to the ESOP sufficient to cover the debt service requirements. There is a prohibition on the use of guarantees during a stock conversion. In leveraged ESOPs, the employer provides contributions to repay the debt and pay administrative expenses associated with the plan.

A suspense account under the control of the trustee of the plan usually holds the stock shares. Employees receive credit to their individual account when the trustee releases shares from the suspense account. The trustee releases shares from the suspense account as the ESOP repays the loan.

An ESOP must be tax qualified in order for the corporation's contribution to the plan to be tax free. This means the plan must meet certain requirements specified by the Internal Revenue Code and is, therefore, subject to IRS examination. These requirements pertain to participation, vesting, distribution, and other rules designed to protect the interests of the employees.

Recognition of a deferred tax liability may occur if a savings association contributes more than the maximum percentage allowed for deduction in the current year. This allows for an inter-period tax

allocation in a future year. Further, ESOPs allow for an above the line deduction for federal income tax purposes. This consists of a pre-tax deduction for employer contributions to the ESOP. The deduction includes both the principal and interest on the loan. Alternatively, if the ESOP is not leveraged, a deduction is allowable for the contribution up to a certain maximum. The net effect of this transaction is a reduction in operating income for the tax year.

An ESOP also may be a non-tax-qualified plan; the corporation simply receives no tax benefits as a result. Attraction or retention of key, highly compensated individuals often involves the use of non-tax-qualified ESOPs.

An ESOP is subject to the provisions ERISA and is consequently subject to the rules and regulations promulgated by the Department of Labor.

ESOPs provide the following benefits:

- Employees can acquire stock ownership in their employer without having to invest their own funds.
- The employer can use the ESOP to generate additional capital with tax-deductible dollars.
- Shareholders of a closely held corporation may benefit from creation of a larger market for their stock.

Federal savings associations have the implied authority to establish ESOPs, as they have the authority to compensate their employees. State-chartered savings associations also appear to possess the implied authority to establish ESOPs. This question, however, is a matter of state law. This also holds true for holding companies.

A savings association must establish and operate an ESOP in a safe and sound manner. Savings associations establishing employee pension plans must satisfy certain requirements specified in § 563.47. Such requirements concern funding, amendments for cost of living increases, and termination. In addition, there are recordkeeping requirements for plans not subject to the recordkeeping and reporting requirements of ERISA and the Internal Revenue Code. The rule is applicable to ESOPs formed by service corporations as well.

A savings association, another financial institution with trust powers, or a service corporation may administer or act as a trustee for an ESOP. Some savings associations have service corporations that are separate trust companies; when this is the case, ESOPs are typically trusteed by those service corporations.

Regulatory Restrictions and Issues

Conversions

Creation and structuring of ESOPs frequently occurs during conversions. There are a number of reasons to establish an ESOP, for example, to reward employees or to serve as an anti-takeover device. Discussion of three issues of particular interest relating to ESOPs follows:

- An ESOP may purchase no more than ten percent of the stock offered in a conversion.
- Limitations exist in a conversion as to the amount of stock that an individual may purchase and as to the amount of stock that management as a group may purchase. An individual's stock purchase limitations do not include stock held in an ESOP. There is no aggregation of the individual and ESOP stock holdings. Stock held in an ESOP that is a management recognition or retention plan (MRP) is non-tax-qualified. You should include stock held in a non-tax-qualified ESOP when determining the overall limitation for management purchases of conversion stock.
- OTS continues to prohibit a savings association, during a conversion, from extending its own credit to finance the funding of any employee stock benefit plan. OTS also prohibits a converting savings association from guaranteeing the debt incurred by the ESOP when it borrows from another lending institution. The major objective of the conversion process is to raise new capital. To permit a savings association to extend financing or to guarantee debt of the ESOP would be inconsistent with that objective. OTS requires a savings association to service the debt of the ESOP and reserves the right to disapprove a plan that is unrealistic subject to the provisions of ERISA.

Transactions with Affiliates

Savings associations are subject to 12 CFR § 563.41, which incorporates the Federal Reserve Board's Regulation W (12 CFR Part 223). These rules restrict and prohibit certain transactions with affiliates. In many cases, ESOPs are affiliates because the trustees are also directors, partners, or trustees of the savings association or its holding company. In some cases, an ESOP is an affiliate because of other control. For example, the ESOP may own, control, or have the power to vote 25 percent of a class of voting securities of the holding company or savings association. If the ESOP is an affiliate, the savings association may not make a loan, guarantee, or other extension of credit to the ESOP. This is because the collateral requirements of § 563.41(c) would be difficult, if not impossible, to meet. The securities issued by an affiliate of the association are not acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of the affiliate.

Despite this limitation, the funding of most ESOPs does not raise concerns. Typically, most ESOPs receive funding by a loan or guarantee from the holding company, as opposed to the savings association itself. A loan by the holding company is not a covered transaction under the affiliate regulations. Refer to Handbook Section 380 for further details on Transactions with Affiliates.

Compliance with ERISA

ERISA imposes complex requirements upon savings associations acting as trustee or in other fiduciary capacities for ESOPs, and severe penalties can result from statutory violations. In addition, the savings association, as the employer or plan sponsor of its own employees' retirement plan, is a party in interest pursuant to ERISA. This is the case whether or not the savings association is the trustee. Almost without exception, all transactions involving the purchase or sale of an asset of the plan to or from the savings association, any affiliate, officer, or employee are subject to the provisions of ERISA. There are only certain narrowly defined exemptions. The plan sponsor or its administrative committee may be subject to reporting, disclosure, and plan design requirements. There are also a number of other responsibilities under ERISA if the savings association is acting as trustee or in a fiduciary or similar capacity.

Risk to Savings Association as Employer or When Acting as Trustee

Most of the responsibility for administration lies with the trustee, and there consequently is little risk to the savings association when it uses an outside trustee. However, the plan and trust establishing the ESOP stipulate the respective rights, duties, and obligations of the employer and trustee. For example, the trustee has a fiduciary responsible to protect the assets of the ESOP. When a board member acts as trustee, a conflict may occur. A board member may be privy to an event that will drastically affect the employers' stock price. The trustees' fiduciary responsibility to the ESOP requires an action to protect and preserve the assets of the trust; however, this same person (board member) is prohibited from trading the stock based on insider information. The employer may be subject to liability under ERISA if it violates any of its duties or obligations.

Acquisition of Control

No company may acquire control of a savings association or holding company without the prior written approval of OTS. An exception under 12 CFR § 563(c)(1)(vii) allows an ESOP to acquire up to twenty-five percent of a savings association's stock.

Valuation of Savings Association Stock

Shares of a publicly held savings association where fair market value is recognizable in an actively traded market generally do not raise problems. Difficulties may arise with closely held savings associations; the stock is not marketable and the ESOP creates but a limited market. IRS Ruling 59-60 outlines major principles of stock valuation; one of the principles requires the use of an independent appraiser.

Repurchase Liability

At separation or retirement, employees generally want cash for their shares of stock. The law requires an employer to redeem the shares if there is no readily available market for them. The issue of cash availability can become a critical one for a small, privately held savings association. The ESOP repurchase liability is the savings association's continuing obligation to repurchase its stock from former ESOP participants and their beneficiaries. The savings association should perform a careful

analysis of the magnitude of the obligation and include it in the financial planning process if necessary to ensure that enough cash is available.

Accounting

The present accounting for ESOPs comes from a project undertaken by the Accounting Standards Executive Committee (AcSEC), which resulted in Statement of Position 93-6 (SOP 93-6, Employers' Accounting for Employee Stock Ownership Plans). This SOP provides guidance on employers' accounting for ESOPs. The SOP applies to all employers with ESOPs (both leveraged and nonleveraged). It does not address reporting by ESOPs. There is a discussion of financial reporting by ESOPs in the AICPA Audit and Accounting Guide: Audits of Employee Benefit Plans.

The necessity for SOP 93-6 is due to the great expansion in the number of ESOPs, their increased complexity, plus revised laws by Congress concerning ESOPs. In addition, the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) issued many regulations covering the operation of plans. These actions caused changes in the way ESOPs operate and the reasons for their establishment.

SOP 93-6 brought significant changes in the way employers report transactions with leveraged ESOPs. Although SOP 93-6 did not change how employers with nonleveraged ESOPs account for ESOP transactions, it contains guidance for nonleveraged ESOPs.

The following paragraphs summarize significant accounting rules applicable to employer's accounting for ESOPs.

Leveraged ESOPs

- Employers should report the issuance of new shares or the sale of treasury shares to the ESOP when the issuance or sale occurs. Also, employers should report a corresponding charge to unearned ESOP shares, a contra-equity account.

- For ESOP shares committed for release in a period to compensate employees directly, employers should recognize compensation cost equal to the fair value of the shares committed for release.

- For ESOP shares committed for release in a period to settle or fund liabilities for other employee benefits, employers should report satisfaction of the liabilities when the employer commits to release the shares to settle the liabilities. Other employee benefits include an employer's match of employees' 401(k) contributions or an employer's obligation under a formula profit-sharing plan. The use of an ESOP has no bearing on the recognition of compensation cost and liabilities associated with providing such benefits to employees.

- For ESOP shares committed for release to replace dividends on allocated shares used for debt service, employers should report satisfaction of the liability to pay dividends when the ESOP commits for the release of shares for that purpose.

- Employers should credit unearned ESOP shares as they commit shares for release based on the cost of the shares to the ESOP. Employers should charge or credit to additional paid-in capital the difference between the fair value of the shares committed for release and the cost of those shares to the ESOP.

- Employers should report dividends on unallocated shares as a reduction of debt or accrued interest payable or as compensation cost. The use of the dividend for either debt service or payment to participants determines the form of accounting entry. Employers should charge dividends on allocated shares to retained earnings. They should make satisfaction of dividends payable by one of the following:

  — Contributing cash to the participant accounts.

  — Contributing additional shares to participant accounts.

  — Releasing shares from the ESOP's suspense account to participant accounts.

- Employers should report redemptions of ESOP shares as purchases of treasury stock. Employers should also report redemption of shares of leveraged and nonleveraged ESOPs as purchases of treasury stock. Employers must give a put option to participants holding ESOP shares that are not readily tradable. When participants exercise a put option, employers must repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs.

- Employers that sponsor an ESOP with a *direct loan* (a loan made by a lender other than the employer to the ESOP) should report the obligations of the ESOP to the outside lender as liabilities. Employers should accrue interest cost on the debt. They should report cash payments made to the ESOP to service debt as reductions of debt and accrued interest payable when the ESOP makes payments to the outside lender. Apply this rule regardless of whether the source of cash is employer contributions or dividends.

- Employers that sponsor an ESOP with an *indirect loan* (loan made by the employer to the ESOP with a related outside loan to the employer) should report the outside loan as a liability. Employers should not report a loan receivable from the ESOP as an asset and should not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Employers do not recognize in the financial statements contributions to the ESOP or the concurrent payments from the ESOP to the employer for debt service.

- Employers that sponsor an ESOP with an *employer loan* (no related outside loan) should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

- For earnings per share computations, consider ESOP shares committed for release as outstanding. ESOP shares are not outstanding if there is no commitment for release.

Nonleveraged ESOPs

- Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Measure compensation cost as the fair value of shares contributed to or committed for contribution to the ESOP as appropriate under the terms of the plan.

- Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings. An exception is that employers should account for suspense account shares of a pension reversion ESOP in the manner described in SOP 93-6 for leveraged ESOPs.

- Account for the redemption of shares of a nonleveraged ESOP in the same manner as that required for a leveraged ESOP. Employers must give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs. Employers should report the satisfaction of such option exercises as purchases of treasury stock. (See the prior discussion of redemptions in the leveraged ESOPs section.)

- Treat all shares held by a nonleveraged ESOP as outstanding in computing the employer's earnings per share, except suspense shares of a pension reversion ESOP. Treat shares of a pension reversion ESOP as outstanding until making commitment for release for allocation to participant accounts. Different rules also apply if a nonleveraged ESOP holds convertible preferred stock.

Consult SOP 93-6 for a comprehensive discussion of rules applicable to employers' accounting for ESOPs.

REFERENCES

United States Code (12 USC)

Federal Reserve System

§371c(23A)	Banking Affiliates
§371c-1(23B)	Restrictions on Transactions with Affiliates
Part 223	Transactions between Bank Member Banks and Their Affiliates (Regulation W)

Home Owners' Loan Act

§1464(i)	Conversions
§1464(o)	Conversion of State Savings Banks
§1464(p)	Conversions
§1467a(10)	Regulation of Holding Companies
§1468(11)	Transactions with Affiliates

Federal Deposit Insurance Act

§1817(j)	Change in Control of Depository Institutions

United States Code (15 USC)

Securities Exchange Act of 1934

§12	Registration Requirements
§13	Periodical and Other Reports
§14	Proxies
§16	Insiders

United States Code (29 USC)

§1001	Employee Retirement Income Security Act of 1974

Code of Federal Regulations (12 CFR)

FDIC Rules

Part 303 Subpart E	Change in Bank Control

Office of Thrift Supervision Rules

Part 543	Federal Mutual Associations
Part 552	Federal Stock Associations
§561.4	Affiliate
§561.5	Affiliated Person

§563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§563.43	Loans to Executive Officers, Directors and Principal Shareholders
§563.47	Pension Plans
§563.81	Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
Part 563 Subpart E	Capital Distributions
§563.181	Reports of Change in Control of Mutual Savings Associations
§563.183	Reports of Change in CEO or Director
Part 563b	Conversions from Mutual to Stock Form
Part 563c	Accounting Requirements
Part 563d	Securities of Savings Associations
Part 563g	Securities Offerings
§565.4	Capital Measures and Capital Category Definitions
§567.5	Components of Capital
§567.13	Obligations of Acquirors of Savings Associations to Maintain Capital
Part 569	Proxies
Part 574	Acquisition of Control of Savings Associations
§584.1	Registration, Examination, and Reports

Code of Federal Regulations (17 CFR)

Securities and Exchange Commission Rules

§240.10b-5	Insider Trading
§240.12b	Registration under the Exchange Act
§240.13	Shareholder and Periodic Reporting
§240.14a	Proxies

§240.14c	Distribution of Information
§240.14e	Tender Offer Rules
§240.16a-1	Reports by Insiders
§240.17f-2	Fingerprinting of Transfer Agent Personnel
§240.17Ad-2	Turnaround of Items by Transfer Agents
§240.17Ad-4	Exempt Transfer Agents
§240.17Ad-11	Reports of Record Differences

OTS Applications Processing Handbook

Section 440	Stock Conversions

OTS Trust & Asset Management Handbook

Section 620	Employee Benefit Accounts

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 47	Disclosure of Long-term Obligations
No. 89	Financial Reporting and Changing Prices

Internal Revenue Service

Revenue Ruling 59-60 Stock Valuation

American Institute of Certified Public Accountants (AICPA) Statement of Position

No. 93-6	Employers' Accounting for Employee Stock Ownership Plans

Capital Stock and Ownership Program

EXAMINATION OBJECTIVES

Identify and determine the nature of ownership and control of the savings association.

Determine whether any individual has exerted a detrimental influence through ownership or control.

Determine if adequate physical safeguards for stock certificates and ownership records are in place.

Determine compliance with applicable laws, rulings, regulations, and any expressed agreements with OTS, FDIC, or state regulators.

Determine the adequacy of the savings association's policies, procedures, and controls related to capital stock.

Review securities filings for information of a supervisory interest and report results of the review to Business Transactions Division (BTD).

Determine if a savings association prudently administers an Employee Stock Ownership Plan (ESOP).

Initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note significant violations of laws or regulations other than securities violations.

EXAMINATION PROCEDURES

LEVEL I

WKP. REF.

1. Determine through discussions with management and other appropriate verification methods, if management has taken corrective action relative to:

   - Prior examination report comments and prior examination exceptions.
   - Internal and external audit exceptions.
   - Any enforcement/supervisory actions and directives.

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2. Summarize information from securities offering filings, directors' minutes, audit reports, and other sources pertaining to any new issuance of capital stock (including the payment of stock dividends), notes, subordinated debentures, and other capital instruments. File the information within the continuing examination file (CEF), if applicable.

3. Either you or the regional office should make a brief review of the Forms 10-K, 10-Q, 10-KSB, 10-QSB and any other Exchange Act reports. (See Appendix A.) Compare the Exchange Act reports to TFRs, other reports, information, and documents relating to the savings association that are available. Immediately report any material discrepancies between the disclosures contained in the Exchange Act reports and information known to the regional office. The regional office should inform BTD and the Accounting Policy Division (APD) by e-mail.

4. Carefully review all transactions involving Treasury stock. Determine whether the board of directors' actions adequately supports Treasury stock transactions. Consider whether transactions have a detrimental effect.

5. Update the CEF, if applicable, with the Schedule of Stockholders (PERK 014). Alternatively, summarize the following information for each director and director's interests, officer, attorney, partner, and all other stockholders who own or control five percent or more of the savings association's stock:

   - Number of shares.
   - Percent to total outstanding.
   - Stock certificate number (optional).
   - Issuing price (optional).
   - Date of issue (optional).

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- Confirm the timely reporting of changes in ownership on Forms 3, 4, 5 or Schedules 13D or 13G by companies subject to the Exchange Act.

6. Determine stock concentration by noting the total number of shareholders along with the number of shares outstanding.

7. If the savings association elected S Corporation status since the last examination, perform the following procedures:
   - Review the association's eligibility for the election.
   - Review shareholder agreements regarding stock transfers which management will use to maintain compliance with the eligibility requirements.
   - Verify that management has a method for monitoring ongoing compliance with S Corporation eligibility requirements.
   - Confirm that management periodically test and review the method for monitoring compliance.

8. Review whether the institution has realistic expectations about its ability to increase its capital while maintaining its S Corporation status.

9. Determine whether the association's management and shareholders understand that limitations may exist on the ability of an S Corporation to pay dividends.

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10. Determine whether management understands the overall effect of any potential dividend distribution limitations on an S Corporation.

11. Review proxy records from the last election of the directors. Identify anyone who has controlled the election of the board through proxies.

12. On the basis of information obtained in procedure No. 5 and review of shareholder and related information, consider:

    - Whether there was a change in control in the association. If yes, determine if BTD received the information for savings associations subject to the Exchange Act, and if not reported, provide details to BTD for a determination of needed disclosures.
    - Whether ownership, or change in control, of the savings association has significantly affected the savings association's operating policies or mode of operations to the detriment of the savings association.

13. ERISA and IRS rules and regulations are complex. Accordingly, you should request the ESOP administrator in the savings association to provide evidence that specialist legal counsel assists in helping to maintain the plan in compliance with all applicable rules and regulations. You should request the ESOP administrator to provide evidence that the savings association is able to meet its repurchase liability. The ESOP administrator also should support the stock valuation of closely held savings associations.

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14. From a review of plan documents or other appropriate sources, determine the duties and responsibilities of the savings association regarding its ESOP. Ascertain whether the savings association is satisfactorily performing its duties and responsibilities. If the need for expert advice is apparent, you should recommend that the savings association obtain the advice of an ESOP legal specialist. (*Note:* See the Trust & Asset Management Handbook for additional examination procedures if the savings association or its service corporation is acting as trustee, or serving in a fiduciary or similar capacity.)

15. If the savings association established an ESOP in conjunction with a conversion, determine if the ESOP purchased ten percent or more of the stock offered in the conversion.

16. Determine if the savings association aggregates stock held in the ESOP with an individual's purchase limitations. (They should not be aggregated.)

17. Determine if during a conversion the savings association extended its own credit to finance the funding of the ESOP. Also determine if during a conversion the savings association guaranteed the debt incurred by the ESOP when borrowing from another savings association.

18. Determine if the ESOP is an affiliate or an affiliated person. If so, verify that transactions such as loans and other financing arrangements with the savings association are consistent with OTS and FRB restrictions and prohibitions. (12 CFR §§ 561.5 and 563.43 and Federal Reserve Act §§ 23A and 23B.)

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19. Determine if an ESOP trust acquired control of the savings association or an S&L holding company outside of the conversion process. If so, verify OTS approval of the acquisition of control, as required by § 574.3.

20. Summarize pertinent information relating to stock option plans and ESOPs and file in the CEF, if applicable.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

LEVEL II

1. Determine whether the association's management and shareholders understand that prohibitions exist on the ability of an association to make loans or discounts on the security of the shares of its own stock. Verify that the association is in compliance with these restrictions.

2. Ensure that capital distributions are of the type and in the amount permitted by Part 563, Subpart E – Capital Distributions.

3. For savings associations subject to the Exchange Act, determine whether the savings association makes timely required filings. If not, contact the regional office or BTD.

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4. If the savings association acts as its own transfer agent or registrar, examine the records pertaining to stock certificates to ensure controls are adequate to prevent over issuance of stock.

5. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and recommendations for any necessary corrective measures, on appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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WASHINGTON AND REGIONAL PROCESSING OF EXCHANGE ACT FILINGS

Background

Savings associations must provide full, fair, accurate and complete information regarding their business and financial condition to the investing public to avoid potential liability under the anti-fraud rules of the federal securities laws. It is essential to the supervisory efforts of the regional offices that regulators be aware of critical information disclosed in filings.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and with the Exchange Act and OTS regulations. Also, BTD, upon request, assists the SEC by reviewing filings of savings and loan holding companies referred by the SEC.

For purposes of this Appendix, we refer to BTD and APD as securities review staff when they perform dual functions. We refer to BTD and APD individually when they perform tasks independent of each other.

Coordination between regional and Washington staff is essential to ensure that savings associations fulfill their obligations to make full, fair, accurate, and complete representations to the public about their financial condition and operations. Reliable public disclosure and market integrity for saving association's securities are key to the savings association industry's capital-raising process.

General Procedures

The responsibility for reviewing disclosure documents filed by savings associations for compliance with the Exchange Act and the OTS securities offerings regulations rests with securities review staff. Securities review staff are responsible for issuing comment letters relating to a particular filing. Further, securities review staff are responsible for resolving legal, disclosure, and accounting questions that may arise under the Exchange Act and 12 CFR Parts 563b, 563d, and 563g. A specific attorney is assigned to each reporting savings association and reviews and examines all of that savings association's Exchange Act reports and any offering circulars it may file.

APD performs accounting reviews for the nontransactional Exchange Act filings and other filings and applications that contain financial statements. APD is primarily responsible for accounting reviews of the following forms: 8-K, 10, 10-SB, 10-K, 10-KSB, 10-Q, 10-QSB, 12b-25, applications for conversions, applications for conversions with mergers, and applications for mutual holding company conversions. The BTD staff is primarily responsible for accounting reviews for secondary offering circulars (of equity, debt and other securities) and mergers.

The regional office should contact securities review staff when questions arise with respect to a particular savings association's disclosure obligations. Also, the regional office should contact securities review staff by telephone or e-mail whenever information comes to their attention that potentially affects such reporting obligations.

Securities review staff closely review examination reports and other supervisory communications in connection with their review of securities filings to ensure appropriate disclosures in the filings. Staff works together to secure resolution of novel and precedential accounting issues.

APD generally issues accounting comments in conjunction with, but separate from, comments issued by BTD on the Exchange Act filings for which it has primary responsibility. Otherwise, BTD provides to the savings association or other filing party all comments relating to the accuracy, adequacy, and timeliness of Exchange Act filings made with OTS. Securities review staff and the regional office receives copies of all comments and responses regardless of which office issues the comments.

Securities review staff maintains a shared electronic file of all comments on filings that is accessible by each regional accountant or a designee. The shared file ensures that each office is aware of each other's findings and can determine if there is a need for a supervisory response. Securities review staff and the regional office must be aware of problems that require disclosure in filings. The regional regulator must be aware of securities review staff comments, and responses to those comments.

Securities review staff will resolve all issues regarding a savings association's compliance with issued comments. Also, BTD will resolve any necessary enforcement or other actions regarding compliance with filing requirements. In some instances, securities review staff may seek the assistance of a regional office in obtaining a savings association's compliance with comments. Securities review staff rely on regional regulators to observe and to report events that may affect Exchange Act disclosures, particularly events raising significant supervisory concerns. Regional regulators, therefore, must have a general knowledge of the content of a savings association's securities filings.

Time Requirements

For a report to be timely, OTS must receive a properly filed report by the required date. The mailing or post-marking of a report on the last day on which a report is to be filed does not constitute a timely filing.

A savings association may receive an extension of time to file a report if the savings association follows the procedures described in the regulations and satisfies all of the requirements of an extension. Exchange Act Rule (17 CFR § 240.12b-25) contains general provisions to follow if a savings association fails to file within a prescribed time frame all or portion of an Exchange Act periodic report. If a savings association fails to submit a complete Exchange Act periodic report within the prescribed time period, it must file a Form 12b-25. The savings association must file Form 12b-25 no later than one business day after the due date of such report. The association must disclose its inability to file the report on a timely basis and the reasons why in reasonable detail, and otherwise comply with all other requirements of Rule 12b-25. Among other things, the savings association must represent in the Form 12b-25 that it cannot eliminate the reasons for the delay without unreasonable effort or expense. The savings association also must represent that it will make the filing within the period of the extension. Rule 12b-25 provides for a 15-day extension for a Form 10-K or 10-KSB and a 5-day extension for a Form 10-Q or 10-QSB. Such extensions are available only upon an appropriate filing with BTD. Only one 15- or 5-day extension period, as appropriate for the type of filing, is available. No additional extensions of time are available under the regulations.

If appropriate, a savings association may represent that its failure to file a timely prescribed report is due to its inability to file the report without unreasonable effort or expense. Generally, late reports satisfy prescribed due dates only if the savings association meets all conditions of the rules.

When a savings association is unable to file a report on time, it should promptly consider its general public disclosure obligations. The savings association should determine whether it is appropriate to issue a press release to advise its stockholders and the public markets of material information pertaining to the savings association. In this regard, savings associations may wish to contact BTD or submit a written statement of the reasons for the delinquency. The statement should include a description of the steps the savings association is taking to come into compliance with the reporting requirements.

Regional Procedures

Securities oversight of savings associations is critically important. Regional regulators must alert the individual responsible for the particular savings association to all supervisory or other regulatory information that affects or may potentially affect securities law disclosure obligations. This reporting may be through e-mail. The use of e-mail provides more time for both the regional and securities review staff evaluation. Also e-mail facilitates the maintenance of the comments in a shared electronic file that is available to the regions and securities review staff.

Critical to an effective OTS oversight role is the certainty that regional personnel are thoroughly familiar with the current financial and operational condition of savings associations. Knowledgeable regional personnel should promptly review filings for supervisory concerns, and communicate any concerns to securities review staff. A critical component in securities review staff's Exchange Act oversight role is ensuring correction, as soon as possible, of any information in a public filing that is inaccurate, misleading, or incomplete. For this reason, regional regulators should promptly review Exchange Act filings, offering circulars, and applications for conversion.

The regional office should provide to securities review staff copies of all nonroutine correspondence to and from the savings association. Further, the regional office should provide copies of documents and internal memoranda that may contain information relevant to a savings association's disclosure obligations. Securities review staff examine this information to ensure that savings associations promptly comply with all disclosure obligations.

Achievement of successful supervision of savings association securities responsibilities requires uniformity and consistency of action. Regional personnel and BTD should coordinate a supervisory approach prior to initiating discussions with savings associations regarding requests for additional information or requiring corrective action under the Exchange Act. Should it become necessary, BTD will inform the Enforcement Division of Exchange Act or securities offering problems needing enforcement attention.

The regional office should determine if the savings association provides timely periodic Exchange Act filings. The regional office should maintain a schedule for each regional Exchange Act and 563g registered savings association indicating the due dates of all Exchange Act filings. This Handbook Section lists all common required filings and their respective time requirements. Regional offices should

use this information to set up the schedules. Securities review staff maintain similar schedules and may assist the regional offices in setting up these schedules.

Savings associations must file required reports within prescribed time frames. Before the regional office contacts a savings association to inquire about a missing filing, they should first check with the assigned individual to determine if BTD has the filing. In certain instances a savings association may explain a late filing by filing Form 12b-25. Generally, this filing will allow a short extension of time to file certain reports. In addition, a savings association may inadvertently file reports with either BTD or the region, but not both. In such a case, BTD will direct the savings association to immediately file reports as required by the regulations, including Parts 563d and 563g.

Failure to file required reports on a timely basis may indicate deeper problems at a savings association. When regional regulators become aware of serious problems with a registrant savings association, they should immediately alert securities review staff by e-mail. Regional personnel should provide relevant supervisory information to securities review staff when practicable, rather than wait until completion of the next examination report.

Regional staff should quickly and promptly review all filings related to savings associations and holding companies to discover any information of supervisory interest. If regulators read the filings promptly, they may find serious problems disclosed in filings months before they would otherwise find them. A quick and timely review of filings may result in more timely initiation of a supervisory response that may require a restatement of earnings and financial position. In addition, the timely review of filings may lead to enforcement action, such as cease and desist, removal and prohibition, or receivership. Regional staff should not rely on securities review staff for this supervisory review. Further, regional staff should not duplicate the work of securities review staff in reviewing filings for compliance with the Exchange Act and Parts 563b, 563d, and 563g of the OTS regulations.

After a review of any filing, regional personnel should prepare a brief memorandum to securities review staff describing the review. The memorandum should disclose the existence of possible supervisory concerns and corrective actions that the regional office recommends. If the regional office notes problems, the filing will receive higher review priority. In the absence of such disclosure of potential concerns, the filing will likely receive a lower review priority. If necessary, securities review staff will prepare and issue a comment letter to the savings association concerning the disclosure problems. The regional office should promptly provide this memorandum via e-mail to securities review staff who will include the information in the shared electronic file.

When a savings association files an offering circular pursuant to Part 563g, BTD generally issues an initial comment letter on the filing within 14 to 30 calendar days of the filing date. This comment letter will generally include comments from the individual assigned to the savings association. Accordingly, regional staff should review offering circulars and provide any relevant information via e-mail to BTD within ten calendar days of filing. Satisfying this time frame will allow BTD to consider such information within the initial review period.

Regional regulators should be aware of significant events that have occurred requiring the filing of a current report on Form 8-K. The regional regulators should determine if the filing is timely. Consult with BTD if there is a question regarding the necessity of making a filing.

Filers must properly file and receive BTD clearance of proxy soliciting materials (or information statements, when applicable) before distribution to stockholders. Regional regulators should note these required steps. In addition, while not necessary, regional regulators may review proxy materials. If they do review proxy material, they should notify security review staff immediately by e-mail if they believe any proxy materials contain a material misstatement or omit any material information.

Regional regulators should be alert to changes in the majority of a savings association's board of directors resulting from actions other than a meeting of the stockholders. Regional regulators should promptly consult with BTD if questions arise regarding a change in the majority of a board of directors. Also, regional regulators should immediately notify BTD if problems arise.

Regional regulators should identify any savings associations with assets of more than $5 million that have 300 or more shareholders and a class of stock not registered under the Exchange Act. Also, regional regulators should identify formerly registered savings associations. Interpretive questions sometimes arise as to the meaning of "held of record" or "class" and regional regulators should refer these questions to BTD. If it appears that a savings association should have registered its stock under the Exchange Act, the regional office should advise securities review staff. The trigger for this inquiry is 300 shareholders because:

- Although 500 shareholders triggers registration under the Exchange Act, the number of shareholders may have increased to 500 or more since the last verification.
- Three hundred shareholders triggers deregistration.

Regional regulators should notify a savings association's officers, directors and significant shareholders of their responsibilities to file reports (with BTD in Washington and with the regional office) relating to their ownership of the savings association's securities. Savings association officers, directors and five percent or greater shareholders have ownership and transaction reporting requirements under the Exchange Act. The Exchange Act requires this information on Forms 3, 4, or 5 and Schedule 13D or 13G. The rules in this area can be extremely complex and there is a large body of judicial precedent dealing with this area. Refer questions regarding interpretation to BTD. Regional regulators should encourage those with obligations to file such reports to consult with their own counsel regarding their filing responsibilities.

Regional personnel should refer all comments or discovery of material information regarding savings and loan holding companies that are subject to Exchange Act filing requirements to BTD. Securities review staff will assess the materiality of the information for purposes of securities law obligations and will work with the regional personnel in deciding an appropriate response under the circumstances. Securities review staff will assess the information to determine whether a referral to the SEC is appropriate.

Regional office personnel are responsible for contacting holding companies that are not filing Form H-(b)11 as required. The inclusion of SEC filings in Form H-(b)11 does not mean that OTS necessarily has a role in performing disclosure review of those documents. Regional regulators should provide any comments to BTD for all securities filings that the holding companies provide and send BTD related correspondence and examination reports upon request.

Regional office personnel should also advise APD of any significant accounting disclosure problems and accounting issues noted during their review of Forms H-b(11) for holding companies that have thrift subsidiaries that file Securities Exchange Act filings with the SEC and/or the OTS.

You should report information concerning accounting or reporting problems that may affect the Thrift Financial Report (TFR) to the Financial Reporting Division (FRD), Dallas, TX. The staff of the FRD in Washington, DC can answer questions and provide advice concerning the correct completion of TFRs. Institutions should correct TFRs that are less than five months old in accordance with FRD's guidance.

Capital Adequacy

Capital absorbs losses, promotes public confidence, and provides protection to depositors and the FDIC insurance funds. It provides a financial cushion that can allow a thrift to continue operating during periods of losses or other adverse conditions. This Handbook Section provides guidance in determining a thrift's capital adequacy.

Capital Adequacy

A thrift's level of capital is adequate when it meets regulatory requirements, *and* is commensurate with the thrift's risk profile. The capital level should also be sufficient to support future growth. While minimum regulatory capital requirements provide a consistent starting point for determining capital adequacy, most thrifts should, and in fact do, exceed well capitalized standards (see Prompt Corrective Action (PCA) Categories below).

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The various OTS capital requirements assume that a thrift primarily engages in traditional, relatively low risk activities. Higher risk permitted activities require more capital, especially if the activities are conducted at significant concentration levels. Lenders engaged in higher risk activities should also have higher Allowances for Loan and Lease Losses (ALLL) and risk management expertise appropriate to the risk.

OTS maintains, revises, and interprets its capital regulations in collaboration with the other federal banking agencies. OTS capital rules are substantively similar to those of the other banking regulators as a result of various statutory requirements. Federal statute requires that OTS capital regulations may be no less stringent than the capital regulations of the Office of the Comptroller of the Currency (OCC). In addition, the federal banking agencies must work together on an interagency basis to develop uniform rules implementing common statutory or supervisory policies, including capital requirements. Many of the agencies' uniform capital rules are based on the principles set out in an international agreement known as the Basel Accord.

You should review recent proposed and final regulations for the most current regulatory guidelines. You may also check with your OTS regional accountant or access guidance on the OTS Internet (www.ots.treas.gov). In addition, Schedule CCR (Consolidated Capital Requirement) of the Thrift Financial Report (TFR) Instruction Manual contains specific accounting and reporting instructions related to capital. OTS also posts on its website a series of Questions and Answers that help further clarify the reporting instructions. You should note however that the TFR instructions, as well as the Questions and Answers are to help inform and provide for a meaningful reporting function. They are generalized and abbreviated for readability. Ultimately the regulations (and statutes) have the controlling force of law.

SECTION OVERVIEW

This Handbook Section provides guidance in three main areas:

- Capital Requirements.
- Evaluating Capital Adequacy.
- Rating the Capital Factor.

Appendices to this Handbook Section provide additional guidance:

- Capital Components & Risk-Based Capital (Appendix A).
- Supplementary Information and Issues (Appendix B).
- Prompt Corrective Action (PCA) Restrictions (Appendix C).

CAPITAL REQUIREMENTS

Thrifts must meet two overlapping sets of capital rules required by different federal statutes. Thrifts must meet tangible, core, and risk-based standards required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established Prompt Corrective Action capital categories.

Tangible, Core, and Risk-based Capital

The FIRREA-based requirements for tangible, core, and risk-based capital are defined in 12 CFR §567. OTS requires thrifts to satisfy three capital levels as follows:

Type of Capital	Percentage of Assets
Tangible Capital	1.5% of adjusted total assets
Leverage Ratio	4% of adjusted total assets (3% for thrifts with a composite CAMELS rating of 1)
Risk-Based Capital	8% of risk-weighted assets

Notes: We also refer to the leverage ratio requirement as the Tier 1 or core requirement. Adjusted total assets are defined in 12 CFR § 567.1. It is based on TFR assets adjusted for investment in subsidiaries, gains and losses on available-for-sale securities, certain hedges, and other adjustments.

Composition of Capital

A thrift's total (risk-based) capital is the sum of its Tier 1 (core) capital and Tier 2 (supplementary) capital, less certain deductions (see Appendix A). Note that Tier 2 capital may not exceed Tier 1 capital.

Appendix A summarizes the composition of Tier 1 and Tier 2 capital, and provides an explanation of the risk-based capital calculation.

Tangible Capital

Schedule CCR of the TFR includes detailed computational instructions for calculating core and risk-based capital. The TFR instructions do not include a calculation for tangible capital. While all three capital requirements exist as a matter of law, the tangible capital requirement has effectively been eclipsed by the more stringent PCA requirements (see below). Tangible capital is defined in 12 CFR § 567.9.

Prompt Corrective Action (PCA) Categories

You may find these FDICIA-based capital measurements in 12 CFR §565.

Thrifts fall into one of five PCA categories. The PCA minimum requirements are as follows:

	Tier 1/Leverage		Tier 1/Risk-Based		Total Risk-Based
Well Capitalized	5% or greater	*and*	6% or greater	*and*	10% or greater
Adequately Capitalized	4% or greater (3% for 1-rated)	*and*	4% or greater	*and*	8% or greater
Undercapitalized	Less than 4% (except for 1-rated)	*or*	Less than 4%	*or*	Less than 8%
Significantly Undercapitalized	Less than 3%	*or*	Less than 3%	*or*	Less than 6%
Critically Undercapitalized	Has a ratio of tangible equity* to total assets that is equal to or less than 2%				

* The definition of tangible equity under PCA differs from the definition of tangible capital under FIRREA. You may find the definition of tangible equity in 12 CFR § 565.2(f).

Minimum Standards vs. Capital Adequacy

The regulatory capital requirements are minimum standards designed for soundly managed thrifts that do not present credit or other risks requiring more capital. *Compliance with the minimum capital requirements does not automatically ensure an adequate level of capital. Thrifts with higher risk should hold capital well in excess of the minimum requirements, and in fact, well in excess of the FDICIA well capitalized standards.* In addition, OTS has

the authority to establish a capital requirement for a thrift that is higher than its normal minimum regulatory capital requirement.

Capital For Subprime Lending Programs

Thrifts with subprime lending programs are responsible for quantifying the amount of capital they need to offset the additional risk for these programs. As a starting point you should reasonably expect a thrift to hold capital against subprime portfolios in an amount that is one and one half to three times greater than for nonsubprime assets of a similar type. A thrift's ALLL should also be adequate to address its subprime program. More information about subprime lending and risk analysis for capital adequacy is available in guidance issued by the four federal banking agencies and available on the OTS website. It applies to subprime lending programs that exceed 25 percent of a thrift's Tier 1 capital. (Refer to CEO Memo No. 137, Expanded Guidance for Subprime Lending Programs, issued February 2, 2001.)

Individual Minimum Capital Requirement (IMCR)

OTS may impose an IMCR in accordance with 12 CFR § 567.3. The regulation includes an extensive (but not all-inclusive) list of the reasons that may support imposition of an IMCR. There are no formal policies or procedures governing the IMCR process, but OTS would generally take the following steps:

- Determine that a thrift should have capital above the minimum regulatory standard.
- Notify the thrift of the determination and provide a general explanation.
- Provide an opportunity for the thrift to respond (generally within 30 days, but OTS may shorten this timeframe if circumstances warrant).
- Consider the thrift's response.
- Determine the appropriate minimum capital level for the thrift.

Whenever you find capital to be insufficient relative to a thrift's risk profile, you should discuss with your regional management the appropriateness of an IMCR.

Reservation of Authority

OTS may use its reservation of authority to target a higher capital level for specific assets or conditions, or to eliminate or limit the inclusion of a capital component, or to otherwise achieve a higher capital level. Through the reservation of authority, OTS may require the discounting or deduction of an asset or capital component, or may assign a higher risk weight or conversion factor than an asset or risk exposure normally receives. Refer to 12 CFR § 567.11. Whenever you find that a capital instrument, an asset, or a portfolio of assets does not provide meaningful capital support (and where the asset classification process does not address the problem), you should discuss the use of the reservation of authority with your regional management.

Documentation Requirements

Thrifts must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a thrift tracks and reports its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a thrift has inadequate documentation to support its assignment of a risk weight to a given item, examiners may assign an appropriate risk weight to that item. Examiners should verify that thrifts are correctly reporting the information requested in Section CCR of the Thrift Financial Report that is used in computing the capital requirements.

Evaluating Capital Adequacy

In order to determine whether a thrift has sufficient capital at a specific point in time, you should first consider whether the thrift complies with the following requirements:

- Regulatory capital requirements.
- Capital levels established by a business plan or the Board of Directors.
- Capital levels established by a capital plan, approved application, IMCR, enforcement action, other applicable agreement or plan, or through use of the OTS reservation of authority.

You should then determine if the thrift holds capital that is sufficient relative to its risk profile. This process evolves during your examination. You should consider all of the following factors, as well as any other important factors that you note.

Asset Quality

Asset quality is a key factor in evaluating capital adequacy. You should consider the extent to which individual assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the dollar value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of nonaccrual or nonperforming loans, and market depreciation of securities. When assessing capital adequacy, you should evaluate the risks associated with each lending and investment program. Thrifts with higher risk lending programs should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses.

Earnings

Consider earnings performance and dividend practices. Good earnings performance enables a thrift to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. However, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Generally, management should first apply earnings to the elimination of losses and the establishment of necessary reserves and prudent

capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

Subordinate Organizations

Subordinate organizations can significantly affect the operations and overall financial condition of their parent thrift. Therefore, it is important to determine if subordinate organizations pose risk to the capital adequacy of the parent. Where a regulator other than OTS regulates the subordinate organization, it is important to consider whether capital from the subordinate organization would actually be available to the parent thrift in a time of stress. Furthermore, it is important to consider whether the parent thrift has obligated itself, either formally or informally, to fund obligations of its subsidiary. As with other assets, OTS examiners may classify as substandard, doubtful or loss, a thrift's investment in its subordinate organizations including loans to subordinate organizations. In some instances, OTS requires deduction (and deconsolidation where applicable) of a parent's investment in its subordinate organization. (See Appendix B for further details.)

Relationships with Affiliates

A holding company's policies and practices can significantly affect the capital levels of its thrift subsidiary. It is critical that a thrift's dividend policies, tax-sharing agreements, consulting arrangements, and other transactions with its holding company do not lead to an unsafe or unsound condition for the thrift.

Double-leveraging occurs when a thrift's parent organization borrows funds to purchase newly issued stock of the subsidiary thrift. If the principal means of servicing the parent company's debt consists of the cash dividends from the thrift, you should consider the potential effect on earnings. In particular, you should ascertain whether the thrift has the ability to sustain an adequate level of capital given the cash dividend demands of the parent holding company.

When you evaluate capital adequacy, you should generally discount the thrift's capital level by the amount of any loans or other credits or investments outstanding to the thrift's holding company or to affiliates that are not subordinate organizations of the thrift.

Interest Rate Risk

Thrifts with excessive interest rate risk exposure may experience a significant decline in capital levels as a result of unfavorable changes in interest rates. Therefore thrifts with relatively high interest rate risk should have correspondingly high capital levels to offset that risk.

Liquidity and Funds Management

Thrifts that are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows, and such losses must be absorbed by the capital accounts. Generally, the lower a thrift's level of liquidity, the more seriously you should consider higher capital requirements.

Deposit Structure

You may analyze capital in light of the historical and projected rate of growth of the thrift's deposit accounts. If a thrift is located in a strongly developing market where earnings retention is unable to keep pace with deposit growth, management should take all reasonable steps to augment the capital accounts, or find other means to maintain capital ratios. In addition to growth trends, the presence of volatile deposit accounts or concentrations in the deposit structure is also relevant. The greater the instability of the deposit base, the greater the need for a strong level of capital.

Contingent Liabilities

Lawsuits involving the thrift as defendant or other contingent liabilities may indicate a need for a greater level of capital protection. You should determine whether the thrift has significant contingent liabilities that have the potential to materially impact the capital level.

Off-Balance-Sheet Activities and Exposures

A thrift may engage in off-balance-sheet activities such as trust administration, mortgage banking, or construction lending. In such cases, you must determine whether the thrift is exposed to economic risks or potential legal liabilities that are not fully captured by generally accepted accounting principles (GAAP) or regulatory capital rules. Note that while risk-based assets include many off-balance-sheet risk exposures, the Tier 1 capital requirement does not address off-balance-sheet risk.

New Products and Activities

The financial marketplace is dynamic and innovative. Many thrifts constantly formulate new products and engage in new activities to meet customers' needs. You should determine whether a thrift has properly analyzed the risks related to new products and activities, and whether capital levels are appropriate to match these risks.

Local Characteristics

The stability and diversification of local population, business, industry or agriculture are important considerations. In evaluating capital adequacy, you should consider potential changes in the thrift's operating environment as well as the pressures of competition.

Risk Diversification

Generally, a greater degree of asset and liability concentrations increases the need for capital at most thrifts. You should review on- and off-balance-sheet assets for concentrations in industries, product lines, customer types, geographic areas, funding sources, and nontraditional activities.

Part 567	Capital

Office of Thrift Supervision Bulletins and CEO Letters

Regulatory and Thrift Bulletins

RB 18	Enforcement Series
RB 33a	FDIC "Pass-Through" Deposit Insurance Coverage Disclosure Rule
TB 56	Regulatory Reporting of Net Deferred Tax Assets

CEO Letters

No. 135	The New Basel Capital Accord
No. 137	Expanded Guidance for Subprime Lending Programs
No. 141	Joint Agency Advisory on Brokered and Rate-Sensitive Deposits
No. 160	Regulatory Capital Treatment for Accrued Interest Receivable in Credit Card Securitizations
No. 161	Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents
No. 162	Implicit Recourse in Asset Securitizations
No. 163	Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

Additional Interagency Guidance

Interim Regulatory Reporting and Capital Guidance on FAS 133, "Accounting for Derivative Instruments and Hedging Activities," 12/29/1998

Capital Adequacy Program

EXAMINATION OBJECTIVES

To determine the adequacy and composition of the thrift's current and planned level of capitalization, considering the thrift's unique risk characteristics, overall condition, and planned direction.

To determine the effectiveness of management and the board of directors in actively monitoring, maintaining, and planning for capital adequacy.

To determine if the thrift's capital-related policies and procedures are adequate and are being adhered to by thrift personnel.

To determine the adequacy of audit and accounting practices and procedures, including the system of internal controls, as they relate to capital accounts.

To determine compliance with laws, rulings, regulations, and specific agreements with OTS, FDIC, or state authorities.

To ascertain the need for, or to initiate, corrective action (including acting under prompt corrective action provisions) when policies, practices, procedures, or internal controls are deficient, or when there are violations of laws, rulings, directives, or regulations.

EXAMINATION PROCEDURES

WKP. REF.

LEVEL I

1. Obtain and review the information on capital provided in the UTPR, off-site monitoring reports, report of examination spreadsheets, latest examination report, latest audit reports, latest SEC reports, business plan, and correspondence with the OTS and other regulatory authorities. Consult with the examiner(s) reviewing the board of directors and committee minutes for any other items pertinent to the review of capital. _____ _____

2. Through discussions with management and review of documents, determine if management has taken corrective action relative to:

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Capital Adequacy Program

WKP. REF.

8. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Capital Components & Risk-Based Capital

This appendix is an abbreviated summary from the Capital Regulation. Refer to the regulation in 12 CFR §567 for important details and other items not included in this appendix. You will find relevant definitions in §567.1. We have organized this Appendix as follows:

- Composition of Capital.
- Risk-based Capital.
- Risk-based Capital Treatment for Recourse Exposures, Direct Credit Substitutes, and Residual Interests.

Composition of Capital

Tier 1 (Core) Capital

Tier 1 (core) capital includes:

- GAAP capital.

Less

- Investments in and advances to nonincludable subsidiaries.
- Goodwill and other intangible assets.
- Equity instruments not qualifying for Tier 1 capital[1] (for example, cumulative preferred stock).
- Servicing assets and purchased credit card relationships (PCCRs) in excess of limitations (see §567.12).
- Disallowed deferred tax assets (see Thrift Bulletin No. 56).
- Credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital (see §567.5 and §567.12).
- Accumulated gains on certain available-for-sale debt and equity securities[1] and qualifying cash-flow hedges.[2]

[1] Refer to the TFR instructions. The purpose is to exclude certain components of GAAP capital that are not part of common stockholders' equity under regulatory capital definitions.

[2] Refer to the December 1998 interagency statement, "Interim Guidance on the Regulatory Reporting and Capital Treatment of Derivatives."

Plus

- Minority interests in equity accounts of fully consolidated includable subsidiaries.
- Mutual thrift nonwithdrawable and pledged deposit accounts.
- Accumulated losses on certain available-for-sale debt securities,[1] and accumulated losses on qualifying cash-flow hedges.[2]

Tier 2 (Supplementary) Capital

Tier 2 (supplementary) capital includes:

- Permanent capital instruments such as:
  - — Mutual capital certificates and nonwithdrawable accounts not counted for Tier 1 capital.
  - — Cumulative perpetual preferred stock.
  - — Qualifying subordinated debt.
- Maturing capital instruments (for example, non-perpetual preferred stock).
- Allowance for loan and lease losses (ALLL) up to 1.25 percent of risk-weighted assets.
- Up to 45 percent of unrealized gains, net of unrealized losses on available-for-sale equity securities with readily determinable fair values.

Note: Tier 2 capital may not exceed Tier 1 capital.

Total (Risk-based) Capital

A thrift's total (risk-based) capital is the sum of:

- Tier 1 capital.

Plus

- Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital).

Less

- Reciprocal holdings of the capital instruments of another depository institution.
- Equity investments (using the definition of equity investments in §567.1).
- Low-level recourse exposures and residual interests that the thrift chooses to deduct using the simplified/direct deduction method excluding:

— The credit-enhancing interest-only strips already deducted from Tier 1 capital. (See low-level recourse and residual examples further below.)

RISK-BASED CAPITAL

General Description

The risk-based capital requirement captures primarily credit risk from on-balance-sheet assets and most off-balance-sheet commitments and obligations. OTS requires a thrift to maintain a total risk-based capital ratio equal to at least 8 percent of assets after risk weighting. Most thrifts have a risk-based capital ratio of 10 percent or higher in order to manage a well capitalized status.

You determine a thrift's risk-weighted assets by allotting assets among the risk-weight categories. There are four standard risk-weight categories: 0 percent, 20 percent, 50 percent, and 100 percent.[3] The risk weight depends upon the nature of the assets, obligors, and collateral. In general, if a particular item can be placed in more than one risk category, you may assign it to the category that has the lower risk weight. However, the following procedures apply:

- You convert off-balance-sheet commitments and exposures to credit equivalent amounts by a conversion factor. You then risk weight the credit equivalent amounts in accordance with the rules used for on-balance-sheet assets.
- Many recourse exposures and direct credit substitutes generally require a gross-up capital treatment.
- Most residual interests receive a dollar-for-dollar capital treatment.

Assuming the PCA category of adequately capitalized, the effect of this risk weighting approach is the following:

Risk Weight Bucket	Effective Capital Charge
0%	No capital charge
20%	1.6%
50%	4.0%
100%	8.0%
200%	16.0%
Dollar-for dollar	100.0%

[3] There is also a 200% risk weight-category used in the ratings-based approach. In addition, certain items receive a dollar-for-dollar capital treatment, equivalent to a risk weighting of 1250% (the reciprocal of 8%). See the Recourse section later in this Appendix.

Risk Weights: On-Balance-Sheet Assets

Asset types not specifically addressed in the regulation automatically receive a 100 percent risk weight unless OTS determines that a different risk weight, or a different capital treatment is appropriate. Below is a general summary of the risk weight buckets:

0 Percent Risk-Weight Category

This category is for the lowest risk assets. This category includes:

- Cash.
- Obligations of, or fully guaranteed by, the full faith and credit of the United States Government (includes most GNMA obligations).
- Balances at Federal Reserve Banks.

20 Percent Risk-Weight Category

This category is for very high credit-quality assets. The 20 percent risk-weight category includes:

- Securities issued by or guaranteed by government sponsored agencies (including Fannie and Freddie for example), *except for their principal only securities (POs), interest-only securities (IOs)*, and their equity securities.
- Claims on, balances due from, and stock of the Federal Home Loan Banks.
- Items collateralized by cash held in a segregated deposit account at the thrift.
- The portion of assets collateralized by the current market value of U.S. Government securities.
- Assets conditionally guaranteed by the U.S. Government or its agencies.
- General obligations of state and local governments.
- Claims on domestic depository institutions.
- Asset-backed securities rated AAA or AA under the ratings-based approach, but excluding stripped securities.
- Certain claims on, or guaranteed by, qualifying securities firms.

  A *qualifying securities firm* in the United States is a broker-dealer registered with the Securities and Exchange Commission (SEC) that complies with the SEC's net capital regulations. A different definition applies to foreign-based firms. (See § 567.1.)

  For a claim on, or guaranteed by, a qualifying securities firm to qualify for 20 percent risk weight, the firm must have a long-term issuer credit rating, or a rating on at least one issue of long-term

unsecured debt, from a nationally recognized statistical rating organization (NRSRO). The rating must be in one of the three highest investment grade categories used by the NRSRO. If two or more NRSROs assign ratings to the firm, the thrift must use the lowest rating to determine whether it meets the rating requirement. The firm may rely on the rating of its parent consolidated company *if the parent guarantees the claim.*

A collateralized claim on a qualifying securities firm does not have to comply with the rating requirement if it meets all of the following requirements:

— It is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation.

— It is collateralized by debt or equity securities that are liquid and readily marketable.

— It is marked to market daily.

— It is subject to a daily margin maintenance requirement under the standard industry documentation.

— It can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or voided under applicable law.

50 Percent Risk-Weight Category

This risk-weight category is for high credit quality assets. The 50 percent risk-weight category includes:

- Qualifying mortgage loans.
- Qualifying multifamily mortgage loans.
- Qualifying residential construction loans.
- Privately issued securities (excluding stripped or subordinated securities) backed by qualifying one- to four- family or multifamily mortgage loans – where the underlying loans are eligible for 50 percent risk weight.
- Most state and local revenue bonds.
- Asset-backed securities rated "A" under the ratings-based approach, but excluding stripped securities.

Qualifying mortgage loans are residential first mortgage loans on houses, condominiums, cooperative units, and manufactured homes. You do not include boats, motor homes, and time-share properties, even if they are a primary residence. Loans must not be over 90 days past due. You include mortgage loans on mixed-use properties that are primarily one- to four-family if they meet the qualifying criteria.

If a thrift holds the first and junior lien(s) on a property, and no other party holds an intervening lien, you treat the transaction as a single loan secured by a first lien. Refer to 12 CFR §567.1 for the definition of qualifying mortgage loans. Note that the definition refers to and incorporates loan to value (LTV) criteria from the real estate lending guidelines in §560.101. Loans above 90 percent LTV will not typically qualify for 50 percent risk weight unless they have acceptable private mortgage insurance or other appropriate credit enhancement to effectively reduce their LTV to 90 percent or less.

Qualifying multifamily mortgage loans must meet the specific criteria of the regulation that tracks a federal statute. (Refer to the definition in 12 CFR §567.1.)

Qualifying residential construction loans must meet the specific criteria of the regulation. (Refer to 12 CFR §567.1.)

100 Percent Risk-Weight Category

This is the standard risk-weight category. You place assets not assigned another risk weighting in this category (excluding assets deducted from capital and residual interests which have a dollar-for-dollar capital requirement). You include the following in the 100 percent risk-weight category:

- Commercial loans and commercial real estate loans.
- Consumer loans.
- Second mortgage and home equity loans (except where you combine them with a qualifying first mortgage – see qualifying mortgage loan explanation above).
- Single-family and multifamily housing loans that do not qualify for the 50 percent risk-weight category.
- Construction loans.
- Mortgage-backed securities not qualifying for a lower risk-weight category, including most stripped securities (POs and IOs) issued by government sponsored agencies (but excluding subordinated classes, and excluding securities backed by subprime assets).
- Corporate debt securities.
- Bonds issued by a state or local government where a private party is responsible for payment.
- Repossessed assets and loans 90 days past due.
- Asset-backed securities rated "BBB" under the ratings-based approach, but excluding stripped securities.

Ownership in Mutual Funds (and other pooled assets)

For investments in investment companies, such as mutual funds, there are two alternatives:

- You may assign the entire investment to the risk-weight category applicable to the riskiest asset held in the investment company portfolio.
- You may assign different risk weights to the fund on a pro-rata basis, according to the investment limits for the different investment categories in the fund's prospectus.

The lowest risk weight for a mutual fund is 20 percent.

Off-Balance-Sheet Risk Exposures

Credit Conversion Factors for Off-Balance-Sheet Items

You determine risk weights for most off-balance-sheet items in a two-step process. First, you multiply the face amount of the item by a credit conversion factor to get the balance sheet credit equivalent amount. You then risk weight the credit equivalent amount based on the nature of the collateral, the obligor, or type of asset.

Example: Conversion of an off-balance-sheet item

The thrift has extended a $30,000 home equity line of credit with a multi-year term. The borrower has not yet drawn the $30,000 and the line of credit remains unfunded. As shown in the bulleted list below, the conversion factor for home equity lines of credit for terms over one year is 50 percent. Assume that the line qualifies for 50 percent risk weight under the definition of qualifying mortgage loan (that is, where it may be combined with the first mortgage and there is no intervening lien – explained above in the 50 percent risk weight section).

- You multiply the unfunded line by the 50 percent conversion factor: $30,000 x 50% = $15,000.
- You then risk weight the $15,000 that you calculated. $15,000 x 50% risk weight = a $7,500 risk-weighted asset.
- You multiply the risk-weighted asset x the 8% risk-based capital requirement. $7,500 x 8% = $600.

As a result, the thrift must hold $600 in capital for the unfunded $30,000 line.

Note: For recourse exposures, direct credit substitutes, and subordinate exposures (other than residual interests), you generally must first gross-up the entire group of assets or total exposure that the off-balance-sheet item supports.

There are four credit conversion factor groups: 0 percent, 20 percent, 50 percent, and 100 percent.

0 Percent Credit Conversion Factor Group

This group includes:

- The unused portion of unconditionally cancelable retail credit card lines.
- Unused commitments (including LIP) with an original maturity of one year or less. (*This applies to most commitments to originate 1-4 family loans*).

LIP and other unused commitments with an original maturity over one year *if* they are unconditionally cancelable at any time at the thrift's option *and* the thrift either: (1) makes a separate credit decision before honoring each draw, or (2) at least annually performs a credit review to determine whether or not the lending facility will continue.

20 Percent Credit Conversion Factor Group

This group is for a narrow set of trade-related contingencies. That is, short-term, self-liquidating instruments used to finance the movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

50 Percent Credit Conversion Factor Group

This group includes:

- Unused portions of commitments, including home equity lines of credit, with an original maturity exceeding one year.
- Most LIP commitments with an original maturity over one year.
- Transaction-related contingencies such as performance bonds and performance-based standby letters of credit related to a particular transaction. For example, arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

100 Percent Credit Conversion Factor Group

This group includes:

- Guarantees or financial guarantee-type standby letters of credit.
- Recourse arrangements.
- Forward agreements with a certain drawdown. For example, legally binding agreements to purchase assets at a specified future date.
- Risk participations purchased in bankers acceptances.

Interest-Rate and Foreign Exchange-Rate Contracts

The credit equivalent amount of an interest-rate or exchange-rate contract is the sum of the current credit exposure (that is, the replacement cost of the contract) and the potential future credit exposure of the contract. You calculate this as follows:

Begin with: Replacement value of the contract, that is, the fair value of the contract, but not less than zero.

Add: Potential future credit exposure. To obtain potential future credit exposure you multiply the notional principal amount of the contract by the appropriate credit conversion factor. You can find the conversion factors from the chart:

Remaining Maturity	Interest rate contracts	Foreign exchange rate contracts
One year or less	0.0%	1.0%
Over one year	0.5%	5.0%

Then: Once you determine the credit equivalent amount, you assign it to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. However, the maximum risk weight is 50 percent.

Note: There are certain exceptions to the above calculation for foreign exchange contracts with an original maturity of less than 14 days, and for interest rate and exchange rate contracts traded on an exchange requiring the daily payment of variations in the market value of the contract. Thrifts may use bilateral netting to compute the net replacement value for multiple contracts with the *same* counterparty under certain conditions specified in the regulation.

Risk-Based Capital Treatment for Recourse, Direct Credit Substitutes, and Residual Interests

On November 29, 2001, OTS and the other federal banking agencies issued a capital rule for recourse, direct credit substitutes, and residual interests in asset securitizations. The capital rule addresses many aspects of risk resulting from asset securitization. While it integrates some aspects of OTS's previously existing capital rules and guidance for recourse and direct credit substitutes, the rule is far more extensive in order to address a very complex, evolving securitization marketplace. This section outlines and highlights some aspects of the rule that should be of interest to many thrifts. However, because of the complex nature of the rule, we recommend that you refer to the rule itself and its extensive preamble published in the federal register, which are available through the OTS web site at: *www.ots.treas.gov/docs/73135.pdf.*

You can find the definitions pertaining to the rule along with other terms used in the OTS capital regulations in 12 CFR §567.1. The capital treatment from the rule is in §567.6(b). Refer also to CEO Letter No. 162, "Implicit Recourse in Asset Securitizations," and to CEO Letter No. 163, "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations." OTS issued these CEO letters on May 23, 2002. They provide important supplementary information.

Through the rule's reservation of authority, OTS looks to the substance of a transaction regardless of how others categorize the allocation of risk. OTS may find that the proposed capital treatment by the thrift does not appropriately reflect risk to the thrift. OTS may then require the thrift to apply another risk weight, conversion factor, or treatment that OTS deems appropriate.

This part contains three sections:

- Capital Treatment for Recourse and Direct Credit Substitutes.
- Capital Treatment for Residual Interests.

- The Ratings-based Approach.

Capital Treatment for Recourse and Direct Credit Substitutes

Recourse

The term recourse refers to a thrift's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when a thrift transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the thrift is responsible for losses associated with the loans serviced (except for servicer cash advances as defined in §567.1).
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the thrift).
- Credit derivatives that absorb more than the thrift's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also exist implicitly. Implicit recourse arises when a thrift repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is *not contractually required* to do so. Refer also to CEO Letter No. 162.

As with other off-balance-sheet exposures, you must convert a recourse exposure to an on-balance-sheet asset by obtaining a credit equivalent amount. In the case of a simple loan sale with recourse, which may or may not involve asset securitization, you convert the entire balance of the loans sold to an on-balance-sheet asset using the 100 percent conversion factor.

In many instances a thrift retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus absorbs *more than its pro rata share of losses*. As a result, the general capital treatment for recourse exposures is gross-up, whereby the thrift must hold capital for the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk; it has the concentrated risk of all of the assets senior to it in the pool.

Therefore using the required gross-up approach, you obtain the credit equivalent amount by multiplying the *full amount of the credit-enhanced assets* for which the thrift directly or indirectly retains or assumes credit risk by a *100 percent conversion factor*. You assign this credit equivalent amount to the risk-

weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral. However, the following points apply:

- A thrift does not have to hold recourse capital for qualifying mortgage loans (50 percent risk weight 1-4 family loans) that it has sold, if the sales contract allows only a 120-day period for return of those loans. The thrift must have originated the loans within one year before sale. This exception would apply to a simple loan sale as well as a sale of loans into a securitization.

- There is an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full ordinary capital requirement.

- A ratings-based approach allows a thrift to reduce its capital requirement for lower-risk, highly-rated recourse exposures.

Example: Recourse sale of loans

A thrift has sold $100 in qualifying mortgage loans (that is, 50 percent risk weight 1-4 family loans) into a securitization with an agreement to repurchase them for up to 180 days. Until the recourse period expires, total risk-weighted assets must include: ($100) x (100 percent conversion factor) x (50 percent r.w.) = $50. Thus, the capital requirement is: $50 x 8% = $4

Note: If the sales agreement limited the recourse to 120 days or less, there would be no capital requirement.

Example: Low-level recourse

A thrift contractually limits its maximum recourse exposure to less than the normal on-balance-sheet capital requirement for the assets sold with recourse. For example, if a thrift sells a $100,000 mortgage loan with 1 percent recourse, it is liable for $1,000 in losses, OTS requires the thrift to deduct $1,000 in computing the numerator for risk-based capital.

(This is in lieu of the thrift holding $4,000 in capital - assuming the loan qualifies for 50 percent risk weight).

The thrift may report this capital requirement in either of two ways: (1) a simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital, or (2) a risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%). In the risk-weighted method the thrift multiplies the $1,000 capital requirement by 12.5 for a risk-weighted asset of $12,500. Then, when the thrift multiplies $12,500 times the 8% risk-based capital requirement, the result is a $1,000 capital charge.

Direct Credit Substitutes

A thrift can guaranty, purchase, or assume a recourse exposure from another organization. We generally refer to these exposures as *direct credit substitutes*. A purchased subordinated security is an example of a direct credit substitute. Direct credit substitutes can be on- or off-balance-sheet. Examples of direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third party that exceed the thrift's pro rata share of the financial claim.

- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

When a thrift purchases a *subordinated asset-backed security* or similar interest, the thrift generally must gross-up the risk exposure in order to determine the capital requirement. This means that the thrift must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes, and the ratings-based approach may also apply.

Example: Direct credit substitute – gross-up treatment

A thrift has purchased the first dollar loss subordinated interest of $5 in a securitization of $100 in qualifying mortgage loans (1-4 family 50% risk weight loans). The thrift must gross-up its exposure to include all exposures that are more senior to the security that the thrift owns. Thus the thrift must convert the $100 balance of the pool to an on-balance sheet asset at a 100% conversion factor. Then, the thrift risk weights the loans at 50%, resulting in $50 in risk-weighted assets. The capital requirement is $50 times 8 percent = $4.

Note: This example assumes that the first dollar loss position is not a credit-enhancing I/O strip (see Residual Interests below).

Capital Treatment for Residual Interests

Residual interests are on-balance-sheet risk exposures arising from sales (transfers) of financial assets that expose a thrift to credit risk on those transferred assets that exceeds a pro rata share of any claim that the thrift has on the assets. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only strips. A primary example of a residual is a *retained* subordinated interest in assets formerly owned by the thrift.

The standard capital treatment for most residual interests is *dollar-for-dollar*. That is, the thrift must hold one dollar in capital for every one dollar in residual interests.

Example: Residual interests

A thrift has retained the first dollar loss subordinated interest of $15 in *its own securitization* of $100 in qualifying mortgage loans (50% risk weight 1-4 family). The risk-based capital requirement is $15, that is, $1 of capital for $1 of residual interests – dollar-for-dollar capital.

Similar to the low-level recourse example, the thrift may report this capital requirement in either of two ways:

- A simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital.

- A risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%).

In the risk-weighted method the thrift multiplies the $15 capital requirement by 12.5 for a risk-weighted asset of $187.5. Then, when the thrift multiplies $187.5 times the 8% risk-based capital requirement, the result is a $15 capital charge.

Credit-enhancing Interest-only Strips

Credit-enhancing interest-only strips (CE I/Os), whether retained or purchased, pose higher risk than most other residuals. If a thrift has a concentration of more than 25 percent of Tier 1 capital in CE I/Os, it must *deduct from Tier 1 capital*, the portion of CE I/Os that exceeds 25 percent of Tier 1 capital.

Example: Credit-enhancing I/O strip:

A thrift has the first dollar loss subordinated interest (whether retained or purchased) that is a credit-enhancing I/O strip, of $15 in a securitization of subprime auto loans. Tier 1 capital is $40 at onset. The thrift does not have any other CE I/Os.

- 25 percent of $40 is $10. $15 exceeds $10 by $5, so you deduct $5 in computing Tier 1 capital.
- Tier 1 capital is $35. ($40 - $5 = $35.)
- The thrift must also hold $10 in risk-based capital for this exposure because you deduct the same amount, $5, as above from the $15 I/O strip. The thrift must hold dollar-for-dollar risk-based capital against the remaining balance.

The Ratings-based Approach

The ratings-based approach allows for the possibility of a lower risk-based capital requirement (reflecting less risk) for certain recourse, direct credit substitutes, and residual interests arising from asset securitization. Ratings must be from one or more NRSROs, for example Standard & Poors, Moody's, and Fitch Ratings. Exceptions to the ratings-based approach include:

- Credit-enhancing I/O strips are ***not*** eligible for the ratings-based approach.
- Bonds not in security form are not eligible.
- Bonds not backed by assets are not eligible.

subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, OTS decides whether to permit inclusion of the subsidiary's excess capital.

Capital Treatment for Subsidiaries

Includable Subsidiaries

For GAAP and TFR reporting purposes, the thrift ordinarily consolidates the assets of its includable subsidiary into the parent. For Tier 1 capital, the subsidiary's assets comprise part of the parent's adjusted total assets on schedule CCR. For risk-based capital, the thrift risk weights the subsidiary's assets on schedule CCR along with its own.

Nonincludable Subsidiaries

When a GAAP-consolidated subsidiary is not includable for regulatory capital purposes, the thrift must deconsolidate the subsidiary's assets and liabilities, and deduct for Tier 1 capital its investment in that subsidiary.[5] The thrift makes the deduction on Schedule CCR according to the instructions and this does not affect Schedule SC or reporting under GAAP. This deconsolidation and deduction approach means that the subsidiary will be ignored for capital purposes: its assets not included with those of the thrift, and its capital not included in the thrift's capital base. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

Capital Treatment for Equity Investments

When a thrift does not have majority ownership of a subordinate organization, it generally does not consolidate the assets of the subordinate organization with the parent. Instead, the thrift uses the equity method to account for its investment in that subordinate organization. In the equity method, the thrift's investment in the subordinate organization is a thrift asset for GAAP and for Schedule SC. The capital treatment, however, will generally depend upon whether or not the subordinate organization engages solely in activities permissible for a national bank.

Includable Activities Only

The thrift's investment in the subordinate organization is a component of adjusted total assets for regulatory capital purposes. When computing the risk-based capital requirement on Schedule CCR, the thrift risk weights its investment in the subordinate organization at 100 percent. The thrift does not risk

[5] There is an exception to this automatic deduction treatment. Section 12 USC 1464(t)(5) exempts from automatic deduction those subsidiary depository institutions acquired before May 1, 1989, even though they may be engaged in activities not permissible for a national bank.

weight the subordinate organization's assets, only the parent's investment in the subordinate organization.

Nonincludable Activities

If the subordinate organization engages in activities that are nonincludable, the thrift should deduct its investment in the nonincludable activity for Tier 1 capital. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

The use of intermediate organizations, or the legal form of organization, will not affect the deduction.

Reservation of Authority

In some instances, OTS uses its reservation of authority to require (or permit) deduction, or deconsolidation *and* deduction, of a subordinate organization that would not otherwise be so treated. Where OTS uses its reservation of authority, a simple deduction from Tier 1 capital would apply to a subordinate organization reported under the equity method of accounting per GAAP; whereas, deconsolidation *and* deduction would apply to subsidiaries consolidated under GAAP.

You may consider whether to recommend to your regional office deduction of *investment in or loans to* a subordinate organization using the reservation of authority. In some instances, a thrift requests a deduction approach. OTS reviews the request and then decides whether to approve it.

Construction Loans

Construction loans receive a 100 percent risk weight unless they meet the definition of qualifying residential construction loans (below), or the definition of qualifying mortgage loans (that is, loans to individual borrowers for the construction of their own homes that meet the definition in §567.1).

Qualifying Residential Construction Loans

Qualifying residential construction loans, also referred to as residential bridge loans, have similar credit risk to single-family residential mortgage loans. Residential construction loans must meet specific criteria in order to qualify for a 50 percent risk weight. You may review the definition of qualifying residential construction loans in §567.1.

Loans-in-Process

Many thrifts initially record a construction loan as a debit entry to loans receivable equal to the gross amount of the loan. They in turn make a credit entry to a contra-asset account called, "loans in process of disbursement" (LIP). A thrift then reduces the LIP balance with each disbursement of funds.

For more information and guidance on TPS refer to Thrift Bulletin 73a, Investing in Complex Securities.

Tier 2 Capital Instruments

Section 567.5(b) describes the components of Tier 2 capital, including *permanent capital instruments* and *maturing capital instruments*. These groups include certain types of debt instruments that are like capital in their capacity to absorb losses.

Permanent Capital Instruments

A thrift can generally include permanent capital instruments in its Tier 2 capital. Permanent capital instruments may include: cumulative and other perpetual preferred stock,[6] mutual capital certificates, perpetual subordinated debt, and mandatory convertible subordinated debt (capital notes). Refer to the regulation for qualifications and other instruments in this group.

Maturing Capital Instruments

Maturing capital instruments include:

- Subordinated debt (excluding perpetual subordinated debt – see above).
- Intermediate-term preferred stock and any related surplus (additional paid-in capital).
- Mandatory convertible subordinated debt (commitment notes).

Refer to the regulation for additional details. The degree to which a thrift can include these instruments in Tier 2 capital decreases according to the formulas and criteria described in §567.5(b)(3).

Thrifts that issue maturing capital instruments must choose between two options for regulatory capital treatment. Once a thrift selects an option, it must use that same option for all issuances outstanding at that time and for any subsequent issuances for as long as there is a balance outstanding. Once the thrift repays all outstanding issuances, it may elect a different option for future issuances.

Limits on Pass-Through Insurance Coverage

Normally, FDIC deposit insurance coverage ($100,000 per account) passes through financial intermediaries such as employee benefit plans to each beneficial owner (for example, to each employee participant in a plan). However if a thrift falls below PCA well capitalized status, the FDIC aggregates for deposit insurance purposes, any deposit that the thrift accepts (new, rolled-over, or renewed) through an employee benefit plan. The FDIC aggregates the deposits at the plan-administrator or

[6] A thrift may not include in capital preferred stock that is, in effect, collateralized by assets of the thrift or one of its subsidiaries, or issued by a nonincludable subsidiary.

fund-manager level, and then the deposits do not qualify individually for pass-through insurance.[7] The limitation affects the following types of employee benefit accounts and plans:

- 401(k) retirement accounts
- Deferred compensation plans
- Keough plan accounts
- Corporate pension plans
- Profit-sharing plan accounts

Simplified Employee Pension plan accounts (SEPs) are not subject to the limitation.

If a thrift falls below well capitalized status, it must notify affected account holders. Management should have procedures in place to monitor capital and notify affected parties. Additional information is in Regulatory Bulletin 33a, available on the OTS website. The relevant regulation section is §330.14, especially §330.14(h).

Net Deferred Tax Assets

OTS places limits on the inclusion of deferred tax assets in a thrift's Tier 1 capital. You may find OTS policy in Thrift Bulletin No. 56. To the extent that the realization of deferred tax assets depends on a thrift's future taxable income (exclusive of reversing temporary differences and carry-forwards), or its tax-planning strategies, deferred tax assets may not exceed the lesser of:

- The amount that the thrift can realize within one year of the quarter-end report date.
- Ten percent of Tier 1 (core) capital.

[7] This general rule applies unless: the institution is at least adequately capitalized, and has either obtained a brokered deposit waiver from the FDIC or provides specific notice to the plan depositor each time a deposit is accepted. Refer to RB 33a for more detail.

Prompt Corrective Action Restrictions 12 CFR §565.6

Capital Category	*Restriction*
Well and adequately capitalized	Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization.
Undercapitalized	**Mandatory actions:** • Capital distributions and management fees restricted. • Capital plan required. • Monitoring of condition and capital plan. • Growth restricted. • Prior approval of certain expansion proposals such as acquisitions, branching and new lines of business.
Significantly Undercapitalized	**Mandatory actions:** • Activities restricted. • Payments on subordinated debt restricted. **Discretionary actions:** • Require recapitalization: — Issue stock. — Require acquisition (if grounds exist for appointing a conservator or receiver). • Restrict interest rates paid. • Impose more stringent asset growth restrictions (or require shrinkage). • Restrict activities. • Improve management by requiring the election of directors or employment of qualified senior executive officers. • Prohibit deposits from correspondent banks. • Require prior approval for capital distributions by a bank holding company. • Require divestiture. • Require other actions the regulator determines appropriate.
Critically Undercapitalized	**Mandatory actions:** • Activities restricted - Associations may not: — Enter into any material transactions other than in the usual course of business. — Extend credit for any highly leveraged transaction. — Amend the association's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order. — Make any material change in accounting methods. — Engage in any covered transaction. — Pay excessive compensation or bonuses. • Payments on subordinated debt prohibited.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM ERIK SIRRI, AS ANSWERED BY DANIEL GALLAGHER

Q.1. How many banks have asked to return TARP funds officially? Unofficially?

Q.2. Have you told any banks that they cannot return TARP funds?

Q.3. What is the process to return TARP funds? Do they just mail it back to Secretary Geithner?

Q.4. If a bank asked to return TARP funds, why would they be denied?

Q.5. What provision of law would justify a regulator or treasury denying a bank's request to return TARP funds?

Q.6. What changes, if any, to the law would have to be made to prevent a regulator from forcing a bank to keep TARP funds?

Q.7. What would be possible negative implications of allowing any bank/company to give back TARP funds at their discretion?

Q.8. Do the regulators have the necessary authority to deal with the consequences of TARP funds being returned over regulator objections?

Q.9. Are you requiring banks to hold capital above the statutory definition of well capitalized, and if so why? Anecdotal reports indicate that examiners are requiring an additional 200 basis points of capital on top of the well capitalized requirements—is that true, if so why?

Q.10. What are you communicating to the examination force on these issues of TARP repayment and capital requirements? Please provide any relevant documents or training materials related to how your agency is instructing examiners to treat capital. In H.R. 1, Congress has said the TARP money can be repaid, please provide information which documents how your agency is getting that legal change out into the field.

A.1–A.10. Thank you for the opportunity to respond to questions for the Hearing concerning "Lessons Learned in Risk Management Oversight at Federal Financial Regulators," held March 18, 2009. To better explain our role in the context of TARP activities, it may be helpful to first describe the SEC's jurisdiction in the current regulatory system.

As you know, several statutes, primary among them, the Securities Act of 1933, Securities Exchange Act of 1934, Investment Advisers Act of 1940, and the Investment Company Act of 1940, grant the SEC authority to regulate, among other things, public disclosure to investors, governance and accounting standards, securities exchanges, securities broker-dealers, municipal securities dealers, clearing agencies, investment companies, and investment advisers. To promote fair markets and to protect against fraud, the SEC conducts examinations through its Office of Compliance, Inspections, and Examinations (OCIE) and investigations of misconduct through its Division of Enforcement.

The Exchange Act is the primary statute governing broker-dealers and covers a wide range of issues, including broker-dealer reg-

istration, sales practices, trading practices, and financial responsibility. In addition, the Exchange Act confers legal status upon self-regulatory organizations (SRO), such as the Financial Industry Regulatory Association (FINRA), to enforce compliance by their broker-dealer members with SRO as well as Exchange Act rules, subject to SEC oversight. The SEC has long promulgated and administered financial responsibility rules for broker-dealers, including the Net Capital Rule, Hypothecation Rule, Customer Protection Rule, the Commission's books and records rules, reporting requirements, and the early warning rule for broker-dealers regarding their capital levels.

The Consolidated Supervised Entity (CSE) regime and Appendix E of the Net Capital Rule that were largely the subject of Dr. Sirri's testimony stem from the SEC's authority to regulate the financial responsibility of broker-dealers. The SEC was prompted to establish the CSE regime in 2004 by the perceived need for group-wide risk monitoring. The firms were concerned about the requirements of the European Union's Financial Conglomerates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis. As discussed in Dr. Sirri's testimony, Goldman Sachs, Merrill Lynch, Lehman Brothers, Morgan Stanley, and Bear Stearns consented to consolidated supervision at the holding company level by the SEC as a condition of the use by their U.S. registered broker-dealers of the alternative net capital (ANC) computation under Appendix E. Of note, the Commission has not otherwise altered the net capital rule for broker-dealers.

As a result of the unprecedented level of distress in the financial markets that began in the Summer of 2007 and has continued through the present, each of the remaining investment banks (other than Lehman) that had been part of the CSE program have been reconstituted within a bank holding company and are now all subject to statutory supervision at the holding company level by the Federal Reserve Board. Under the Bank Holding Company Act, the Federal Reserve Board has statutory authority to impose and enforce supervisory requirements on those entities.

The SEC continues to work closely with the Federal Reserve Board and other banking regulators concerning risk management oversight of these large financial conglomerates, but focuses on our statutory obligation to regulate their broker-dealer subsidiaries. Since the SEC no longer oversees the holding company as a consolidated supervisor, the SEC typically would defer to the relevant consolidated supervisor on matters concerning the holding company, such as holding company capital, liquidity, leverage, risk models and methodologies, stress testing, and contingency funding. The receipt, use, handling, and repayment of TARP funds generally would fall under this category.

In addition, as you know, the TARP was created pursuant to authority granted to the Secretary of the Treasury under the Emergency Economic Stabilization Act of 2008. Since then, a number of programs have been developed under the TARP with the goal of stabilizing the financial system and restoring the flow of credit to consumers and businesses. As administrator of the TARP, Treasury has the authority to determine eligibility and allocations for inter-

ested parties and sets terms and conditions for participants in TARP programs. I understand that this is done in consultation with the appropriate Federal banking supervisors. Further, on June 9, 2009, Treasury announced that 10 of the largest U.S. financial institutions participating in the Capital Purchase Program (CPP) had met the requirements for repayment established by the primary Federal banking supervisors, and that Treasury had notified the institutions that they are now eligible to complete the repayment process. Many of these institutions have now made their repayment.

Under Section 104(e) of the EESA, the Chairman of the Commission is one of five members of the Financial Stability Oversight Board, which is responsible for reviewing the exercise of Treasury's authority with regard to the lending program and making recommendations to Treasury regarding the use of that authority. The Commission, however, has no direct authority over the terms of the lending program and does not functionally oversee any of the fund recipients. The SEC continues to monitor and take interest in activities of the holding company or other affiliates that would materially impact the financial stability of the broker-dealer.