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EXAMNATION OF THE CURRENT CONDITION OF THE BANKING AND CREDIT UNION INDUSTRIES

HEARING

BEFORE THE

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

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

IMPROVED RISK-MANAGEMENT PRACTICES OF BANKS, THE CURRENT STATUS AND DIRECTION OF REGULATORY EFFORTS TO REVISE CAPITAL STANDARDS FOR INTERNATIONALLY ACTIVE BANKS, DEPOSIT INSURANCE, AND CONSOLIDATION WITHIN THE DOMESTIC BANKING INDUSTRY

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EXAMINATION OF THE CURRENT CONDITION OF THE BANKING AND CREDIT UNION INDUSTRIES

TUESDAY, APRIL 20, 2004

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

The Committee met at 2:34 p.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I want to thank our witnesses for being here today. The purpose of this hearing is to examine the current state of the banking and credit union industries. This, I recognize, involves consideration of numerous other issues. I think this is a particularly worthwhile endeavor for this Committee, though, because of the tremendous significance of so many of the matters facing the industry.

On the broadest level, the performance of the banking system is critical to the function of the overall economy. So critical, in fact, that Congress created a backstop for the system that potentially gives it direct access to the wallet of the American taxpayer.

On a more basic level, the system provides consumers credit and other financial services.

There are also issues associated with the banking system which go beyond economic matters. As the principal means for movement of financial resources throughout the world, the system is something that terrorists would readily exploit to further their murderous endeavors.

Furthermore, while examining these issues in relation to the system, we must keep in mind that it is not comprised of a simple, monolithic entity. Rather, the "banking system" is made up of thousands of different firms of various sizes with different regulators, which are vigorously competing in extremely complex and dynamic national and international markets.

Thus, in light of the significant macro and microeconomic and national security issues associated with the performance of the banking system, I think that it is important for the Committee to address some basic questions.

For example, how healthy is the banking system today?

What are the present risks that could compromise the performance of the system?

What future risks are looming on the horizon?

What can be done to strengthen the system against these risks?

I have long supported ongoing review of the regulatory structure governing the banking system. I think it is important to closely monitor these laws and rules because, due to the fast-paced nature of changes in the financial service industry, they can readily outlive their intended purposes and become inefficient and very burdensome.

In the past, I have worked directly on regulatory relief legislation. I am happy to note that Senator Crapo has taken up this effort on this Committee and is working on his own regulatory relief measure. I commend him for this. I look forward to working with Senator Crapo and others and hope that today's hearing will prove helpful to their efforts.

Before moving on, I want to recognize the contributions of Chairman Dollar, who will soon be leaving his post at the National Credit Union Administration. Good luck in your future endeavors. And I thank all of you for being here today.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I really do not have any opening statement. I do have a short one I will just put in the record because I am anxious to hear from the panel.

Chairman SHELBY. It will be made part of the record, without objection.

Senator ALLARD. I would just like to thank all of you for taking the time to testify before our Committee and I look forward to what you have to say.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. I just would like permission to put my statement in the record.

Chairman SHELBY. Without objection, your complete statement will be made part of the record in its entirety.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. I will make my statement a part of the record as well, Mr. Chairman. I look forward to working on reg relief and the other critical issues before us today. Thank you.

Chairman SHELBY. Senator Crapo, I do not know if you were here a minute ago. I did acknowledge your work in the regulatory relief area because as we all know and as you especially know, there are a lot of laws and regulations that have no meaning in today's financial world, except to add a burden of cost to people.

Senator CRAPO. You are correct, Mr. Chairman, and I did have a statement on that. I am not going to give it all because I have questions for the panel, and I would like to get into those. But I appreciate the Chairman's recognition of that and the Chairman's willingness to work with me on developing that legislation.

Chairman SHELBY. Absolutely.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Well, thank you, Mr. Chairman, and I will be brief because we do need to move on to the panel. And I welcome all of them to this hearing.

I want to thank you and Ranking Member Sarbanes for holding this hearing. My constituents in South Dakota are extremely fortunate to benefit from a stable mix of large and small financial institutions. We have more than 100 small banks and credit unions scattered throughout the State, reaching into the most remote of our communities. These small banks and credit unions provide critical financial services to these communities which might otherwise be underserved. And as I have noted in the past, deposit insurance is a critical component to the financial services provided in those communities.

I remain hopeful that this Committee will work together over the next few remaining months to pass once and for all comprehensive deposit insurance reform to ensure the continued health of the system. With the number of legislative days waning, we are up against the clock. At this point the major hurdle appears to be getting the Administration and others to look at the facts behind the need for increased retirement coverage. I strongly believe that the retirement coverage issue deserves distinct analysis, and that is why in November 2001, I held a Subcommittee hearing on that topic alone. Health care costs are exploding, corporations are taking away benefits from retirees in too many instances, and it is no longer absurd to suggest a person might need more than $100,000 to make it from age 65 through the remainder of their life.

We have agreement, just about everyone, on all the other components of our proposed legislation, and we have a strong bipartisan team committed to reform, including Senators Hagel, Reed, Enzi, Stabenow, and Allard. The time to adopt comprehensive deposit insurance reform is now, and I expect we will hear today that the FDIC and NCUA funds and the banking and credit system as a whole seem to be doing quite well. The last thing we want to do is wait to legislate during a crisis, and this issue first gained traction because of concern over the declining insurance fund ratios, particularly in the Bank Insurance Fund. I do not think anyone is sorry to see these ratios rise since the whole point of this discussion is the safety and soundness of America's financial system.

In addition, nothing changes the fact that new entrants into the marketplace, large security firms that have recently chosen to sweep large deposits into insured accounts, continue to receive deposit insurance for free. The uptick in ratios is simply no excuse for Congressional inaction in the face of what everyone agrees is a system that needs revision.

Coming from a rural State, I know firsthand how bleak the situation would be if community banks and credit unions did not provide the first-rate services that they do. We need to make sure that Congress does not turn a blind eye to marketplace distortions that allow enormous corporate entities to manipulate the system to their advantage, and the banking industry continues to generate record profits year after year. Capital levels have remained steady, problem institution levels remain at historic lows, and the deposit insurance fund ratios are growing.

During this period of stability in the system, our financial institution regulators have had the opportunity to focus on the future, and we here in the Committee need to do the same.

I look forward to listening to the panel testimony today, and I thank the panel members for joining us.

Chairman SHELBY. Thank you, Senator Johnson. I just want to briefly respond to your request.

A lot of us are interested in deposit insurance reform. I am particularly interested in about four or five items there, but I do not think reform is necessarily reaching back and running the insurance rate up. And others, I think, tend to agree with me on that. I do not know if it is a majority, but I would be glad to sit down with you and work and see if we could look at something prospectively in the future.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman SHELBY. I know you have worked hard in this area.

We are honored to have again before the Committee a distinguished panel: Alan Greenspan, who really needs no introduction, Chairman of the Board of Governors of the Federal Reserve System; John D. Hawke, Jr., Comptroller of the Currency; Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation; James E. Gilleran, Director, Office of Thrift Supervision; Dennis Dollar, Chairman of the National Credit Union Administration; and Kevin Lavender, the Tennessee State Bank Commissioner, Tennessee Department of Financial Institutions, testifying on behalf of the Conference of State Bank Supervisors.

Gentlemen, we welcome all of you here. Your written testimony will be made part of the record in its entirety and be part of the hearing process.

We will start with Chairman Greenspan because I think people would like to hear from you and have a chance to question you.

Chairman Greenspan.

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

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

Chairman Shelby, Members of the Committee, I am pleased to be here this afternoon to discuss the condition of the U.S. banking system and related matters.

Three years ago, bank asset quality, mainly in the corporate sector, began to decline, but banks were well positioned to deal with emerging problems. Their capital position was strong, the industry's overall asset quality was high, and banks had made significant progress in diversifying their sources of revenue.

As the economy slowed, the industry was quick to act in addressing its emerging asset problems. Household credit demand stayed high and earnings remained at or near record levels, while assets continued to expand.

Importantly, the recession was mild and short-lived, making the necessary adjustments easier. Strong capital positions and a mild recession were probably the most important factors, but the benefits of an ongoing effort by banks to improve risk measurement and management and the maturing of new techniques for shifting risk should not be ignored.

The basic thrust of recent efforts to improve the management of risk has been better quantification and the creation of a formal and more disciplined process for recognizing, pricing, and managing risks of all types. Earlier detection of deviations from expectations now can, and does, lead to earlier corrective actions by bank managers and, as necessary, by bank supervisors as well.

Better methods for measuring credit risk also have spurred growth in secondary markets for weak or problem assets which have provided banks with a stronger basis for valuing these credits and an outlet for selling them and limiting future losses.

The result is greater liquidity for this segment of bank loan portfolios and the earlier transfer of weakened credit from bank balance sheets. Portfolio risks also have been increasingly hedged by transactions that do not require asset sales, such as derivatives that transfer credit risk.

Recent initiatives of the Basel Committee on Banking Supervision to revise international capital standards have helped focus attention on risk measurement practices and have encouraged further investment in this area. In my view, such efforts are crucial to extending the progress that the industry has already made. We need a more accurate, more risk-sensitive measure of capital adequacy to provide our large, complex banking institutions with appropriate risk management incentives and to provide the regulators with a more reliable basis for supervising them in a way that focuses on true risks. In the process, such a measure should also enhance our efforts in taking prompt corrective action.

For all these reasons, I believe the U.S. banking agencies must remain committed to the process of developing and applying a revised regulatory capital standard and a new capital accord, Basel II, for the world's international banks.

In reflection of public comments on last summer's advanced notice of public rulemaking on such a revision to the U.S. capital rules, the agencies have been successful in extending the negotiation period at Basel and incorporating into the proposal significant revisions as described in my statement.

There are still some important details to be worked out among the U.S. agencies, mainly on the capital treatment of credit cards. The Federal Reserve for its part will continue to make every effort to reach a consensus on this issue that is both risk-sensitive and workable. If successful, a new Basel proposal then could be published on schedule at mid-year that could be tested among larger U.S. banks later this year and could be the basis for a good-faith notice of proposed rulemaking next year.

Our basic goal, shared with all the other agencies, is to develop a revised accord that reflects 21st century realities, that meets our needs for a safe, sound, and competitive banking system, and that addresses the legitimate concerns of the industry. Among the legitimate concerns of some banks that must be addressed is ensuring that the application of Basel II in the United States to only our largest banks does not upset the domestic competitive equilibrium. As explained in my statement, we are carefully studying this issue and have, in fact, uncovered some potential problems between large banks that choose not to adopt Basel II in this country and those

that are required to do so or opt in. We are studying other markets to see if there are similar problems.

We will not go forward on Basel II until policies are adopted that mitigate such effects, where appropriate. We cannot, however, respond to unsubstantiated and generalized fears of change. Such concerns should not halt the evolution of regulatory capital standards for large, complex banking organizations that play such an important role in domestic and global financial markets.

The significant bank consolidation that began 20 years ago reflects technological, global, and statutory and regulatory changes and has resumed in recent months after a period of relative inactivity. This ongoing consolidation of the U.S. banking system has not, in my judgment, harmed the overall competitiveness of our banking and financial markets. Although they have facilitated and fostered consolidation, the reduced legal barriers to entry—such as the relaxation of interstate banking laws, along with technological advances such as the use of ATM's and electronic banking—have provided net competitive benefits to American consumers of financial services.

Developments such as these have stimulated competition among depository institutions and between depositories and nonbank providers of financial services. Moreover, it is worth emphasizing that measures of concentration in local markets, both urban and rural, have declined modestly since the mid-1990's as most mergers are for the purpose of expanding into new markets. Importantly, it is in local markets where most households and small and medium-sized businesses, those customers that may have the fewest alternatives for acquiring financial services, obtain the vast majority of their banking services.

Briefly, Mr. Chairman, let me say in answer to the question in your invitation letter that the Federal Reserve still supports the merger of the deposit insurance funds, enhanced flexibility in setting deposit insurance premiums, and especially wider latitude for risk-based pricing. However, we still do not support higher deposit insurance coverage limits.

Finally, I want to reiterate that the past decade is one in which the banking industry has recorded persistent record profits while providing an ever wider range of products and services to much more diverse groups. The industry's experience during the past several years in dealing with clear weakness in key economic sectors reinforces the importance of strong capital positions and robust risk management practices. Bank supervisors worldwide are working to encourage both through more accurate and more effective regulatory capital standards based on even better internal risk management procedures.

Thank you very much, Mr. Chairman. I look forward to your questions.

Chairman SHELBY. Thank you, Chairman Greenspan.

Mr. Hawke.

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

Comptroller HAWKE. Chairman Shelby and Members of the Committee, I appreciate this opportunity to review the condition of the national banking system. I would like to make two key points in my oral testimony this afternoon.

First, by virtually every measure, the national banking system, which consists today of about 2,100 financial institutions, is in excellent health. Earnings have been at historically high levels for a decade. In 2003, national banks set records for both return on equity and return on assets. Loan growth has also been strong overall. In 2002 and 2003, total loans grew by 7.8 and 7.6 percent, respectively.

The rise in bank assets has been fueled by the growth in bank deposits that one might expect to see in a low interest rate environment. Deposits in national banks grew at an average 7.4 percent over the past 3 years. But asset growth has not come at the expense of asset quality. The noncurrent loan ratio for national banks in the second quarter of 2002 was 1.6 percent. At a comparable point in the last economic cycle, it was 4.4 percent.

Data on failures and new entrants similarly reflects the banking system's health and dynamism. In 2003, only two commercial banks failed—one national and one State-chartered institution. By contrast, 100 commercial banks, including 33 national banks and 67 State banks, failed in 1992—the first year of recovery after the 1991 recession. Last year also saw 111 new commercial bank entrants.

By historical standards, the system is also exceedingly well capitalized. Today, all national banks, with minor exceptions, have risk-based capital above 8 percent, and less than 1 percent of national banks have risk-based capital below 10 percent.

Concerns have been expressed about declining demand for consumer loans and loans backed by commercial and residential real estate in a rising interest rate environment, as well as the impact of such a development on bank earnings, to which they have made such an important contribution. And, as recent events have taught us, operational, strategic, and reputational risks posed by bank activities can have just as serious an impact on bank soundness as changes in a bank's financial condition.

Yet I am optimistic about the ability of the banking system to overcome these challenges, just as it overcame the challenges of the recent recession. Our optimism is based on two factors. The first is the dramatic improvement in the tools, techniques, and processes available to financial institutions to manage just such risks. Banks increasingly look at risk in more comprehensive terms rather than on a transaction-by-transaction basis.

Risk management has also benefited from the use of tools that enable banks to better adjust and manage their risk profiles. The growth of the syndicated loan market has enabled banks to more broadly distribute credit exposures within the banking system, as well as to foreign banking organizations and nonbanks. The expanding asset securitization market has provided banks with a way of managing concentration risk and diversifying funding sources.

And growth in the derivatives markets has given banks additional tools to manage their credit and interest rate risk exposure.

OCC supervision provides the national banking system with a second layer of protection against the challenges posed by our changing economy and provides a second reason for optimism. Our risk-based approach involves supervisory policies and processes that tailor OCC oversight to the key characteristics of each bank, including asset size, products offered, markets in which the bank competes, and the board's and management's appetite for risk.

In response to the growing importance of nonfinancial risks, we have strengthened our supervision in the critical areas of audit and corporate governance. New supervisory guidance, developed both in conjunction with other the U.S. banking agencies and independently by the OCC for national banks, set forth our expectations that well-planned, properly structured, and independent auditing programs are essential to effective risk management and internal control systems.

Finally, I would like to comment briefly on developments relating to the Basel II process. This is an enormously complex and important project in which the OCC has been deeply involved for more than 5 years, together with our sister regulators. Even so, some important substantive issues have not yet been resolved, and we continue to work hard on those issues.

The important thing to understand is that the Basel process is far from over. Before we adopt final implementing regulations for national banks, a number of important domestic processes will need to be completed. We will need first a new quantitative impact study to provide good and reliable estimates of what the actual impact of Basel II will be on the capital of our banks. The economic impact analysis required by executive order will also give us a better idea of the implications of Basel II for our economy. And, of course, we will need to continue the dialogue with this Committee and its House counterpart on the progress of the process.

Only when all of these steps have been completed will we be in a position to draft and then put out for comment our final implementing regulations. Clearly, it will be a major, if not impossible, challenge to get this done in time to meet the current implementing date of year-end 2006.

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It successfully weathered the recent recession and is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change and improving our approach to supervision. We look forward to working productively with you, with Members of this Committee, and with State officials as we pursue our efforts to achieve that goal. Thank you.

Chairman SHELBY. Mr. Powell.

STATEMENT OF DONALD E. POWELL
CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman POWELL. Thank you, Mr. Chairman, for the opportunity to present the views of the FDIC.

FDIC-insured institutions are as healthy and sound as they have ever been. Improvements in underwriting and risk management

practices helped to limit the effect of credit losses on industry earnings during and after the recession. Meanwhile, strong growth in mortgage loans, a steep yield curve, new sources of fee income, and cost containment efforts helped boost the net operating income of the industry. Record earnings 2 years in a row, record returns on assets, and a strong capital foundation are all indicators that banks not only weathered the recent economic downturn, but also have been a source of significant strength for the economy and for the American consumer.

This strength is mirrored in the strength of the FDIC insurance funds. At year-end 2003, the combined funds stood at 1.33 percent of estimated insured deposits, eight basis points higher than the statutory target of 1.25. While several factors, outlined in my submitted testimony, may bring this number down a bit, the fund will likely remain strong for the foreseeable future.

As you are aware, my concerns about the deposit insurance system relate to the way it is structured. We cannot price deposit insurance based upon risk. We cannot manage the fund size relative to our exposure. And we maintain two funds even though the historic rationale for doing so has gone away.

There is broad agreement on the key elements of the deposit insurance reform package, and the FDIC remains willing to work with this Committee to achieve reform as soon as possible.

While the industry is strong and the outlook is favorable, we should not overlook the potential risks in the system. Furthermore, we should be aware of several fundamental trends in the industry that will bring significant consequences for bankers, regulators, and policymakers.

One area of general concern involves household balance sheets. While households have been an engine for growth, they also have accumulated debt to a historical high of 112 percent of disposable, personal income. Further, households took out $1.4 trillion of new mortgage debt since the end of 2001. Escalating household debt raises questions about the sustainability of consumer spending and the ability of borrowers to meet obligations when interest rates rise. Our concerns are tempered, however, by the strength of the household assets and the strengthening job and wage data we have seen in recent months.

Second, vacancy rates for office, retail, and warehouse space are near historic highs, yet commercial real estate concentration in banks are high and increasing. We have not seen any significant deterioration in loan performance thus far, but higher interest rates could yield problems in some areas of the country, and we are implementing enhanced procedures to monitor and better understand this area of the economy.

Third, it is important to recognize the volatile nature of financial markets and the potential for disturbance to spread throughout the system. In today's interconnected financial system, problems that initially appeared to be localized could lead to a more widespread loss of confidence with a resulting impact on liquidity throughout the system. This issue bears watching to ensure that financial market disruptions do not produce significant banking problems going forward.

I am gratified that the banking industry is facing these risks with a strong foundation of capital. The industry's capital base has led it to a position of unparalleled strength and competitiveness in the worldwide banking marketplace. It is the best hedge against the unexpected and the unknowable. We must ensure, as we move forward with Basel II and other important initiatives, that we do not erode this base or the regulatory framework it is built upon.

In addition to these specific issues, the FDIC is working hard to understand the long-term trends that are driving the industry and looking ahead to the policy questions that may arise. While the rate of decline in the number of banks and thrifts has been slowing in recent years, the pattern of industry consolidation is leading to a greater divide between large and small bank organizations and is likely to create pressures on the existing regulatory structure and existing regulatory barriers. It also has the potential to pose unique challenges for the FDIC.

Community banks, while numerous, represent a relatively small exposure to the deposit insurance funds, and it would take a major crisis among small banks to do serious harm to the funds. On the other hand, there are a few large institutions that represent an increasingly significant share of the FDIC's exposure.

A continuing challenge is how best to protect the stability of the system as customers' choices continue to expand and bank deposits become less important in the overall financial system. Federal deposit insurance works very well for traditional community banks. For the largest banking organizations, as they increasingly engage in diverse, nontraditional activities, it makes sense to consider whether different safety-net arrangements would be more suitable for this segment of the industry. Since some aspects of our regulatory system already are tailored to recognize the differences between large and small institutions, we should consider the explicit creation of a two-tiered safety-net that better addresses these differences.

In addition to potentially broad implications for the safety-net arrangements, the large/small divide in the banking industry will pose other interesting questions for policymakers. For example, the FDIC could look more to market instruments like reinsurance contracts, or catastrophe bonds to help us assess our large-bank exposure. We also should ensure that regulatory burden does not weigh too heavily on community banks and stifle the innovation and consumer choice that are hallmarks of our system.

Finally, as this banking transformation matures, we will see the remaining regulatory barriers come under pressure. Issues such as the 10-percent deposit cap and the remaining barriers between banking and commerce will need to be addressed. As the market pressure in this area intensifies, I believe policymakers will need to find ways to accommodate consumer demands while constructing arrangements that address these issues. We hope that, as this Committee and others deal with these important issues, we can be a resource to you. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Mr. Gilleran.

STATEMENT OF JAMES E. GILLERAN
DIRECTOR, OFFICE OF THRIFT SUPERVISION

Director GILLERAN. Thank you, Mr. Chairman. It is a pleasure to be with you today. I am happy to report that the thrift industry has come off the last 3 years in the finest shape it has ever been, and we have reached a situation where we are at an all-time high in the dollars worth of assets in the system and the system is at its best profitability level that it has ever been at. Loan loss reserves are well adequate to cover all expected losses. Capital is the highest that it has ever been. And even though we as regulators focus on all of the risk factors already mentioned about the credit quality and the interest rate risk and the compliance risk, et cetera, none of these risks right now looks like it will be overwhelming to the system, at least in the near future, as far as we can see. In fact, we believe that when we total up the first-quarter results for 2004, they again will be a very strong quarter for the thrift industry, even though the refinancings dropped substantially, that the increase in homeownership in America and the continual support of the homeownership area by the public, it looks like it is going to be another good year.

I agree with Chairman Greenspan that we, too, support going forward with the Basel II Accord. We look forward to the test that has to be made in the future to determine whether or not it is a reliable system to be able to regulate the banking system. At the OTS, however, we believe that we as regulators should be allocating additional resources to see whether or not we can take some of the concepts that have been devised in Basel II and see if we can make Basel I more risk-sensitive for those other 9,000 banks in the system that Basel II will not be touching.

Mr. Chairman, there are some things that we would like to have changed. We would continue to like to have parity with the national banks in terms of selling investment products, and to this date we have not been able to receive the same exemption from the SEC that the national banks have. This is creating a competitive disadvantage for our thrifts. So we would like to have the Committee address that going forward.

Thank you very much, sir. Glad to be with you.

Chairman SHELBY. Thank you, Mr. Gilleran.

Mr. Dollar.

STATEMENT OF DENNIS DOLLAR
CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Mr. DOLLAR. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I want to thank you for the invitation to testify before you today on behalf of the National Credit Union Administration regarding the condition of the credit union industry in America and the National Credit Union Share Insurance Fund that insures the deposits of credit union members nationwide.

I am pleased to report to the Committee that the state of the credit union industry remains strong and healthy, with all indicators clearly portraying a safe and sound industry, serving over 82 million Americans and well-positioned for continued strength and vitality in our Nation's financial marketplace, both now and in the future.

At this point I would like to just provide a brief discussion of a couple of key ratios and trends that have been compiled from call report data submitted by Federal credit unions to NCUA as of December 31, 2003.

The average net worth-to-asset ratio of all federally insured credit unions remains extremely strong at 10.72 percent, even though there has been a significant share growth of over 15 percent in 2001, almost 11 percent in 2002, and just over 9 percent in 2003. Such a strong share deposit growth would normally bring about a significant decrease in the net worth ratio were not the credit unions managing these increased shares effectively and continuing to build net worth.

For example, over the course of 2003, credit union net worth, which we need to recognize is built solely from the retained earnings of credit unions—credit unions cannot issue stock, cannot issue subordinated debt—has increased in total dollars by 9.6 percent. This growth in actual dollars of net worth results in the highest level in history of total industry net worth, currently at $65.4 billion as of December 31.

Return on average assets is 0.99 percent, which, even with a historically high growth in shares during a low interest rate environment, compares very favorably with the recent historical trends.

Loan volume increased by 9.75 percent in 2003, but yet the credit unions' overall delinquency ratio remains steady at 0.77 percent and is lower than the ratios recorded in the previous 2 years.

Savings grew to $528 billion in 2003, an increase of over 9 percent. Total assets grew to an all-time high of $610 billion, again, an increase of over 9 percent.

Member business lending in credit unions increased $8.9 billion, and although this category of credit union lending has increased over the past years, member business lending still represents only 2.3 percent of all loans in federally insured credit unions.

First mortgage real estate loans grew over 16 percent to $117.5 billion, thus credit unions continue as a source of access to the American Dream of homeownership for millions of their members.

New auto lending increased over 5 percent; used auto lending, indicating the economic times that we are in, increased by a higher percent, 12.5 percent.

These ratios and trends, of course, taken as a whole I think are indeed indicative of a healthy and robust industry.

We are closely monitoring a number of emerging key issues and some of the same ones that my colleagues have mentioned here today—challenges specifically affecting the credit union industry, some of them; others are those related to the overall financial marketplace: interest rate risk and net margin compression; increased competition for consumer lending; information systems and technology risk. These are all items that I discuss more in depth in my written testimony.

I would like to briefly address, before I conclude, the condition of the National Credit Union Share Insurance Fund, which provides Federal share insurance, coverage on credit union accounts generally up to $100,000 per member in a single, federally insured credit union.

As of December 31, there were $479 billion in insured funds, with a 1.29-percent equity ratio at the end of the first quarter of 2004. Earnings have been sufficient to keep the fund well capitalized well into the future. But dividends to insured credit unions, that are allowed by statute when the fund equity level exceeds the established operating level are not likely to return, nor have they been able to be paid over the last several years. They are not likely to return at least until interest rates rise sufficiently to allow earnings to return to the historical levels of the previous 6 years in which a dividend was paid.

Losses are anticipated to remain low, and extraordinary losses are certainly not anticipated. Based upon our ongoing examination and supervision program, we feel that credit unions are indeed positioned to have all-time record lows in losses.

As of December 31, there were 217 problem credit unions out of a total of right about 10,000.

Chairman SHELBY. What were the sizes of those credit unions?

Mr. DOLLAR. The overwhelming majority of them, Senator, are smaller credit unions, with risk to the fund very minimal. We, of course, take seriously the status of small credit unions as well as large ones, but the overwhelming majority are small.

Chairman SHELBY. Would you close those troubled ones?

Mr. DOLLAR. There are 217 of them that are coded CAMEL 4 or 5. We are watching those very closely. Where the market will lead, or whether our prompt corrective action will be required, will be taken—we would love to bring those credit unions back, Senator. But some of them will not make it, and that is a part of the difficult part of our job. But that is our job, nonetheless.

In 2003, we were called upon to liquidate, merge, or arrange a purchase and assumption for 13 federally insured credit unions. And this number is trending lower than in the past 10 years when we were averaging about 27 to 28 credit union mergers, liquidations, purchases, and assumption per year. So although there are ongoing losses, it is trending downward.

In closing, let me just, without going into the in-depth detail that I did in my written testimony, refer you to a number of our agency initiatives that we think the Committee will find of interest, as well as our position in response to your earlier letter for regulatory relief suggestions. We made seven specific regulatory relief suggestions that we hope the Committee will give consideration to, and, again, thank you for the opportunity to testify today. And I look forward to answering any questions and serving as a resource for the Committee.

Chairman SHELBY. Thank you, Mr. Dollar.

Mr. Lavender.

STATEMENT OF KEVIN P. LAVENDER
COMMISSIONER, TENNESSEE DEPARTMENT OF FINANCIAL INSTITUTIONS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. LAVENDER. Thank you very much, Chairman Shelby, Members of the Committee. My name is Kevin Lavender. I am the Commissioner of Financial Institutions for the State of Tennessee, and I am also the Chair of the Regulatory Committee for the Con-

ference of State Bank Supervisors, better known as CSBS. Again, I thank you for giving CSBS the opportunity today to testify on the condition of the State banking system.

As you have heard from my colleagues, the general health of the banking industry is excellent. State-chartered banks, which make up approximately three-quarters of the Nation's commercial banks, have shared in the industry's record levels of prosperity. Net income of State-chartered commercial and savings banks at year-end 2003 reached $44.2 billion, which is an 18-percent increase over the previous year's record levels. State banks' aggregate equity capital ratio stands above 9 percent. This level exceeds the industry aggregate and regulatory requirements and has risen steadily over the past 3 years. State banks' ratio of nonperforming assets to assets continues to decline and stands even lower than the industry's overall level.

Even some areas of concern have shown improvement in recent quarters. We saw deposits in State-chartered banks grow for the last 2 consecutive years. Our banks are still finding good loans to make, and we saw strong growth in earning assets in 2003.

We never forget, however, that these record levels of prosperity are occurring in an environment of historically low interest rates. Our examiners are paying special attention to our banks' vulnerability due to interest rate changes. My colleagues and I have also been particularly concerns about banks' internal control systems because experience has shown us that nothing disguises bad management as well as a good economy.

As you have also heard, consolidation of the banking industry continues, raising our concerns about concentration of risk and the range of meaningful choices available to consumers. The Nation's 50 largest banks now hold almost 90 percent of banking assets nationwide. In Tennessee, the six largest banks hold more than 50 percent of local banking assets, and in my hometown, the capital of Nashville, that percentage jumps to more than 80 percent.

Consolidation has in many ways benefited not only the institutions involved, but also the consumers. But my colleagues and I also worry about declining diversity in our banking system and about the forces driving this latest round of consolidation. A steady stream of new bank charters and conversions has partially offset the number of institutions lost to mergers over the past several years. However, as I mentioned before, the banking system's assets are increasingly concentrated in a small number of institutions held by a national charter.

Our Nation's financial system and its financial services policies have always emphasized the need for diversity, balance, and opportunity. Our State banking system encourages entrepreneurship, creating opportunities for new credit providers to enter the market and to find new ways to serve their communities.

Senators, State banks in Tennessee and nationwide are very healthy. The State banking system, however, faces a threat, and I ask your help today in restoring the necessary balance.

A key element of this balance is the question of Federal preemption of State authority. Federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity. But few matters of Federal preemp-

tion meet this high standard. One that did was the permanent extension of the FCRA amendments, which we congratulate you on enacting last year.

The Comptroller's recent actions do not seem to meet this standard. The regulations usurp the power of the Congress and stifle States' efforts to protect our citizens. They threaten not only the dual banking system but also the public confidence in our financial services industry. They also seem to encourage consolidation among our largest institutions, concentrating financial risk in a handful of gigantic institutions that may become, if they are not already, not only too big to fail but also perhaps too big to supervise effectively.

Maintaining a local role in consumer protection and a strong banking system is more important than ever in the wake of the current rounds of mergers among our Nation's largest financial institutions. Centralizing authority of financial power in one agency or a small group of narrowly regulated institutions would threaten the dynamic nature of our economy.

The State banking system is now stronger in many ways than it was 10 years ago before the passage of the interstate branching and financial modernization. The States have developed models for interagency information sharing, cooperation, and coordination that benefit the entire financial services industry.

Our work shows that the dual banking system remains a vital and essential dynamic for promoting new financial services while offering new approaches for consumer protection. Our dual background acknowledges the needs of multi–State banks and financial service firms while protecting consumers. We have worked hard to develop a system of supervision that allows for innovation while ensuring safety, soundness, and economic stability. The strong condition of our 6,400 State-chartered banks and 400 State-regulated offices of foreign banks is the best evidence of our success.

CSBS looks forward to working with the Congress to find additional ways to address the needs of an evolving nationwide financial services system in a way that maintains the strong condition, minimizes unnecessary regulatory burden, and ensures that all Americans retain their access to the broadest possible range of financial opportunity.

At CSBS, we look at this relationship very much in partnership not only with the Congress but also with our Federal counterparts. And given the history and importance of the dual banking system, we again thank you for the opportunity to testify today on the condition of the State banking system.

Chairman SHELBY. Thank you.

Chairman Greenspan, I cannot resist this question, since you are the Chairman of the Fed. Do you still feel optimistic about the economy? And do you agree with most economists that we will continue to add jobs in the next 5, 6, 7, 8 months?

Chairman GREENSPAN. I do, Mr. Chairman.

[Laughter.]

That is what I wanted to hear from you.

[Laughter.]

Chairman SHELBY. But only that is in keeping with about dozens of other economists. You are an economist that feels that we are

going to add on average 180,000 jobs a month. I know it will come down and go up some. Do you agree with that, or is that guessing?

Chairman GREENSPAN. Mr. Chairman, I do not want to get into specific numbers. Indeed, I am going to be getting into these data in some detail tomorrow before the Joint Economic Committee.

Chairman SHELBY. I know.

Chairman GREENSPAN. However things are changing. We evidenced some slowing down in the middle of the first quarter, and it is fairly apparent from the data since that things have picked back up again. March was a good month. We moved into April with retail sales doing reasonably well. Motor vehicle sales looked as though they were doing quite well in the beginning of the month. New orders are moving along at a reasonably rapid pace.

Chairman SHELBY. Does that include durable good orders?

Chairman GREENSPAN. Basically durable goods.

Chairman SHELBY. Okay.

Chairman GREENSPAN. It is more anecdotal than it is statistical at this particular point, but the anecdotes are fairly convincing at this particular stage.

It is fairly apparent that pricing power is gradually being restored, and as I will indicate tomorrow, threats of deflation, which were a significant concern last year, by all indications are no longer an issue before us. But, clearly, it is a change that has occurred in recent weeks, and it is a change, as best I can see, that has been long overdue and most welcome.

Chairman SHELBY. Are you concerned about some of the commodity pricing? I know that is just part of the PPI and CPI.

Chairman GREENSPAN. Yes, we are looking at the full detail of the cost structure, of which the commodity price inputs are a relatively small part. And remember that more than two-thirds of the consolidated, underlying domestic costs in the United States are unit labor costs. And, clearly, the productivity patterns that we have observed in recent months are still quite impressive and still not fully understood by us. We know what is happening and we know why it is happening, but we have very little capability of projecting into the future how this is all going to resolve.

So the inflationary pressures will be reasonably well contained, so long as productivity is moving at a reasonably good clip. And unit labor costs, as best we can judge, are still going down, but going down at a slower rate than they had previously.

There are a lot of data that are involved in putting all of this together, and I will try to make it clearer tomorrow, and go over into some detail about the mix of issues of costs, jobs, pricing, and the like, and try to suggest where we think we are coming out, with the full recognition that in periods like this, forecasting is less than perfect.

Chairman SHELBY. It is maybe an art and a science.

Chairman GREENSPAN. Yes, sir.

Chairman SHELBY. Do you feel good basically from what you have said about the overall thrust of the economy, putting it in the total picture?

Chairman GREENSPAN. I do, Senator.

Chairman SHELBY. Thank you.

I want to touch quickly on Basel. Chairman Greenspan, Basel II, we had a hearing about a year ago, I guess it was here, and there were some differences of opinion on Basel. Senator Sarbanes and I were in Europe back in August, and that was raised everywhere we went, other than Sarbanes-Oxley. Those were the two main issues we talked about. But do you feel real good about Basel II? Are you still looking at it to see how this model will work that they propose?

Chairman GREENSPAN. Well, I think it is important to recognize certain issues that created Basel II, indeed created Basel I. The international financial community is advancing at a fairly impressive clip. The changes have been unquestionably to the benefit of the United States and the rest of the world, and it is in our interest to see if we can create a regulatory structure which essentially produces a level playing field throughout the world.

This basically means that we have really three choices in front of us: One, we can stay with Basel I. The problem with that is that it is increasingly obsolescent and increasingly unrelated to the extraordinary changes that have occurred in the banking system in recent years. We can go to Basel II, which is where we want to go. Or we can decide we cannot do anything and go back to the pre-Basel I period, which, in my judgment, would be very dangerous so far as the structure of international finance is concerned.

Since I rule out Basel I, my general conclusion—and that of my colleagues, and I trust the rest of the international banking community—is to make Basel II work. It is not an easy job, as my colleagues have indicated to you here. But we are all working together to make certain that whatever comes out works for the United States.

None of us, as I understand where we all stand, will recommend to the Congress something which we do not believe is to our advantage, indeed to the advantage of the international financial community, or, most importantly, that will not work.

Chairman SHELBY. Mr. Hawke, many, if not most, of the Basel II participant nations do not have minimum capital requirements. Is it possible that the Basel II Accord, the new Accord, will start us down a path toward elimination of that leverage ratio?

Comptroller HAWKE. I certainly hope not, Mr. Chairman.

Chairman SHELBY. Is that one of your concerns here?

Comptroller HAWKE. I have concerns about Basel, but I want to state emphatically that we will not do anything that erodes or impairs the vitality of our existing Prompt Corrective Action regime. I think it is enormously important, and it is one of the things that distinguishes our system of bank supervision from that in other countries. I think it is enormously important for us to maintain that regime.

The big unknown in Basel II right now is exactly what the impact is going to be on banks' capital. That is one of the reasons that we have been very insistent on conducting a fourth quantitative impact study.

Chairman SHELBY. Mr. Powell, do you have a comment on that.

Chairman POWELL. I could not agree more. I think the minimum regulatory leverage capital ratio is critically important.

Chairman SHELBY. Mr. Gilleran.

Director GILLERAN. I agree.

Chairman SHELBY. Mr. Dollar.

Mr. DOLLAR. Credit unions are not under Basel.

Chairman SHELBY. I know that.

Mr. DOLLAR. But, we would like to talk about a risk-based capital standard for credit unions.

Chairman SHELBY. But you are interested in capital.

Mr. DOLLAR. We are, and we are interested in risk-based capital. And I think although Basel is not a proper fit for credit unions because it is oriented more toward for-profit institutions, I do think the need to get away from a one-size-fits-all prompt corrective action for credit unions over into a risk-based system is good public policy.

Chairman SHELBY. Mr. Lavender, have you studied this issue, Basel II?

Mr. LAVENDER. Mr. Chairman, I have not studied it, but I know CSBS has been pleased and proud to be at the table to discuss it with our Federal counterparts.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

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

Chairman Greenspan, taking the opportunity to ask you a question about the overall economy, it seems that personal wages increased by less than inflation in 2003, and that real wages fell by about 0.3 percent. This is in contrast to those stories we all read about very high compensation, nonwage compensation for executives and other wealthier individuals.

Are you seeing an economy that is becoming bifurcated, that working families who are working for wages are seeing their pay diminish while those individuals through their talent or luck or whatever, who are at the top of the organization chart, are reaping extraordinary benefits? And is not that a concern if that is the case?

Chairman GREENSPAN. Senator, I am concerned about the increased concentration of income, but the major problem is not in the very few people who are at the top, but the significant income differences that are emerging in this country between the highly skilled workforce and those with lesser skills. I addressed this issue in an earlier presentation, and the point I tried to make is that we seem to be exhibiting a marked change over the past 20 years in which as the technology of the capital stock of the United States moves forward at a very rapid pace, the level of skill of our workforce on average is not moving up comparably. And a consequence, we are turning out to have a shortage of high-skilled people and, hence, an increase in their relative wage, which shows up very significantly in increased premiums between college-educated workers and those with a high school or less educational experience.

And what this means basically is that there is a large number of people below the median income whose real wages have not changed at all over the last 20 years. And it strikes me, as I have indicated in other testimonies, that it is important that we confront this issue, enhance the capability of our educational system to ef-

fectively move a significantly larger number of people through our high schools and into colleges where their educational capabilities will bring them higher skills, and increase the supply of highly skilled workers, which will bring down their relative wage and decrease the excess supply of people with lesser skills and raise their wages.

So, yes, I am concerned, Senator, that there is an increasing concentration of income, and that is not good for a democratic society. I think the issue is broader than the relatively small group whose incomes, as you point out quite correctly, have gone up very materially relative to the average. But I think that is a small part of a much larger problem.

Senator REED. Well, there is, I think, a further complicating element. I think the theory that most of us have is similar to yours, Mr. Chairman, which is if we just educate our people better, they will be increasingly competitive in the world market. But that is being confounded now by this question of outsourcing, whereas I think the image of most of my contemporary back in Rhode Island, if their son or daughter got a good degree as an accountant, they would be all set because that is college and beyond. Then you read where more and more tax returns are being prepared in India and other places.

I believe in a closed system your remedy might work, but this system is not exactly closed any longer. And I also think it adds further complexity to the dilemma you have charted.

Let me just follow that line of questioning with a very specific question to Mr. Hawke and his colleagues, and that is, there is indication now that there are third-party vendors abroad that are working for financial institutions in the United States, which raises issues of privacy. In fact, I have a story—this is medical privacy, but it is a story about a woman in Pakistan who is protesting her pay by indicating that she would post the private medical records of people on the Internet if she did not get paid, which is cyber-extortion. But that is an example, probably a very melodramatic example, of what could happen.

But, Mr. Hawke, what are you doing to ensure that customers are being notified if their records are being sent overseas, and regulation, are you inspecting facilities overseas to ensure that privacy is maintained?

Comptroller HAWKE. We have done a number of things, Senator Reed. We have put out several advisories to our banks about making appropriate risk assessments concerning the maintenance of privacy with respect to customer records and security of customer records, where processing has been outsourced to foreign servicers. This is an issue that we have focused a fair amount of attention on. It is also an issue that the Basel Committee is considering through one of its subsidiary organizations.

Senator REED. My time has expired. Could I ask the rest of the panel to submit a response to the record about what your agencies are doing with respect to this, Mr. Chairman?

Chairman SHELBY. Absolutely. You want to do it now?

Senator REED. Mr. Gilleran has a comment.

Chairman SHELBY. If you want to comment, do it now.

Director GILLERAN. Senator, outsourcing to another country is no different than any of the other outsourcing that a financial institution or any other company is doing, but when you are dealing with the public the way banks are, financial institutions must satisfy themselves that whoever they outsource to have the controls and the procedures that are necessary in order to properly deal with the customer relationship. So therefore, regulators are going to be expected in the future, in my opinion, to be able to satisfy themselves that outsourcing to foreign countries is as reliable as outsourcing to an organization in the United States. If they are not, I think it calls into question whether or not that outsourcing is appropriate.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman Greenspan, the Federal Reserve Bank of Dallas wrote an article in their January/February issue of *Southwest Economy,* title "Small Bank Competitors Loom Large," which discusses the problems small banks are facing. In your testimony you talked about pressure small banks are facing. What can be done to help small banks both through regulation or statute, which are critical to the financial institutions and health of my State, the smaller institutions in my State?

Chairman GREENSPAN. Senator, I think that the community banking industry of the United States is one of the jewels of the international financial system in the sense that it does not really exist anywhere else, and has served us exceptionally well, and I think it is very important that we continue to support that system as it goes forward.

I am concerned, as all regulators are, that these institutions are particularly vulnerable to heavy regulation, because they do not have staffs and cost structures which enable them to address it. It is important that we be careful in balancing how we regulate these institutions because it is important that they continue viable and support our communities, which in large measure they have done.

This is not a simple issue because we have numbers of regulations that apply to all banks and the ability of differing banks to handle them must be judged in a manner that, one; advances the purposes of the laws which the Congress has put forward, but second; does so in a manner which is most efficient and effective in maintaining the stability of our system.

Senator BUNNING. This is a question for anyone who would like to answer it.

Director GILLERAN. Senator, just to respond, we did a study in the last year to determine why certain thrifts do better than others, and it is very interesting that we isolated about 87 thrifts under a billion dollars in size, and these thrifts have been able to achieve in excess of 1.50 on assets over a long period of time, in excess of 10 quarters, and they all have some very interesting similarities. One is they are very well-diversified, that is, they are in all kinds of lending. They offer all kinds of products, but in addition to that, they are extremely well-managed, and their boards of directors are very strong, and on top of that, they have excellent

relationships with their regulator, which is a similarity which we like to see, of course, but these institutions are institutions that are flourishing because of good business practices, and therefore, we are quite confident about the ability of smaller institutions to compete and survive.

Senator BUNNING. So you call an institution, a thrift under a billion dollars small? In other words, my $15 million bank in Northern Kentucky, what is that?

Director GILLERAN. That would be in the same group, but I mean it is under a billion, but some of these institutions are smaller than a billion dollars.

Senator BUNNING. Yes, they are, a lot of them.

Director GILLERAN. Lots of them are.

Senator BUNNING. In fact, most of the ones in Kentucky are under a billion dollars.

Director GILLERAN. But still we find the same characteristics hold true.

Senator BUNNING. Okay. Let me ask all the regulators here, can any of you give me an update on the steps financial institutions are taking to guard against terrorist threats, cyber, whatever? Nobody wants to answer?

Chairman POWELL. I will address it.

Senator BUNNING. Mr. Powell.

Chairman POWELL. There is a joint effort, Senator, among all the regulators, to make sure that every insured institution has in place policies and procedures that will deter any cyber or any other information breakdown by terrorists. The FDIC has sponsored some symposiums, as recently as last week, that was in cooperation with all the regulators, wherein we bring bank management, directors, and interested parties together to in fact make them aware of procedures and policies that would inhibit any terrorist strike against the system. I think there is a keen awareness among the regulators, I think among all regulators, and part of it is an educational effort and part of it is working with other regulatory agencies within the Federal Government and also the State governments.

Senator BUNNING. My time has expired.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Senator Crapo was here earlier.

Chairman SHELBY. He is going to defer to you because you were here earlier, Senator Crapo.

Senator CRAPO. Thank you very much, Senator.

I would like to first direct a question to Mr. Powell, Mr. Gilleran, and Mr. Lavender. As I indicated when I came in, I am very focused on the regulatory reform legislation we are developing. One of the issues there relates to industrial loan banks, and the question I have is that concerns have been raised about the fact that owners of industrial loan banks are not regulated as Federal bank holding companies. Some critics have charged that industrial banks, their depositors, and perhaps the deposit insurance system are endangered by the bank's affiliation with unregulated parent companies. Can you describe the regulatory regime that applies to industrial loan banks and their parent companies and what authority do the FDIC, OTS, and State banking regulators have to look

into activities of industrial banks, holding companies, and their affiliates?

Mr. Powell.

Chairman POWELL. Yes, Senator. Our safety and soundness examination is not any different with industrial loan companies than it is with any commercial bank. The same procedures, policies that we adhere to at the FDIC are applied to examinations conducted at the ILC. I am convinced that we have the ability at the FDIC and the willingness to make sure that we examine those institutions from a safety and soundness standpoint as we would any bank.

Furthermore, we are not restricted by law, and we will from time to time enter into the parent, and look at the parent's situation and have questions and answers as it relates to their support of the insured institution. There is no barrier there that I can detect at all.

Senator CRAPO. Thank you.

Director Gilleran.

Director GILLERAN. Senator, we have 650 holding companies that the OTS is responsible for, and some of those holding companies own industrial loan companies, and we have the same supervisor role responsibilities for those holding companies that we have for the ones that own thrifts, and we examine them in the same fashion and we have the same authorities over them as we would have under any holding company situation. So our authorities are complete.

Senator CRAPO. Mr. Lavender.

Mr. LAVENDER. Thank you, Senator. I agree with both of my colleagues here at the table. There are only a handful of States that actually license ILC's. Tennessee in fact is not one of them. However, the CSBS and the States that do regulate them, look at them no differently than the other institutions that regulate and work very closely with our Federal counterparts to apply the same standards of safety and soundness.

Senator CRAPO. Thank you.

Mr. Greenspan, for years industrial loan banks have had authority to basically offer NOW accounts to individuals and corporations. In the context of the question that I just asked of Mr. Powell, Mr. Gilleran, and Mr. Lavender, are you aware of any risk of threat of injury to depositors, competitors, or the deposit insurance system as a result of the way this industrial loan bank system operates?

Chairman GREENSPAN. I do not think that is where the problem that concerns us resides.

Senator CRAPO. Please elaborate.

Chairman GREENSPAN. I was looking at some of the commentary that I have been involved with over the years, and if I may just read a note that relates to this, it is something that is part of the testimony I gave before this Committee in 1998, relating to the issue of whether or not we should open up the prohibition between commerce and banking. The general view that the Federal Reserve had at that time would best be described by part of my testimony, which said that technology was in the process of eroding any bright line between commerce and banking. Nonetheless, we concluded that the free and open legal association of banking and commerce would be a profound and surely irreversible structural change that

should best wait while we absorb the significant changes called for by financial modernization.

Since Gramm-Leach-Bliley passed, which is essentially moving in the direction that the testimonies back in 1998 were indicating, the key issue here is that arguments relevant to industrial loan companies concern how far the Congress wishes the banking system to move toward increased integration of commerce and banking.

As I indicated back in 1998, over the very long run that is going to happen largely because of the technological changes which inevitably are going to occur and alter irreversibly the structure of finance. But I think we have not given the existing Gramm-Leach-Bliley Act and all of the other types of regulatory structures which the Congress has put in place, a chance to work, to see how this gradual evolution is evolving, recognizing that once we move in a direction, it is very difficult to reverse. So my judgment is that what we need here is caution, and what the ILC issue ultimately comes down to is breaching the line between commerce and banking, and that I think is premature.

Senator CRAPO. Thank you very much. I see that my time is up, and I will not go further at this point. I do appreciate the answers that you gentlemen have given me on one of the critical issues we deal with in reg reform.

Mr. Chairman, if I could, I would like to just ask one question of all members of the panel, that I would ask that they respond to in writing, if I could do so. That is, as has been indicated, we are in the process right now of putting together a regulatory relief package, and we have here in front of us virtually all the regulators. I would just like to ask each of you if you could respond to me in writing, and to the Committee in writing, about what you believe the top two or three items that we should consider in a regulatory relief package should include.

Chairman SHELBY. Senator Crapo, would you include your request, respond to you because you are the leader here, but also to the Committee Members?

Senator CRAPO. Yes. In fact, I meant to say that, Mr. Chairman.

Chairman SHELBY. Will you all do that?

Senator CRAPO. Thank you very much.

Chairman SHELBY. Thank you, Senator Crapo, and I thank you for your leadership in this area because as I said earlier before you came in, there are so many regulations and a lot of laws, that we wonder what they are still doing on the books, do we not? Because Chairman Greenspan talked about, and all of the witnesses have talked about, how far the financial service industry has moved in the last 10, 12 years, or the last 5 years.

Senator Sarbanes is recognized.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. Before I turn to the panel, I want to commend you for scheduling this hearing. It has been my long-held view that the oversight function of this Committee is actually one of its most important responsibilities, and it is very clear that is a responsibility you take very seriously, and this is but one in a series of hearings you have held ad-

dressed really to meeting the Committee's oversight responsibility, and I want to thank you for that focus.

I want to just follow up on Senator Crapo very briefly before I turn to the other areas I had here. Mr. Powell, is it your position that the FDIC conducts regular, annual holding company examinations? I know the Fed does, but I was not under the impression that the FDIC does so.

Chairman POWELL. Is it the holding company of the ILC's you are referring to, Senator?

Senator SARBANES. Do you do regular, annual examinations of the holding company?

Chairman POWELL. No, sir.

Senator SARBANES. I mean the process you follow does not begin to be the equivalent in terms of reviewing banking practices to the one that is followed by the Federal Reserve; is that correct?

Chairman POWELL. That is correct. I was referring to the ability to look into the ILC's parent company.

Senator SARBANES. But you do not review on a regular basis the holding companies that have ILC's in them, do you?

Chairman POWELL. We do not.

Senator SARBANES. Does the Fed review them on a regular basis, Chairman Greenspan?

Chairman GREENSPAN. You mean the ILC's?

Senator SARBANES. No, the holding companies that hold the ILC's.

Chairman GREENSPAN. Yes, we do.

Senator SARBANES. That is what I thought.

Now, let me ask, I want to go to this issue of money laundering first and how effective the regulators have been in overseeing and giving proper priority to compliance with the Bank Secrecy Act, especially the rules of Title 3 of the USA PATRIOT Act. Of course, this is designed to counter money laundering and the financing of terrorism, but I think it can only be effective if its mandates are not an afterthought but that the regulators are testing the adequacy of bank reporting and recordkeeping in real time.

Just on Sunday,the *Washington Post* had a report about the asserted failure of Riggs Bank to follow the Bank Secrecy Act's suspicious transaction reporting rules in a case involving possible ramifications for U.S. antiterrorist efforts. They state "FBI scrutiny of Riggs' international business began soon after the September 11, 2001 attacks," but according to the article, the inquiry "widened to include parallel probes by the OCC and Riggs itself after a *Newsweek* report in November of 2002." The article goes on. It says "in the course of the inquiries, bank and Federal investigators found tens of millions of dollars in questionable transactions that had not previously been reported. That led to the flurry of suspicious activity reports filed by the bank." But the article also stated, "Riggs failure to file reports had been noted by regulators years ago, but no action was taken. In annual bank exam reports for 1999, 2000, and 2001, OCC officials outlined problems in Riggs' procedures to guard against money laundering or other illicit activities by bank customers, but the OCC never fined or sanctioned the bank, sources familiar with the examinations said."

Comptroller Hawke, obviously, you are first in line to address this question. What is your comment about this article which just appeared, especially about the relationship between the annual examination reports and what appears to be a delay of extensive examination in this area until 2002? How does a situation reach this point in a bank that is subject to continuous examination, and that does a significant level of international business?

Comptroller HAWKE. Senator Sarbanes, I am a bit limited in what I can say about Riggs specifically, because it is a matter of ongoing enforcement action by the OCC. But I can say that, particularly after September 11, there was increasing concern about the internal controls over one segment of Riggs' banking operations and increasingly heavy emphasis by the OCC on taking corrective action. Last year, we did get a consent cease-and-desist order from Riggs that was intended to bring about significant change in the way that they administer certain aspects of their business, and it is a matter of ongoing enforcement involvement by the OCC.

Senator SARBANES. You have a 25-page written testimony here today. I admit I skimmed it but maybe I missed it. You could correct me, but I did not see any mention of the Bank Secrecy Act or any efforts by your agency to implement Title 3 of the USA PATRIOT Act to combat terrorist financing.

I do not know what message that sends to the banks, frankly.

Comptroller HAWKE. Implementation of the USA PATRIOT Act is a matter of high priority, not only for us, but for all the agencies, and we are working on an interagency basis in the promulgation of a variety of regulations that are called for under the USA PATRIOT Act.

In response to questions that Chairman Shelby raised at the hearing 2 weeks ago about Bank Secrecy Act concerns, yesterday I delivered a letter to the Chairman addressing some of those issues in great detail, and I would request that that letter be made part of the record, Mr. Chairman.

Chairman SHELBY. We will ask that it be made part of the record. We will share that with all the staff and Senator Sarbanes. We are both interested in this, in noncompliance of the Bank Secrecy Act.

[Letter of Mr. Hawke:]

Chairman SHELBY. Do you have some more questions?

Senator SARBANES. I will defer to Senator Carper.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

To each of our witnesses, welcome. It is good to see all of you.

Earlier in the hearing, Mr. Chairman, you asked a question of, I think it was Chairman Greenspan, and he gave a two-word answer to that question, and the words that he answered in response to your question were: I do.

A number of years ago, Chairman Greenspan probably said those same 2 years to a woman named Andrea Mitchell, who is being honored this Saturday evening along with some other truly remarkable people from around the world at the Commonwealth Awards in Wilmington, Delaware at the Hotel Dupont. This is

about the 25th year we have had the Commonwealth Awards. I just wanted everybody to know he said "I do" more than just today, and he said it to good effect at least on one other occasion. I know you are proud of her, and we look forward to hosting her, and maybe if we are lucky, maybe even you too. Congratulations, and convey that to her.

What I would like to do is revisit some of the comments of Mr. Lavender. What do they call you back in Tennessee?

Mr. LAVENDER. Commissioner. My wife calls me Kevin though, so whatever your please, Senator.

[Laughter.]

Senator CARPER. Robert Glen is our Commissioner of Banking. I do not know if you know him, from Delaware, but he is a very able person. I was privileged to appoint him when I was Governor of Delaware.

There was some back and forth between you and the Comptroller of the Currency, and Mr. Comptroller, good to see you too today. I am not going to ask Mr. Powell or Chairman Greenspan to referee this disagreement, but I would ask for them just to share their thoughts with us as the OCC preempts the ability of States to have the kind of say they have had in the past on State-chartered banks.

Let me just ask Chairman Greenspan and Chairman Powell if you have any thoughts with respect to the impact on the dual-banking system, of what is transpiring on this front?

Chairman GREENSPAN. Senator, this is an issue which is really a question of the law, and courts at some point will resolve it. My only concern relevant to this issue is that however it is resolved, it not undercut the dual banking system which has been so critical an element in the development of banking in the United States and continues to be so.

The dual banking system is a very unusual competitive structure for regulation, and it has served us well, and I am concerned that however we develop issues in the years ahead, that we be careful to maintain the appropriate balance of regulation between State and Federal agencies.

Senator CARPER. Mr. Powell.

Chairman POWELL. I agree with Chairman Greenspan that the dual banking system is vital to the banking industry in America. I, at one time, owned a State-chartered institution, and at one time had a national-chartered institution. I think it is also important to note that there continues to be strong appetite in the marketplace for a State banking charter, so that tells me the market perceives that there are some benefits to having a State banking charter.

Also, I think it is important that on the issue of deposits and loans that there be national standards. I think it is important the way our society is today, as mobile as we are through interstate commerce, that those issues, deposits and lending, that we have some uniform standards. I also think it is important—and I understand and recognize that certain States, through their elected officials and legislatures, will have unique laws particular to that State, that do not necessarily deal with loans and/or deposits in interstate commerce. So, I recognize and understand that also is important.

But the dual banking system is one of the things that distinguishes I think America from the rest of the world, that we should protect and that we should encourage it to continue to thrive.

Comptroller HAWKE. Senator, could I add one point? This is obviously an issue as to which there are deeply held views on each side.

Senator CARPER. I am starting to gather that.

Comptroller HAWKE. I wanted to refer to a table in my prepared statement. It plots on a graph the share of commercial bank assets held in the national banking system. The dual banking system has been enormously stable for many, many years. Preemption is something that has been around for as long as the national bank system has existed, 140 years, so it is not a new concept. The national bank share of total commercial bank assets has remained very, very steady over many years. For the past 15 years it has been at about 56 to 58 percent. It has held very stable, and we do not see any reason to think that there are going to be changes in that equilibrium that has existed for so long.

Senator CARPER. Commissioner Lavender.

Mr. LAVENDER. Senator, you are absolutely right. I have only been a regulator for 15 months now, after having been a corporate lender with both a national-chartered institution and a State-chartered institution for 14 years.

I would say the Comptroller's chart after this year will change dramatically. Being in this position for 15 months, I can attest and testify for you today that there have been at least 50 instances where national-chartered institutions or their subsidiaries have either turned in their charters or licenses to State regulators, or put us on notice that they would be supplying those to us, and those are institutions that range from the $15 million that this Senator mentioned over here, to as much as a billion dollar plus institutions. I think this charter is a little deceptive today. The preemption that was issued by the Comptroller's Office is far sweeping. It takes away the ability of States not only to enforce consumer rights regulations and laws, but also the capability to do things such as predatory—let me back up and say I agree with Chairman Powell. As a former banker, I think there should be a national standard, but I do not think the Comptroller's preemption, the rule that went into effect on February 12 goes far enough.

When you say predatory lending in particular in this case, that the standard is simply do not lend based on the borrower's inability to repay, I do not think that goes far enough, when in today's environment we have all talked about historically low interest rates. Gentlemen, when there is a citizen of the State of Tennessee, that comes in and has a loan that in today's market is 24 percent, she had to pay 5 points to get in the loan, she has a prepayment for 7 years, that is predatory lending.

As a new State regulator I would love the ability to set the standards with my Federal counterparts of what in fact defines predatory lending, what we can do jointly as Federal and State regulators to combat it, but I just do not think the Comptroller's rule goes far enough to protect the citizens, not only the great State of Tennessee, but also across the country.

Senator CARPER. My thanks to each of you.

Thanks, Chairman Shelby.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman.

To all the participants, welcome, and thank you for being here.

My first question is, I would love to hear what the broad conceptual differences between Basel I and Basel II are, that we have had hearings on, and tried to have conceptualized to those of us that are a little farther away from the markets and do not fully understand. My question will get at whether we think risk-based capital is really the way that regulatory structure should be applied to financial institutions' balance sheets, what circumstances would lead us also to have second-tier requirements like leverage rules?

Comptroller HAWKE. Let me take a crack at that. Senator Corzine, Basel I was a first effort at risk-based capital rules, and I think there is fairly general acceptance of the conclusion that it was a very coarse attempt. Various types of bank assets were classified into several risk buckets, and that was essentially the end-all of risk-based capital. The experience since Basel I has been that those buckets do not accurately reflect risk and they are easy to game.

Basel II takes some very different approaches to risk-based capital. It looks at probabilities of default, exposure at default and loss given default, and calculates capital requirements under some much more sophisticated formulas. It also takes into account credit risk mitigation, that is, the extent to which risk may be mitigated by various devices, such as guarantees, collateral, and the like. It also takes into account operational risk, which is a subject that has been recognized by banks themselves for many years but has never been embodied in regulatory capital requirements. All told, I think that the basic conceptual differences between Basel I and Basel II are that Basel II takes a much more sophisticated and, frankly, much more complicated approach to the development of regulatory capital rules.

You asked about the leverage ratio, and we discussed that a little bit earlier. I think we probably all share the view that the leverage ratio is an exceedingly important component of our approach to bank supervision. One of the concerns that has been raised is whether Basel II will reduce bank capital requirements to a point where the leverage ratio becomes the binding constraint, in other words, where capital ratios calculated under Basel II fall below the leverage ratio. An issue has been raised as to whether that will put pressure on us to reduce the leverage ratio in the interest of assuring that U.S. banks will not be put at a competitive disadvantage vis-á-vis foreign banks that do not have a leverage ratio.

I think we probably all share the view here that the leverage ratio is an essential component of Prompt Corrective Action on which our whole system of bank supervision is based. If we find that Basel II does result in the lowering of regulatory capital requirements below what would be required by the leverage ratio, I am perfectly prepared to go back to the Basel Committee and seek recalibration of the capital requirements so that we do not have that anomaly.

Senator CORZINE. You would argue to raise the risk-based capital rules to conform with the leverage rules?

Comptroller HAWKE. I think that is what we would be faced with. Otherwise, our banks would be put at a competitive disadvantage vis-á-vis banks in countries that do not have a leverage ratio, and reducing the leverage ratio would undermine our whole system of Prompt Corrective Action, which is the foundation stone of our system of supervision.

Senator CORZINE. I would love to hear others' comment on this, but does that not strike at the heart of the value of risk-based capital, presuming that one has been intelligent enough to actually create a rule that reflects the various risks associated with managing a financial institution?

Comptroller HAWKE. I think there may be something of a disconnect there, but the leverage ratio and Prompt Corrective Action for more than 10 years have been the foundation stone on which our system of bank supervision is based. That reflects a fundamental difference between the United States' approach to bank supervision and that in most of the other Basel countries. I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk sensitive, but we should not do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks.

Senator CORZINE. Anyone else like to comment?

Chairman POWELL. Senator, I think your comment is well said. That is assuming however that the models are perfect. I think the process will be dynamic as it goes forward. There will always be tweaking of those models based upon market conditions, based upon history, what we have got wrong. I think we all agree that those models are a marked improvement, but they are not an end to themselves. That is the reason we need the minimum regulatory capital.

Senator CORZINE. Mr. Chairman.

Chairman GREENSPAN. I think the Senator has raised a fundamental question here because at roots, a risk-based system is an evolution from the earlier versions of any form of leverage-based system, and at the end of the day they are mutually exclusive. I think the problem, as the Senator is implying, is that we are in a transition stage, and as I think we all have to be aware that, at the end of the day, we would like our regulatory system to essentially merge into the economic-based system of risk management that the larger, more risk-managed institutions have. I think the question here is how, in this interim stage where we are still developing the technology and the economics of the type of risk management which is implicit in the Basel II system, do we manage this in a manner which does not create problems? Obviously you cannot manage the type of rules which the FDIC of necessity has to focus on, in a wholly risk-based system. But I do think it is important not to think that we are trending toward some merger of a leverage ratio and risk-based capital systems. That is not possible. I think it is a question of how we do it.

Senator CORZINE. It is just a matter of when the conflicts will occur, as we certainly have seen, I guess in the discussion of GSE's in particular, but these are really challenging elements because if

one become preemptive of the other, and I think in many ways potentially undermines the credibility of the other because it sets a different kind of floor.

I will end here, Mr. Chairman. I will say though that the complexity of the risk-based models, which I am fully supportive of, reflective of underlying economics, are really quite difficult for those of us that sit on this side of the table, maybe even on that side of the table, to understand whether they actually fit the reality of the circumstances that meet in the complexity of a balance sheet today, but it seems to me we are posing a major dilemma if we have a leverage ratio overlaid on top of a risk-based system.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and I want to thank our witnesses. My first question is to Comptroller Hawke. It is about the Riggs Bank situation. I have been very concerned about what has been going on here. You know that earlier this year the State Department revoked or refused to renew visas for 16 Saudis who were here under diplomatic cover, but in actuality worked in a Virginia school that was teaching terrorism. Similarly, in 2003, American officials deported a Saudi consular official in Los Angeles. I have a number of questions.

First, did any of these individuals have accounts at the Riggs Bank or receive money from those accounts? If so, how much?

Second, I would like to know if your review of the Riggs Bank accounts turned up any untoward activity. In your enforcement action on July 16, 2003, Riggs Bank was tasked with filing suspicious activity reports within 150 days in relationship to these accounts. Have these reports been filed? If so, how many?

Then third, just generally, Riggs was passing money in violation of the Bank Secrecy Act for 2 years until all of this came up. What are you doing to tighten things up so that there is no future Riggs Bank doing that kind of thing?

Comptroller HAWKE. Senator Schumer, if we may provide a response to those questions in writing, I would be happy to do so, with the caveat that I gave a bit earlier. Because Riggs is the subject of ongoing supervisory action by the OCC, we are somewhat constrained in what we can say publicly about it, but I would be happy to do the best we can in addressing the questions.

Senator SCHUMER. You could do those, and if you have to protect specific names, that is fine. I am not interested in the specific names of the case. I am interested in whether Riggs filed the reports and whether any of these people—I do not have to know which ones—were involved in the Riggs Bank. Of course, if all 16 were, then you cannot say that, but if it is one or two, you probably can without revealing identities.

Second question. Hedge fund regulation. There have been two reasons given for hedge fund regulation, and that is one is to protect investors. I am not terribly sympathetic to that if, and only if, as they used to say in law school, hedge funds deal with people of great wealth. In other words, when the hedge funds try to find ways of getting people to make $5,000 investments, they are going to make themselves more like mutual funds. But leaving that part

aside, someone is putting a million dollars in, caveat emptor is okay with me. But second is the issue of systematic risk which relates more directly to this hearing, that if we do not have registration, if we do not have regulation, we get something like long-term credit and other things, systematic risk is a problem.

I would like, I guess the most relevant people are Chairman Greenspan, Mr. Hawke, and Mr. Powell to talk about those, but anyone should feel free to answer.

Chairman GREENSPAN. Senator, the hedge fund industry, which is made up of far more diverse types of institutions than originally existed, in the context of, as you put it, the million dollar investments, is a major contributor to the flexibility, stability, and liquidity of the overall system. They do not, in my judgment, pose any significant systemic risks largely because the people who lend them money, their counter-parties, are large institutions who basically know what they are doing and the system has worked rather well.

I fully agree with the point that you make that hedge funds which endeavor to attract retail money in fact become mutual funds as far as I am concerned, and should be subject to all of the rules that exist for those institutions.

I do, however, wish to point out that if we endeavor to regulate hedge funds merely for the sake of regulating hedge funds, it is not clear to me what the justification is, and indeed, I can see significant losses to the flexibility of our very sophisticated financial system were we to do that. So, I think in moving forward, the criteria which you point out, Senator, should be the criteria of the type of regulation which is imposed.

Senator SCHUMER. I think the SEC did cite—I said the word wrong—systemic risk as one of their potential justifications. Did they consult with you on that before then?

Chairman GREENSPAN. Not with me specifically. There may be systemic risks, but I have not found any yet.

Senator SCHUMER. Anyone disagree with that?

Comptroller HAWKE. I would just add to what Chairman Greenspan said, Senator Schumer, that the discipline exerted by counterparties is enormously important here. One of the failings that we saw in Long Term Capital Management was that counter-parties were not exercising the discipline that we would expect. Lending banks were waiving access to information when the borrower refused to give them that information. That is something that can be addressed through the normal bank supervisory process.

Senator SCHUMER. Anyone else on that subject?

[No response.]

Last question, if I could, Mr. Chairman?

Chairman SHELBY. Go ahead.

Senator SCHUMER. I guess I am asking Chairman Greenspan. In recent days, last month, as you noted, talking about the economy, the general condition of the economy seems to have picked up in a wide variety of ways, whether it is employment with the last month's jobs numbers, retail sales, manufacturing, et cetera. It seems when the markets hear the good news, they have a bifurcated reaction. On the one hand they say, "Gee, this is good news." On the other hand they say, "Inflation is around the corner. We had better watch out." I think that is a reasonable reaction because

of the deficit that we have here, which to me is unprecedented in the short amount of time it has been created. I am wondering in light of recent market reactions, what your views are on this deficit? I know last time we talked about this, we got into Social Security, which I think is, at least for the near-term, a political nonstarter. The ability to cut Government costs, well, I voted against the prescription drug bill which was the greatest prescription cost around, making me a fiscal conservative around this place, but that has not happened for a while, and it just strikes me, given what I have seen in the last while, that supporting making these tax cuts permanent actually hurts the continued recovery, not over a 6-month period but over an 18- or 24-month period, rather than helps. Could you comment?

Chairman GREENSPAN. The deficit problem that I think should give us pause is not the short-term one, which is a problem but is not in and of itself destabilizing. At least the markets certainly do not read it that way. There is a very significant problem which confronts us in the next decade, and that occurs because the very large baby-boomer population retires and doubles the aggregate number of people on various forms of retirement income. As best we can judge, the uncertainties associates with Medicare specifically are greater. I should say parenthetically that Social Security is a defined benefit program, it cannot be forecast in exact detail, but close enough. Medicare cannot. The range of possibilities is in my judgment sufficiently worrisome that it creates uncertainties in the longer-term fiscal system which I do not think we have come to grips with as yet. It has not yet impacted on the short-term markets clearly. You cannot find footprints of either the immediate deficit or the long-term deficit in long-term Treasury yields as yet, but clearly, you cannot create a fiscal problem of the type that is potentially out there without ultimately impacting on the rate structure and impacting on economic activity and economic growth.

There are all sorts of elements involved in what level of taxation you think is appropriate for the longer-term, what level of taxation creates problems for long-term growth. Those are issues which I think the Congress has to address at some point, in my judgment, sooner rather than later.

Senator SCHUMER. Just one follow up. It seems to me, at least from the few people I have talked to, and obviously, you know much more about this than I do, that the market's reaction is not to the long-term worry about the Medicare and Social Security problem which obviously loom out there, but have been there for 5 or 10 years, but rather to the short-term, that because of the immediate year-to-year deficits we have even now before the baby-boomers retire, that they are greatly worried that the Fed will have to raise interest rates rather quickly and rather steeply as the economy begins to take off. Am I wrong in thinking that?

Chairman GREENSPAN. The market commentary clearly is that in response to the fact that the economy is clearly coming back, and indeed as I mentioned earlier, the problems which we have confronted and the concerns that we had about deflation last year are no longer an issue, that there clearly is an emergence of views as to how this will all balance out. I will try to address that in testimony which I am scheduled to give tomorrow at the Joint Eco-

nomic Committee, but the news is good. I mean if you look out at various economic scenarios that could have emerged out of the extraordinary events subsequent to September 11 with the corporate scandals and wars in Afghanistan and Iraq, we are doing rather well, and I think the question is, how do we manage that in a manner that we will continue to do well?

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator.

I want to get back on the Riggs situation, Mr. Hawke. Do you believe that the examination process that you have currently in place is robust enough to ensure bank compliance of the Bank Secrecy Act?

Comptroller HAWKE. I do, Mr. Chairman, and I should say that we have all learned a lot in recent years about the importance of making that process even more robust than it is.

The issue, for example, of transaction testing is one that we have been giving thought to. We do not, as a regular matter, do extensive transaction testing in Bank Secrecy Act compliance. We look primarily at a bank's own internal controls, their internal audit, the way that they manage their own compliance. We take a risk-based approach to it as well; we concentrate on those institutions that present the highest risk.

Chairman SHELBY. A lot of people that know a lot about fighting terrorism basically concluded that money, financing of terrorist activities, training, movement, everything, is central to their activities, so this plays right into the regulator, in the Treasury's hands as far as your obligation to root this out or try to root it out, does it not?

Comptroller HAWKE. I think that is clearly right.

Chairman SHELBY. Could you provide to the Committee, Mr. Hawke, a brief overview of how the issue of Bank Secrecy Act compliance is handled by your examiners? Specifically, do the examiners look at a general program, a list of activities or programs the bank engages in? Do the examiners ever look at individual transactions to gage a bank's compliance with the Bank Secrecy Act? Do you want to do that for the record?

Comptroller HAWKE. Mr. Chairman, that was one of the questions that you raised with us at the last hearing.

Chairman SHELBY. I know.

Comptroller HAWKE. It is addressed in the letter that we delivered yesterday.

Chairman SHELBY. Is it addressed fully? My staff wanted it addressed totally, not cursory.

Comptroller HAWKE. It is addressed in four or five pages of the letter. We would be happy to supplement that if there are additional questions.

Chairman SHELBY. Okay. Are there other banks besides Riggs, Comptroller Hawke, that you are currently watching, that have problems similar to Riggs? Out of your whole banking system, there are bound to be some.

Comptroller HAWKE. Riggs presented a special kind of situation because they——

Chairman SHELBY. Because of where they were located?

Comptroller HAWKE. Well, in part. They had made a specialty of embassy bombing——

Chairman SHELBY. That is because of where they were located too.

Comptroller HAWKE. They did it overseas, as well, but that was a specialty that they had developed. I think we all recognize that that product line, if you will, presents considerably higher risks than other types of banking relationships.

Chairman SHELBY. As far as other banks are concerned, I know they are here in Washington and they went after a lot of the diplomatic business and so forth, or maybe with the diplomat's bank among other things. But there are other banks in this country under your jurisdiction that I hope you are looking at too.

Comptroller HAWKE. We are, Mr. Chairman, and, as I said, we take a risk-based approach. We look at a number of different attributes that a bank presents, the extent to which they have foreign customers, the extent to which they are doing private banking, their location, the number of SAR's that are filed and so on. All of that gets factored into the decision as to how much——

Chairman SHELBY. Has the word gone out though from the Comptroller of the Currency, that it is not business as usual, that we are in a war against the terrorists and money is important to the terrorists? Also, is that one of your highest priorities?

Comptroller HAWKE. It is a high priority with us, Mr. Chairman, with respect to the training and incentivizing of our examiners, as well as with the banks that we supervise.

Chairman SHELBY. Mr. Powell, what about you?

Chairman POWELL. It is a high priority with us also, Senator.

Chairman SHELBY. Do you have some troubled banks similar to Riggs, like that, in dealing with the Bank Secrecy Act?

Chairman POWELL. I am sure we do. We have had something like——

Chairman SHELBY. Would you furnish that to the Committee for the record?

Chairman POWELL. Be happy to. I think we have had 24 enforcement actions.

Chairman SHELBY. Twenty four enforcement actions.

Mr. Gilleran, you have a lot of banks. I know a lot of them are all over the country.

Director GILLERAN. A lot of thrifts.

Chairman SHELBY. Well, thrifts and savings banks.

Director GILLERAN. We do not have any that we know of that are of the nature of the Riggs situation. We do see a problem for some of the smaller institutions in complying because the laws require special training for their employees, and special surveillance on the part of the organization, so that we are giving particular attention to how this is all being handled by smaller organizations.

Chairman SHELBY. Mr. Dollar, what are your responsibilities for the credit union?

Mr. DOLLAR. We are not exempt from this one, Mr. Chairman.

Chairman SHELBY. I hope not. Thank you.

Mr. DOLLAR. And although there is not much money laundering going through institutions as small as credit unions, 60 percent of which——

Chairman SHELBY. We also have some huge credit unions. I know one in my State is well-run and a couple of billion dollars in size. I call that pretty good size.

Mr. DOLLAR. Well, you do have, and the point I wanted to make is that we take it seriously, and we take it seriously to the point during the 6 years I have been on the NCUA Board, the single largest conservatorship that we have done of any credit union in the United States, Senator Schumer, was in your home State, and it was for Bank Secrecy Act violations. We do take it seriously.

Chairman SHELBY. Senator Sarbanes, thank you for your indulgence. You want to get back into this too.

Senator SARBANES. I have to tell you, David Aufhauser, when he was General Counsel to the Treasury Department, in testimony before this Committee, said that the Bank Secrecy Act part of the bank audit might be a stepchild to the rest of the audit and not receive the priority and primacy it deserves. Aufhauser went on to suggest that we might be better served if Treasury constituted a separate examination and compliance force in the area of bank secrecy. What is your reaction to that suggestion by Mr. Aufhauser?

Comptroller HAWKE. I am not sure that the problem of Bank Secrecy Act compliance is going to be addressed by just adding more examiners to the mix, Senator Sarbanes. I think that the fundamental aspect of Bank Secrecy Act compliance is very consistent with the fundamental approach to bank supervision generally, and that is to look, in the first instance, at the extent to which the institution has established the kind of controls and audit processes that are necessary for it to assure itself that it is complying with the law. That is the starting point for virtually all bank supervision. It is not by any means the end, but that is the starting point. And that is the thing that bank examiners are trained to do and do every day. In the course of several years of dealing with Riggs, there was an escalating response by the supervisors that started with a focus on the bank's own internal controls, on training, and on those fundamental aspects of bank supervision that we look at in other areas, as well.

Senator SARBANES. Yet, we are talking about the possibility of terrorist financing here. I mean, it goes from year to year. You are running along doing these reports every year, but at what point do you move to really move in there and correct it and make sure that this is not constituting access to funds for terrorist activities?

Comptroller HAWKE. As I say, there was escalating concern over a period of several years that culminated in the issuance of a cease-and-desist order last year.

Director GILLERAN. I can appreciate your concern, Senator Sarbanes. I do think, however, that the bank regulators should be given time to prove that they can regulate appropriately in this area, because I think in order to be effective in this area, you must understand bank procedures, bank controls, and bank systems. Therefore, the bank regulators have the best staff to do that with.

I think it is not a question of our not having the staff to do it. I think you are concerned about whether or not we have sufficient emphasis on this important area and whether or not we are giving it the correct amount of attention. I can tell you that, for the OTS, I believe we are, but we have to prove ourselves in this area. And

therefore, I would ask that Congress give us more time to prove that we can do this.

Chairman SHELBY. Do you have that time? Do we have the luxury of time?

Director GILLERAN. Well, I think that we have the best staff, I think, that you can look to us to get this job done, because these are people that know the financial institutions and know the systems and know what to look for. So you have the best people to do it here.

Chairman SHELBY. I understand that, but do we have that luxury of time in our war against terrorist financing?

Director GILLERAN. If you were to change the regulatory structure and create a new agency, it would be creating a hiatus of time.

Chairman SHELBY. No one has suggested that, that I know about.

Director GILLERAN. I think that is what this started from.

Senator SARBANES. Didn't the Inspector General of Treasury criticize the OTS last year for insufficient follow-up on Bank Secrecy Act problems?

Director GILLERAN. That was true, Senator, and I would say that we appreciated that review so that it turned us to a problem that I mentioned earlier, and that is the criticism that was made of us was that we had given some smaller institutions more than one examination period to correct their problem. For instance, the Act requires an institution to have a sufficient training program, it requires the institution to have sign-offs. In no instance was there any thrift that was involved in any money laundering, and that the criticism was to procedural items.

Now, I agree with the GAO. They were criticisms. But the criticism was the fact that the thrift did not correct their lack of training or their lack of sign-offs within one examination period. We have since addressed ourselves to that criticism.

Senator SARBANES. Mr. Chairman, I mean, we have all the regulators here and of course the agenda is a full scope of their responsibilities, I guess, with a particular focus on safety and soundness. But I would suggest that we may want to do a hearing specifically addressed to money laundering and the Bank Secrecy Act. We could go through very carefully with each of them exactly what they are doing and where they may have fallen down on the job and what more needs to be done. This is an important area of activity, obviously, and if something happens, you can bet your life it is going to be an important area of activity.

Chairman SHELBY. I think it is a good suggestion and we would be properly prepared for it. Chairman Sarbanes wanted to comment.

Senator SARBANES. Chairman Greenspan.

Chairman SHELBY. Greenspan. I am saying Sarbanes. He was the Chairman. I do not want him to be the Chairman in the future.

[Laughter.]

But he could be, you know. If he is, I will be respectful.

Chairman GREENSPAN. Mr. Chairman, I would just like to associate myself with some of the remarks of my colleagues. To be sure, we do not have time. But bringing in a third party at this stage, in my judgment, is not going to expedite this process. And the rea-

son, essentially, is that enforcing the Bank Secrecy Act invariably requires that you, in the normal examination process, sense anomalies in the system, things that look just a bit off, things that do not seem to square. And it is when you dig into those fissures in the system that you come up with embezzlement, you come up with money laundering, you come up with illegalities which the process endeavored to hide. I do not think somebody coming in from the outside can do it by some shortcut method. They have to go through a whole examination process. I do not think you can separate examination of banks, under the Bank Secrecy Act, from the overall examination process.

Chairman SHELBY. In other words, what you are saying, as I understand it, have the right mentality, culture to do the job, it is just a question of adding this on to their work. Is that correct?

Chairman GREENSPAN. Exactly, yes.

Senator SCHUMER. Mr. Chairman.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. I have just one question here, really, directed at Mr. Hawke. You said that you had a risk-based approach. In reference to the Chairman's comment, Riggs Bank was high-risk because of its location. And yet, it is my understanding that there were two checks on Riggs in relation to Bank Secrecy, one in 2000 and then one in 2003, and most of the bad stuff occurred between. Is it that you are understaffed? I mean, why, with a particularly high-risk bank, are we supposed to wait 3 years between examinations? Or am I wrong in the——

Comptroller HAWKE. I do not think that is right, Senator Schumer. Riggs was regularly examined by the OCC and, as I said, over——

Senator SCHUMER. This was for Bank Secrecy Act violations.

Comptroller HAWKE. Over a period of 3 or 4 years, there was escalating concern about Bank Secrecy Act compliance issues at Riggs. In retrospect, one could easily wish that we had been tougher earlier. But it was not that issues of Bank Secrecy Act compliance went unnoticed. It was that supervisory attention focused initially on internal control systems and training, and concern gradually escalated over that period of time.

Senator SCHUMER. If I am right—and maybe I am wrong, but if I am right that there was one examination for Bank Secrecy in 2000 and then the next one was 2003 for a particularly high-risk bank would you say that would not have been enough?

Comptroller HAWKE. It probably would not have been enough. I do not think——

Senator SCHUMER. Could you check and get back in writing about that?

Comptroller HAWKE. I would be happy to.

Senator SCHUMER. That would be great.

Chairman SHELBY. Mr. Hawke, did your examiners call in the FBI or did the FBI call in your examiners? In other words, who got into Riggs first? Was it FBI or was it your examiners examining the bank because of possible violations of the Bank Secrecy Act?

Comptroller HAWKE. I cannot tell you definitively, Mr. Chairman.

Chairman SHELBY. Would you do that for the record?

Comptroller HAWKE. I would be happy to.

Chairman SHELBY. Okay, it is important.

I want to move to deposit insurance. Senator Johnson is not here right now, but he made part of that his opening statement.

Last year, I asked each one of you to work with the Treasury to develop a consensus deposit insurance reform proposal. I thought that the proposal that was produced would provide meaningful, comprehensive reform. Do you still support that proposal, Chairman Greenspan?

Chairman GREENSPAN. We do, Mr. Chairman.

Chairman SHELBY. Mr. Hawke.

Comptroller HAWKE. Yes, Mr. Chairman.

Chairman SHELBY. Mr. Powell.

Chairman POWELL. Yes, sir.

Chairman SHELBY. Mr. Gilleran.

Director GILLERAN. Yes, sir.

Chairman SHELBY. Mr. Dollar.

Mr. DOLLAR. Yes, sir. We seek parity with the other Federal insurance fund.

Chairman SHELBY. We have discussed many ways in which banks have become smarter—you know, they have learned, grown healthier and better able to operate in a safe and sound fashion. Should we be mindful of creating inappropriate incentives and disincentives in deposit insurance reform legislation? In other words, one of the statements around has been that if the reform package passed, it would increase basic coverage as well as coverage for retirement accounts, to amounts such as $150,000 to $250,000. Would banks lose some of their discipline here and management skills, and slip back? I do not know. And especially all that bothers me in view of the average savings account that is ensured across the country. I do not know exactly what it is. I would bet you would know. Is it less than $30,000?

Chairman POWELL. Yes, sir.

Chairman SHELBY. We are talking about running the rates up past $100,000—I am not, but others are. And then retirement accounts or whatever are even past that. And that is troubling to me. Somebody sat on this Committee during the thrift debacle, the former Chairman did.

Chairman POWELL. Mr. Chairman, a couple of comments. I was in the industry, on the other side.

Chairman SHELBY. So you know.

Chairman POWELL. And oversaw an institution that almost failed. A couple of comments. I cannot imagine a CEO of an institution who would take undue risks because coverage increased. Most CEO's have a vested interest in that institution in the form of ownership and reputation. It would be committing suicide——

Chairman SHELBY. But the insurance is really assuming part of the risk, is it not?

Chairman POWELL. It is assuming part of the risk, but I can assure you if the institution fails, your net worth goes to zero.

Chairman SHELBY. I understand.

Chairman POWELL. And also you are subject to some other issues. But our view at the FDIC has been clearly, from the very beginning, that the coverage issue should be indexed. I would hope that——

Senator SARBANES. Is that the position—the Chairman put a question earlier about the proposal that was——

Chairman SHELBY. That was not in the proposal.

Senator SARBANES. And you all said you were for that proposal and now you are telling us you differ on an important aspect of the proposal.

Chairman SHELBY. We did not—as I recall, that did not call for indexing, even retroactively or prospectively.

Chairman POWELL. I think it was silent on the coverage issue. I could be wrong about that.

Chairman SHELBY. It was not silent at the table.

Chairman POWELL. Our issue has always been that it should be indexed.

Chairman SHELBY. That is the FDIC you are speaking of.

Chairman POWELL. Yes, sir. I think it is unfortunate that this particular part of deposit insurance reform gets an enormous—and I am not saying it is not important, but it gets an enormous play when other parts of deposit insurance reform, in my view, are more critical to pass, that we can serve the industry, and that those components of deposit insurance reform be passed. I think it is past time that we need to focus on those issues that Senator Johnson and you have spoken about.

Chairman SHELBY. I know my time is running fast, but protection of the banking system generally. Chairman Greenspan, in your opening statement you referred to the interagency whitepaper on sound practices to strengthen the resilience of the U.S. financial system. Mr. Hawke, you similarly referred to the issue of resilience of the financial system, although within the context of Basel II. I would like to focus my question briefly on the whitepaper to which Chairman Greenspan referred.

It has now been a year since the final report was concluded and 2 years since the draft report was on the street and available for industry comments. Sound practices outlined in the report set forth certain goals for recovery and resumption of operations following a major regional disaster. Specifically, business activities of core clearing and settlement organizations, according to the recommendations of the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission, should be resumed within the same business day as the disruption, with the goal to resume operations within 2 hours.

While I understand this goal is consistent with pre-September 11 policy within the banking industry, I would be interested in hearing your views on the progress industry has made to date in meeting the key objectives of the whitepaper. Have the goals of the whitepaper been taken to heart by the industry, and are the recommendations being implemented? Have the legitimate considerations of cost proven prohibitive to meeting these goals and, if so, what measures, including incentives, would you recommend for facilitating progress?

That is not too much for any of you. I will start with Chairman Greenspan.

Chairman GREENSPAN. I think you should start——

Chairman SHELBY. Okay, you defer to Mr. Hawke.

Chairman GREENSPAN. Go ahead. I will follow up on his remarks.

Chairman SHELBY. He handed you a good one, then. Go ahead.

Comptroller HAWKE. Well, I was waiting to hear what Chairman Greenspan had to say.

The whitepaper set forth a number of expectations and time frames for financial institutions with respect to clearing and settlement activities, recovery and resumption objectives, and other criteria, as well. With respect to progress at national banks, all of our large national banks that are covered by the paper have either already satisfied those requirements or are making substantial progress in meeting those goals. Our evaluation is that they are all taking this effort very seriously and devoting substantial resources to complying with the parameters that were set out in the whitepaper.

Chairman SHELBY. Chairman Greenspan, do you agree with that?

Chairman GREENSPAN. Yes, I do. I think we are fortunate in the sense that the price of technology has been coming down fairly dramatically and it has enabled redundant systems to be developed off-site in many different areas. And it is not only the individual banks who are addressing this issue, but also those of us who were involved in the payment systems, specifically the Federal Reserve banks, have also been engaged in an extraordinarily intensive endeavor to make certain that we insulate our systems from various different types of shocks. So far, we have, obviously, run into various different types of problems and they were handled well. We recovered remarkably well out of September 11 despite the fact that there were numbers of weaknesses in the system. And we seem to be gradually getting to the point where the flexibility and the resiliency of the system is increasing every month.

Now, whether that means we will be able to come back immediately from any shock, I do not know the answer to that. But clearly, we are heavily involved in the payment system and the major banks in the system, which are all acutely tied to this problem. I think we are making major progress. Will we ever get to the point where we will say we are fully insulated? The answer is no, we will not.

Chairman SHELBY. Sure.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. Just one brief question. This bothers me, so I want to come back at it a little bit with Chairman Greenspan. And that is, again, this deficit and how it is going to affect the medium-term nature of the recovery—not in the next 6 months, but in the next 18, or year or two.

I want to mention an editorial from April 15 *Financial Times,* hardly a liberal mouthpiece or Democratic mouthpiece. They say, But as the Bush Administration chooses not to hear, the problem is not the short-term deficits run up now as a result of the global economic slowdown, but those that respectable economists predict will persist even when the U.S. economy has returned to full employment. The borrowing spree will push up real interest rates on dollar assets, constraining investment and consumption such that the net medium-term effect of the recent U.S. tax cuts on economic growth will probably be negative.

Now, that seems to me to be—when I go around and talk to people on Wall Street and economists and experts, that is not the universal opinion, but I would say—it may not even be the majority opinion, but it is the mode. You see more people saying that than any other opinion. And it seems to me, that is what the markets are feeling right now.

Should we be doing something about that now? Do we not have to worry that interest rates will—you will be forced to raise interest rates too quickly and the longer-term recovery that we had in the late 1990's, because of fiscal responsibility, will be cut short?

Chairman GREENSPAN. Senator, I am concerned that we first put into place a process which will enable us to address not so much the short-term deficits, which I think are worrisome but the longer-term deposits. The short-term deposits pale against the problems in the longer-term future. I think it is probably not very fruitful to talk about programs or what we are going to do until we get a budget process in place with PAYGO back in the structure of the decisionmaking, and discretionary caps, which served us so well in the earlier period.

Senator SCHUMER. Would you say those should be on the tax side as well as on the spending side?

Chairman GREENSPAN. My view is that what we should reintroduce are the PAYGO and discretionary cap provisions which effectively expired in September 2002, which includes both spending and taxes. And if we fall short on that, we are going to find that we will not be able to maintain the degree of discipline which is going to be necessary to address what is a very significant problem out there.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Powell, I want to ask you about payday lending. The OCC, the OTS, and the Fed have all taken action to ensure that payday lenders do not rent charters from the depository institutions which they supervise. Why does the FDIC continue to allow banks that it supervises to engage in payday lending practices when the other regulatory agencies strongly discourage partnerships between payday lenders and Federal thrifts, national banks, and State-charter members of the Federal Reserve? You are the only regulator who is turning a blind eye—more than turning a blind eye, really, allowing this rent-a-charter practice to go on. Why are you doing that?

Chairman POWELL. Senator, we supervise in excess of 6,000 institutions. There are 11 institutions that currently have arrangements with payday lenders. We have examined those institutions on several occasions. We have issued guidelines for payday lenders that are much more harsh as relates to capital allocation, to procedures and policies, to discrimination, to fairness, to anything that might be illegal as it relates to the existing law. We have asked one of those payday lenders to discontinue that activity.

Senator SARBANES. Yes, but the others do not think they should be doing it at all. They are not allowing this rent-a-charter practice to go on. The Center for Responsible Lending estimates that the

debt trap of payday lending, those borrowers who have five or more payday loans per year, cost borrowers in excess of $3 billion a year.

Chairman POWELL. We have not——

Senator SARBANES. What are you doing about rollovers? What are your rules on that?

Chairman POWELL. We have stringent guidelines as it relates to rollovers. We look for violations of usury laws. We look for violations of any of the laws. And when we find those violations, we ask them to stop.

Senator SARBANES. What is your rule on the number of payday loans that can be made to the same borrower in a single year?

Chairman POWELL. I cannot answer that specifically——

Senator SARBANES. Do you have a rule?

Chairman POWELL. —but I will be happy to get to you——

Senator SARBANES. Do you have a rule on that issue?

Chairman POWELL. I cannot answer that. But payday lenders are——

Chairman SHELBY. Excuse me, Mr. Chairman, could you furnish that for the record and Senator Sarbanes?

Chairman POWELL. I would be happy to. Payday lenders are not unique to the FDIC, in that under the shared national credits, payday lenders are part of shared national credits. They have—and we participate in—shared national credits, together with OCC and the Federal Reserve. And payday lenders are part of the shared national credits. So they are not unique as it relates specifically to the FDIC.

Senator SARBANES. Of the 11 FDI-supervised banks partnering with payday lenders, how many of them have you examined?

Chairman POWELL. All of them.

Senator SARBANES. All 11?

Chairman POWELL. Yes, sir.

Senator SARBANES. Do you examine them every year?

Chairman POWELL. Yes, sir.

Senator SARBANES. So each of those 11 has been examined within a year?

Chairman POWELL. I cannot specifically tell you that they have been examined to the calendar year, to the point, but they are examined on a regularly scheduled basis as we would examine any other institution.

I was just passed a note, Senator——

Senator SARBANES. Aside from the examining, what is the rationale for—all the other regulators do not think this practice should take place. You are the only one at the table who thinks it should go on. Now, what is your rationale to support your taking an odd-man-out position on this important issue?

Chairman POWELL. I think that the rationale is that they are meeting a need in the community that the marketplace has said is there. And it is our job to make sure there is no safety and soundness issues and no violation of the law.

Senator SARBANES. Without any regard to the exploitation that is taking place?

Chairman POWELL. Without any regard to——

Senator SARBANES. I mean, they are obviously coming in trying to use the Federal charter in order to get around State laws which

control those practices. Is that not right, Mr. Lavender? Do you know about this issue?

Mr. LAVENDER. I am familiar with the issue. And that is a concern that we have, that some institutions will——

Senator SARBANES. The States enact laws to guard their people from these payday lending practices, and then they go rent a Federal charter under the supervision of Federal regulatory authorities in order to get around those limitations. Is that not correct?

Mr. LAVENDER. In Tennessee, the payday lenders are a duly licensed entity that we regulate, that we can regulate.

Senator SARBANES. Okay, you do it a different way, then.

Mr. LAVENDER. Exactly, but——

Senator SARBANES. There are some States that prohibit them.

Mr. LAVENDER. We do have a concern that as banks continue to express an interest in getting into that business that they will affiliate with some of our payday lenders and thereby avoid the State regulation.

Senator SARBANES. Mr. Chairman, my time is running and I want to ask one more question, if I might.

Chairman SHELBY. You may.

Chairman POWELL. Mr. Chairman, pardon me, I have not answered Mr. Sarbanes's question.

Chairman SHELBY. Go ahead.

Chairman POWELL. Our guidelines requires a 60-day mandatory charge-off for payday loans.

Senator SARBANES. I want to ask this question of the panel people. Since 1992, total assets in the banking system have doubled, from $4.5 trillion to $9 trillion. Deposits have grown from $3.5 trillion to almost $6 trillion. Over that same period, the assets held by the five largest institutions have increased more than fivefold, and the deposits held have increased by 460 percent. The issue, I guess, is better put if we say in 1992 the five largest banks had 12 percent of the total assets of the banking system; today they have 32 percent. That is assuming these two mergers that are now pending go through. Similarly, in 1992, the five largest banks had 11 percent of the total deposits of the banking system, while today they have 31 percent. Does this level of consolidation and concentration cause any of you any concern?

Comptroller HAWKE. Mr. Chairman, Senator Sarbanes, let me take a first crack at that. There are two aspects to the issue. One is looking at it from a competitive point of view, in antitrust terms. The other is looking at it in terms of the ability to supervise and examine institutions of growing size.

On the competitive side, the numbers you are looking at reflect nationwide concentration levels. While it is true that concentration nationwide has increased, concentration in local markets has actually decreased over this period of time. I think Chairman Greenspan may have mentioned this earlier. We find that local markets, which are critically important for consumers and small businesses, are becoming less concentrated and more competitive, even as concentration on the national level is increasing.

From a safety and soundness point of view, there is no question that mega-banks present challenges for supervision. We already supervise some very, very large banks, and we have full-time resident

teams of examiners in these banks with a variety of specialists who are trained in particular aspects of the bank's business, such as capital markets, asset management, and the like.

The continued growth of mega-banks is certainly going to put a high premium on the training of specialists and on interagency cooperation. We will have to work closely with our colleagues at the Federal Reserve, as the holding company supervisor, and Chairman Powell has already mentioned the FDIC's concern with large banks, to make sure that we are taking a coordinated approach to supervision of these large banks. There is no question that the increased concentration in the banking system does present supervisory challenges. I think we are up to those challenges.

Senator SARBANES. Anyone else?

Director GILLERAN. My own reaction, Senator, is that having come from the smaller bank arena, having run one is San Francisco, I believe that a smaller institution has every capacity and capability of competing in the niches that it has selected for itself, and that a strategy of going head-to-head as a small bank against major banks and to compete on rates is not one that is successful very often.

Therefore, there is definitely an arena to service America's financial needs for small banks, and, therefore, small banks will always be with us, as long as we permit them to be there. And on top of that, they are very profitable.

So from the standpoint of the profitability of the investment, it is a good investment; and from the standpoint of servicing the public, it is very good because you must search for niches that the bigger banks are not servicing.

I believe that the growth of the major banks is not something that we should be afraid of. It is really the growth of the kind of mass-produced services that credit cards represent and other types of lending. But there is a niche out there for smaller banks that will always be with us, and they are doing it very well.

Senator SARBANES. Well, I am trying to anticipate a trend. If the consolidation were to continue at the same rate that it has been taking place, and if the total amount of assets in the system were to grow at the same rate, in 10 years' time the top five banks would control 65 percent of the total assets of the system.

Would that level of concentration be a matter of concern?

Mr. LAVENDER. Chairman Sarbanes, as a State regulator I am concerned today about this level of concentration. I agree from a competitive standpoint that our small community banks do an excellent job, another year of record profits. From a standpoint of choice, while we continue to see a concentration, I do believe in free market enterprise where let the free market reign. And, therefore, citizens have to choose where they are going to do their banking.

But I would like to go to the point Comptroller Hawke mentioned, and that is supervision and examination. As a State regulator, I am concerned that my Federal counterparts have the capacity, the staff, the budget, to continue examination, the depth of examination of these entities as they continue to consolidate.

I hate to sound like a broken record today, but, again, looking at the preemption and the inability of not only this department but also Attorneys General to enforce consumer protection rights for

our consumers, I am concerned not only about the bank and the industry; but I am also concerned about the consumer as well. And I do not have a comfort level today that with continued concentration the industry is positioned to supervise and examine adequately.

Senator SARBANES. Thank you very much.

Chairman SHELBY. Thank you, Senator Sarbanes.

I am going to go back to Chairman Sarbanes—not Chairman Sarbanes. I have it on my mind, haven't I?

[Laughter.]

We have a roomful of people here and they are all chairmen.

China, Chairman Greenspan, I have been told they consumer 40 percent of the coal in the world, 25 percent of the scrap metal, and a similar amount of precious ores and other metals, not counting oil. I do not know how much oil and gas they are consuming, but as they continue to grow industrially, they will consumer more.

Some people have said that because of China, not just because—that they have put—they have driven the price of scrap metal and other things up. I guess the question is: Will they absorb this because of their labor market, because there is no real pressure on them in the labor market, 1.3 billion people, a lot of people looking for work? Will they let their currency float within some kind of an upward band? Or what do you predict? Or you do not. You see what I am getting at?

Chairman GREENSPAN. Yes. First of all, let us recognize that there has been a particular surge in the demand for metals which, to a large extent, reflects the marginal demand coming from China as it is endeavoring to move toward a market economy in some of the older industries. The reason they are absorbing such a significant part of the steel scrap in the world and, indeed, iron ore and coke and all of the basic ingredients, is that that industry has not been growing all that rapidly around the world, and they are now moving into a state of industrial advance which creates very heavy demands for what we 50 and 100 years ago went through and others did as well.

I think they are adjusting to an early stage of an industrial dynamic which is going to rapidly change. They are moving and in a very impressive way.

The major problem that they have is not the reflection so much of the demand for commodities. It is that there is a concern increasing in China that they are overheating as a consequence of a fairly rapid increase in the money supply, which has been going up approximately 20 percent a year.

They do not have the flexibility that we do. They have got still very significant proportions of their output produced by State-run enterprises, which by their very nature are rigid. They recognize this, and they are moving to try to find the appropriate balance. And implicit in that there is clearly going to be greater flexibility of their exchange rate, there is clearly going to be at some point, hopefully sooner rather than later, a reduction if not the ultimate removal of the capital controls that they impose on Chinese residents in the accumulation of foreign assets. But it is a very delicate process because their banking system is not in robust shape.

So they are moving, as best as I can see, in the right direction in endeavoring to contain this, and I think it is in everybody's interest that China move forward but not move forward in a unbalanced way, which could create great difficulties for them. And if they run into trouble, they will create significant problems for Southeast Asian economies, for Japan, and indirectly for us.

Senator SARBANES. Mr. Chairman.

Chairman SHELBY. Go ahead.

Senator SARBANES. Mr. Chairman, is it the case that if they reset the peg rather than going immediately toward flexible rates, that that would avoid dangers to the banking system that are constantly put forth as a reason why they cannot move now or in the near future to flexible rates? But they could reset the peg without those problems, could they not?

Chairman GREENSPAN. They could, but they would have to be careful where they set it, because if they set it with too small a change from where we are today, the markets would quickly presume that there are going to be further adjustments and they will get a very large increase in capital inflows, which will create even a greater problem.

There is, I would agree, a peg level which probably prevents that from occurring. I do not know where that is. I am not sure that they do. But they are working toward some resolution of the type you are suggestion, as best I can judge.

Chairman SHELBY. Chairman Greenspan, when you use the term "peg," is that like trading within a certain band?

Chairman GREENSPAN. Well, "peg" usually means a very narrow band, and the Chinese insist that they have a flexible exchange rate. But it is flexible in a very, very narrow range.

Chairman SHELBY. Gentlemen, thank you very much for your contribution. We look forward to a number of questions that we will ask you for the record, but we are also waiting, Mr. Hawke and Mr. Powell, both of you, for answers to some questions. Thank you.

The hearing is adjourned.

[Whereupon, at 5:14 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

Thank you, Chairman Shelby for convening this hearing on the current condition of the banking and credit union industry. I am pleased to have the opportunity to hear from our banking and credit union regulators to hear about issues facing the United States banking system both domestically and internationally. It has been nearly 3 years since we have taken a look at the industry and many events have occurred that could have greatly shaken the economic stability of this country . Yet, the banking system remains strong and able to meet the demands of its customers.

The year 2003 saw net profits of over $100 billion for commercial banks and the demand for household credit has remained strong. Additionally, the total volume of problem assets in commercial banks has declined steadily, and sustained confidence in the capital markets is evident through risk measures derived from prices of stocks, debt securities, and credit default swaps. The significant decline in loan losses and credit losses has signaled the industry's responsiveness to the lending experiences of the 1980's and 1990's. Overall, the banking industry remains strong, and that is credited to the good work of our Nation's banking and credit union regulators.

In order to continue this pattern of success, it is imperative that we maintain a disciplined examination of both the banking system and the modernization of our entire financial system. I would like to thank the witnesses for appearing before the Committee today. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you Mr. Chairman for holding this hearing and I would like to thank all of our witnesses for joining us today.

I believe holding these state of the banking industry hearings is a very fine and necessary tradition of this Committee. It is very worthwhile to hold these hearings, so during the good times, we are prepared for the bad times. I am very glad that all three of the Chairman during my tenure on this Committee have embraced this tradition.

For the most part, the state of the industry seems pretty healthy. There are things we need to keep an eye on, but for the most part, the safety and soundness of our institutions is not a concern. I personally have some concerns about small banks, which are crucial to the financial health of Kentucky. There have been many mergers and acquisitions of small banks. My small banks are also becoming more and more concerned about the competing pressures they are facing. The small community banks are the only source of capital in many areas of my State, and it is crucial that ensure their health and safety.

Once again deposit insurance is an issue we are facing. I fully support deposit insurance reform. However, I am very troubled by attempts to raise the insurance coverage limits. I have been Chairman Greenspan's most vocal critic on monetary policy. But I agree with him wholeheartedly on raising insurance coverage. I believe we agree so strongly about this, along with the Chairman and Ranking Member of this Committee, because all of us had to deal with the S&L bailout in the late 1980's. I think I can speak for all of us who were in the Congress at that time and say that none of us wants to go through that again.

I am very interested to hear about your specific sectors of the industry, and if there is anything that we as Members of this Committee can do to help financial institutions grow and remain profitable with jeopardizing safety and soundness. All of you are the experts of the your sector. You know your sector much better than we do. I look forward to hearing your opinions.

Thank you again for holding this hearing Mr. Chairman and I thank all of our witnesses for testifying today.

PREPARED STATEMENT OF SENATOR MIKE CRAPO

I look forward to your testimony on the condition of the banking and credit union industry. In addition, I am interested in what issues you believe should or should not be considered in a regulatory relief package to improve the condition of the banking and credit union industry. As you are all aware, the House recently passed the Financial Services Regulatory Relief Act by a vote of 392 to 25.

A regulatory relief package should eliminate outdated, ineffective, or unduly burdensome regulations that are not justified by either the need to ensure safety and soundness or to provide consumer protection.

Outdated laws and regulations only serve to squander scarce resources that could otherwise be used to provide financial services demanded by customers. The banking industry estimates that it spends somewhere in the neighborhood of $25 billion annually to comply with regulatory requirements imposed at the Federal and State levels.

While finding a consensus on these issues may be difficult, I look forward to working with you and my colleagues on this Committee to begin the process of taking up regulatory relief in the Banking Committee.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 20, 2004

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to be here this morning to discuss the condition of the U.S. banking system and various related matters. They include improved risk-management practices of banks, the current status and direction of our regulatory efforts to revise capital standards for internationally active banks, deposit insurance, and the ongoing consolidation process within our domestic banking industry.

Growth in the size and complexity of the largest U.S. and foreign banking organizations, in particular, has substantially affected financial markets and the supervisory and regulatory practices of the Federal Reserve and other bank regulatory agencies around the world. It has, in part, required authorities to focus more than before on the internal processes and controls of these institutions and on their ability to manage risk. Only through steady and continued progress in measuring and understanding risk will our banking institutions remain vibrant, healthy, and competitive in meeting the growing financial demands of the Nation while keeping systemic risk at acceptable levels. Therefore, the regulatory authorities must provide the industry with proper incentives to invest in risk-management systems that are necessary to compete successfully in an increasingly competitive and efficient global market.

When I last discussed the condition of the banking industry with this Committee in June 2001, the industry's asset quality had begun to decline, but from a relatively high level, and banks were generally well-positioned to deal with the emerging problems. Moreover, as early as the late 1990's, both the industry and bank supervisors had begun to address the slippage in credit standards that was one of the causes of the drop in asset quality. By most measures, this was an unusually early stage in the economic cycle to begin addressing such deterioration.

Today, with the benefit of hindsight, we can see that the weaknesses I cited then have indeed been mild for the banking system as a whole and that the system remains strong and well-positioned to meet customer needs for credit and other financial services. During the past 2 years, in particular, the industry extended its string of high and often record quarterly earnings. For the full year 2003, commercial banks reported net profits of more than $100 billion while maintaining historically high equity and risk-based capital ratios and enjoying brisk asset growth. Although the demand for business loans and the underwriting of equity securities have been weak over the past few years, banking organizations have continued to benefit from strong demand for household credit, not least for residential mortgage products as interest rates declined substantially.

Moreover, the volume of problem assets in commercial banks declined each quarter last year, including a drop in the fourth quarter of nearly 10 percent, which brought the ratio of problem assets to total loans and foreclosed assets to less than 1 percent—its lowest level since year-end 2000. As a result of this favorable performance, both the size and the number of bank failures in recent years have been exceptionally small. Last year, for example, only two banks, with combined assets of just $1.5 billion, failed.

The results of last year's interagency review of large syndicated loans and internal reports about the level and distribution of their criticized and classified credits lead us to expect still further improvement in the industry's asset quality this year. Notably, the pool of "special mention" credits that are weak but still performing (and which tend to produce the more serious problem assets) has shrunk both in the annual Shared National Credit review and in the quarterly bank reports.

Risk measures derived from prices of publicly traded bank securities—stocks, debt securities, and credit default swaps—also signal that market participants are taking an increasingly positive view of the future of banks. Indeed, these measures suggest the lowest level of market concern about these companies that we have seen during the 5 years in which we have tracked them.

The banking industry's relatively benign experience with loan losses these past few years may not be surprising given that the recession was mild by most measures. The experience is more notable, however, when one considers the broader range of shocks and developments that have occurred during this period, including the September 11 attacks, Argentina's credit default, the continuing shift by large and not-so-large firms in this country from bank to capital market financing, and the concentration of recent economic pressures on specific industries and business sectors. These events tended to reduce the overall quality of corporate loan portfolios at banks and contributed significantly to banks' efforts to improve their measurement and management of risks, especially after the substantial credit losses they suffered in the late 1980's and early 1990's. These efforts, aided by the continued trend toward industry consolidation, helped moderate previous concentrations of credit exposures in bank portfolios and fueled greater use of new methods of hedging and managing risk.

At present, credit risk-management practices are perhaps least developed in measuring risk associated with exposures related to construction projects and to the financing of commercial real estate, which have grown rapidly, particularly among regional and community banks. At all banks, such lending represented nearly 19 percent of all bank loans at year-end 2003—the highest level thus far recorded—and accounted for essentially all the loan growth last year at banks with less than $1 billion in assets.

Despite the limited development of formal risk-management practices, credit standards applied to these loans have apparently been quite high. At least, we see as yet no signs of rising credit losses from such lending, and supervisory and market sources indicate that the poor lending practices of the late 1980's and early 1990's have been largely avoided. Nonetheless, the historical record provides ample evidence of the risks associated with this form of lending and of accumulating large credit concentrations in any form of exposure. Supervisors continue to monitor these concentrations and the lending practices and market conditions that will ultimately determine their effects on the banking system.

These and other gradual changes in the balance sheets of banks, along with the sustained decline in market rates, helped compress net interest margins at many banks, as they chose not to reflect the full effect of lower market rates into rates paid on deposits without a specified maturity. As a percentage of earning assets, net interest income of all insured commercial banks declined 27 basis points last year, to 3.80 percent, the lowest level in more than a decade. Although this compression eased slightly during the fourth quarter, we cannot yet tell whether margins have begun to rebound.

This compression of margins needs to be understood in the fuller context of the banks' sensitivity to changes in interest rates and, in particular, the effect of historically low rates on banks' financial performance and condition. At the same time that declining rates were adversely affecting the industry's interest margins, they were also spurring growth in mortgage-related assets and associated loan-origination fees and were producing significant capital gains in bank investment portfolios. Lower interest rates, along with the decline in equity valuations experienced during 2000–2002, also contributed to a substantial inflow of liquid deposits by lessening their opportunity cost.

Under these circumstances, and with a steep yield curve, a banker's natural inclination might be to shift the credit mix and extend the maturity of assets in an attempt to bolster asset yields. To some extent such actions have been taken. Residential mortgage loans and pass-through securities have increased from 17.5 percent of assets in 2000 to 20 percent in 2003. But the manner in which this growth has occurred suggests a balanced assessment of risk. Call Report data indicate that a substantial portion of the increase in mortgage assets has been in adjustable-rate or shorter-term mortgages, particularly at smaller banks. For their part, large institutions also have significant capacity to offset on-balance-sheet exposures through off-balance-sheet transactions.

All told, the available data, industry and supervisory judgments, and the long and successful experience of the U.S. commercial banking system in dealing with changing rates suggest that, in general, the industry is adequately managing its interest rate exposure. Many banks indicate that they now either are interest-rate neutral or are positioned to benefit from rising rates. These views are based partly on specific steps that they have taken to adjust portfolios and partly on judgments about

the effects that rising interest rates would have in easing pressure on interest margins. That is, many banks seem to believe that as rates rise—presumably along with greater economic growth—they can increase lending rates more than they will need to increase rates paid on deposits. Certainly, there are always outliers, and some banks would undoubtedly be hurt by rising rates. However, the industry appears to have been sufficiently mindful of interest rate cycles and not to have exposed itself to undue risk.

In other areas, earlier concerns about the effect of the century date change on computer systems, the destruction of infrastructure in the September 11 attacks, and the increased volume and scope of banking transactions generally have also required financial institutions, particularly large institutions, to devote more effort and resources to contingency planning in order to ensure the continuity of their operations. Last fall's power outage and Hurricane Isabel may have offered only limited tests of the industry's improved procedures, but financial firms handled those challenges extremely well.

As the Nation's central bank and as a bank supervisor, the Federal Reserve has a strong interest in the continued operation of the U.S. financial system after a disruptive event. To that point, last year, the Federal Reserve Board, the Securities and Exchange Commission, and the Office of the Comptroller of the Currency jointly issued an interagency paper, "Sound Practices to Strengthen the Resilience of the U.S. Financial System." That paper provides guidance that supplements long-standing principles of business continuity planning and disaster recovery and is directed at the entities that pose systemic risk to the financial system, particularly in the context of their clearing and settlement activities. Through the Federal Financial Institutions Examination Council, we also issued revised examination guidance on business continuity planning. This guidance covers a variety of threats to business operations, including terrorism, and will be used in future examinations.

Improved Risk Management in Banks

Independent of continuity planning for unusual events, the basic thrust of recent efforts to improve the management of risk has been better quantification and the creation of a formal and more-disciplined *process* for recognizing, pricing, and managing risk of all types. In the area of credit risk, by providing those involved with a stronger, more-informed basis for making judgments, this development has enhanced the interaction between lending and risk-control officers. Operating with better information does not mean that banks will necessarily reduce credit availability for riskier borrowers. It does mean that banks can more knowingly *choose* their risk profiles and price risk accordingly. Better, more-informed lending practices should also lead to a more-efficient allocation of scarce financial capital to the benefit of the economy at large.

Greater internal transparency and quantification of risk have helped bank managers monitor portfolio performance and identify aspects of the risk-measurement and credit-granting process that begin to move off track. As risk-measurement and disclosure practices evolve, investors and uninsured creditors will also become more motivated and better positioned to understand the risk profile of banks and convey their own views of banking risks. Indeed, accommodating greater and moreinformed market discipline is an important goal of bank supervisors.

Perhaps most important, better risk management has already begun to show real potential for reducing the wide swings in bank credit availability that historically have been associated with the economic cycle. Sound procedures for risk quantification generally lead to tighter controls and assigned responsibilities and to less *unintended* acceptance of risk during both the strengthening and weakening phases of the business cycle. Earlier detection of deviations from expectations leads to earlier corrective actions by bank managers and, as necessary, by bank supervisors.

Better methods for measuring credit risk have also spurred growth in secondary markets for weak or problem assets, which have provided banks with a firmer, sounder basis for valuing these credits and an outlet for selling them and limiting future loss. Insurance companies, hedge funds, and other investors acquire these assets at discounts that they judge are sufficient to meet their expected returns and balance their portfolio risks. The result is greater liquidity for this segment of bank loan portfolios and the earlier removal of weakening credits from bank balance sheets. Portfolio risks have also been increasingly hedged by transactions that do not require asset sales, such as derivatives that transfer credit risk.

With greater use, more-thorough review, and more-extensive historical data, risk modeling has improved in accuracy and will continue to do so. Supervisors are also learning these techniques and are pressing banks to improve their own methods and systems to keep up with the latest developments. In the United States, our leading banking organizations began the process years ago and, in many respects, were in

the vanguard of the effort worldwide. Nevertheless, they and the risk-measurement process itself have much further to go.

Recent initiatives of the Basel Committee on Banking Supervision to revise international capital standards have helped focus attention on risk-measurement practices and have encouraged further investment in this area. Moreover, the very improvements in technology that facilitated better bank risk measurement and management have undermined the current regulatory capital regime by creating transactions and instruments that were not conceived when the current regulatory standard was developed.

Although these developments have sometimes helped banks circumvent existing rules, they have also enabled banks to hedge portfolio risk in ways that the current accord does not address well. As a result, the current regulatory capital standard is increasingly unable to establish capital requirements for our largest and most-complex banking organizations that reflect their true underlying risks. We need a more accurate, more risk-sensitive measure of capital adequacy to provide these institutions with appropriate risk-management incentives and to provide ourselves with a more reliable basis for supervising them in a way that focuses on true risks. In the process, such a measure should also enhance our efforts in taking prompt corrective action. For all these reasons, I believe the U.S. banking agencies must remain committed to the process of developing and applying a revised regulatory capital standard for the world's international banks.

Proposed Capital Standards

Last summer, the U.S. banking agencies took another step toward adopting the new capital standard by issuing for public comment an advance notice of proposed rulemaking (ANPR). The conception and design of the proposed standard, referred to as Basel II, are based on techniques developed in recent years by the largest banks, especially those, as I noted, in this country. As the scale and complexity of their activities grew, the banks needed to find better and more efficient ways to understand, manage, and control their risk-taking activities; to promote and respond to the emergence of new markets, such as those for securitized assets; and to make greater use of available technology and financial theory in measuring and managing their risks.

Before the agencies issued the ANPR, numerous changes in the proposed Basel II Accord had already been made in light of earlier comments. Reflecting the comments received on the ANPR, the Basel Committee agreed to extend the period for reaching an agreement in principle until mid-2004 to permit more time for revisions of the proposal to be formulated. Indeed, we have already negotiated some major changes in the international proposal to reflect U.S. public comments. These changes include the adoption of a framework based on unexpected loss and a revised set of rules on securitization. We have also modified the implementation process to ease the burden on banking organizations that operate across borders. These technical changes were high on the list of modifications suggested by commenters.

The shift from a combined "expected" and "unexpected" loss framework to one that focuses on unexpected loss only is crucial to ensuring that the *regulatory* capital framework is consistent with standard *internal* banking practices, both here and abroad. That change will also simplify other parts of the proposal. The modification on securitization was imperative to permit U.S. banks to continue participating in important funding markets that they pioneered and to ensure a prudent risk-sensitive capital treatment for securitization exposures. Beyond these achievements, working groups in Basel are considering other U.S. proposals related to refining measures of expected loss, an issue that a number of commenters raised. The U.S. agencies are still trying to reach a consensus on a revised proposal for capital charges on retail credit to put before our colleagues in Basel. The Federal Reserve, for its part, will continue to make every effort to reach consensus on this issue that is both risk-sensitive and workable.

I believe that all the Federal banking agencies are committed to achieving a revised accord that reflects the realities of the 21st century; that meets our needs for a safe, sound, and competitive banking system; and that addresses the legitimate concerns of the industry. The Federal Deposit Insurance Corporation has raised important issues about capital adequacy, and the Office of the Comptroller of the Currency has expressed significant concerns about a capital structure that may inadvertently disrupt retail credit operations of banks. All the agencies are addressing these concerns by jointly developing proposals to bring to Basel. In working to reach full agreement among ourselves, and ultimately with our colleagues abroad, we all seek a solution that promotes sound banking practices and that we can adequately implement and enforce. I hope that in the days ahead the agencies can close the gap on credit cards within such an overarching framework.

If we can do so, the Basel Committee should be able to reach agreement in principle on a new proposal around mid-year, and the U.S. banking agencies expect to evaluate that proposal through another "quantitative impact study" that we plan to conduct at large U.S. banks this fall. Committee Members are aware that this survey and public comments on a forthcoming Notice of Proposed Rulemaking may raise still further issues that will need to be addressed before we can implement Basel II in the United States. Of course, other countries have their own national and European Union-wide review processes to conclude, and those consultations too, may raise issues that will require additional attention.

As this Committee knows, the U.S. agencies have proposed that in this country the most-advanced version of Basel II is to be required only of the largest, most-complex banking organizations, although we anticipate that some of the other larger banks also will choose to adopt that version. Non-adopters in the United States will continue to operate under the current capital rules. The current regulatory capital regime, as I noted, has become less effective for the largest organizations while consolidation has sharply increased the scale and scope of their activities. In this country, the Basel II proposal focuses on them. The current rules remain appropriate and prudent for other banking organizations in the United States, and the agencies have decided that imposing the cost of new rules on these banking organizations does not pass a cost-benefit test.

Nonetheless, change in the procedures for calculating regulatory capital for larger banks creates uncertainty among those entities to which the new rules would not apply. The comments we received on the ANPR and from the Congress last year indicate that some smaller banks are concerned that their competitive environment will change. More specifically, these fears include the possibility that Basel II will induce adopters, who are likely to have reductions in regulatory capital requirements, to redeploy their capital by acquiring nonadopters or to gain a competitive advantage, particularly in the markets for small business and residential mortgage loans.

To judge the merits of these concerns, the Federal Reserve conducted two technical and empirical analyses of the underlying issues and made the papers available to the public last month; Congressional staff members were also briefed. A third study will be completed shortly, and a fourth will commence soon.

The first of these papers, dealing with mergers and acquisitions, found virtually no statistical support for the view that either the level of, or changes in, excess regulatory capital have played a role in past merger and acquisition decisions, which suggests that any future effect of Basel II on such decisions is also likely to be quite small. Moreover, reductions in regulatory capital requirements for adopters relative to the requirements for nonadopters are unlikely to lead to an acceleration in the pace of consolidation.

The second study evaluated the likely effect of Basel II on the competition between adopters and nonadopters in the market for small- and medium-sized business loans. It estimated that the marginal cost of such loans at adopting banks would decline no more than about 16 basis points, on average, and is likely to decline by less than that in most cases.

Importantly, the study also found that most small business loans made by community banks are sufficiently different from those made by either required or likely adopters of Basel II as to make any marginal cost differences virtually irrelevant. Moreover, being riskier, the small business loans made by most community banks are priced so much above the loans made by the large banks that the marginal cost benefit to adopters would not be a material competitive factor. The study did find, however, that the types of small- and medium-sized business loans made by adopters and other *large* banks are, indeed, similar and similarly priced, so that adopting institutions may have a competitive advantage in many cases over other large banks that choose not to adopt Basel II. I will return to the implication of this finding in a moment.

A paper analyzing competitive effects in the residential mortgage market will be available later this spring, and once the U.S. agencies agree on a proposal regarding the treatment of credit cards, staff members can begin analyzing potential competitive effects of the proposal in that market, as well. All four papers will then be re-evaluated early next year when new data become available from the agencies' next quantitative impact study.

If the evidence following these reviews and a public comment process suggests that implementation of bifurcated capital standards in this country may affect competition in certain markets, the proposals for Basel II may need to be reconsidered. We may need, for example, to modify the application of Basel II in the United States, where permissible under the Basel agreement; negotiate further changes in

the international agreement itself; or change the way the current capital rules are applied to institutions that do not adopt the new standard.

In short, if we have sufficient indications that implementation of a new capital standard will distort the balance of competition, we can and will apply policies to mitigate this effect consistent with the risk profile of individual institutions. We cannot, however, respond to an unsubstantiated and generalized fear of change. Such concerns should not halt the evolution of regulatory capital standards for the large, complex banking organizations that play such an important role in our banking system and in global financial markets.

Bank Consolidation

Legislation designed to deregulate U.S. banking markets, technology, and other factors have contributed to significant structural change in the banking industry and to a decline of nearly 40 percent in the number of banking organizations since the mid-1980's, when industry consolidation began. Consolidation activity has slowed sharply in the past 5 years, but a recent uptick in merger announcements, including a couple of very large transactions, may signal a return to a more rapid pace of bank merger activity. Since 1995, the 10 largest U.S. banking organizations have increased their share of domestic banking assets from 29 percent to 46 percent at year-end 2003. Yet, over the past decade, roughly 90 percent of bank mergers have involved a target with less than $1 billion in assets, and three-quarters have involved an acquiree with assets of less than $250 million.

This ongoing consolidation of the U.S. banking system has not, in my judgment, harmed the overall competitiveness of our banking and financial markets. Although they have facilitated consolidation, the reduced barriers to entry—such as were provided by the Riegle-Neal Act's relaxation of interstate banking laws—have provided net competitive benefits to U.S. consumers of financial services.

Other economic forces, such as technological change and globalization, have stimulated competition among depository institutions and between depositories and nonbank providers of financial services. In addition to other credit-extending businesses, our system of depository institutions alone continues to be characterized by many thousands of commercial banks, savings institutions, and credit unions. Measures of concentration in local banking markets, both urban and rural, have actually declined modestly not just since 2000 but since the mid-1990's. Significantly, most households and small and medium-sized businesses obtain the vast majority of their banking services in such local markets.

Deposit Insurance

I would like to turn now to the issue of deposit insurance reform and to the need for some legislative change in this area. As the Committee knows, most depository institutions have not paid any deposit insurance premiums since 1996, and in fact, some large institutions that have been chartered in the past 8 years have never paid them at all. Under current conditions, not only is a Government guarantee being provided free, but also depositories having similar or identical risks are exposed to potentially disparate treatment should one, but not the other, of the deposit insurance funds fall below its funding target. In that situation, the FDIC would be required to impose a charge on one set of depository institutions while continuing to provide free deposit insurance to those in the other fund. Because some depository institutions today have commingled BIF- and SAIF-insured deposits as a result of bank and thrift mergers, this disparate treatment could apply even to different deposit accounts within the same depository institution.

At this time, the Congress has the opportunity to provide the FDIC with greater flexibility to charge risk-based premiums, possibly using market data (for example, rates on uninsured deposits) for the largest banks, to allow such premiums to increase or decrease in a gradual manner over a wider range of fund reserve ratios, and to treat all depositories with similar risk ratings equally and equitably. Such reforms should be implemented in a manner that does not unnecessarily create additional moral hazard and that strengthens, rather than erodes, market discipline.

Higher coverage limits, for example, would exacerbate moral hazard problems without apparent and offsetting benefits. The current level of coverage seems adequate to meet the needs of an overwhelming majority of depositors. First, depositors have certain flexibility in distributing large balances among multiple accounts and depository institutions to obtain higher insurance coverage. Second, the Federal Reserve's latest survey of consumer finances indicates that at year-end 2001 less than 4 percent of U.S. depositor households had *any* uninsured deposits. Moreover, the median bank IRA/Keogh account balance was only $15,000, well below the existing insurance limit. Finally, community banks have shown themselves just as adept as

the largest banks in attracting uninsured deposits when necessary to fund customer loan demand.

Conclusion

In closing, let me reiterate that the past decade has been one in which the banking industry has recorded persistent record profits while providing an ever-wider range of products and services to much more diverse groups. The industry's experience during the past several years in dealing with clear weakness in key economic sectors demonstrates the importance of strong capital positions and sound risk-management practices. Bank supervisors worldwide are working to encourage further progress in these areas, through more-accurate and more-effective regulatory capital standards based on even better internal risk-management procedures.

PREPARED STATEMENT OF JOHN D. HAWKE, JR.

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

APRIL 20, 2004

Introduction

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I appreciate this opportunity to review the condition of the national banking system. My written statement covers two principal areas.

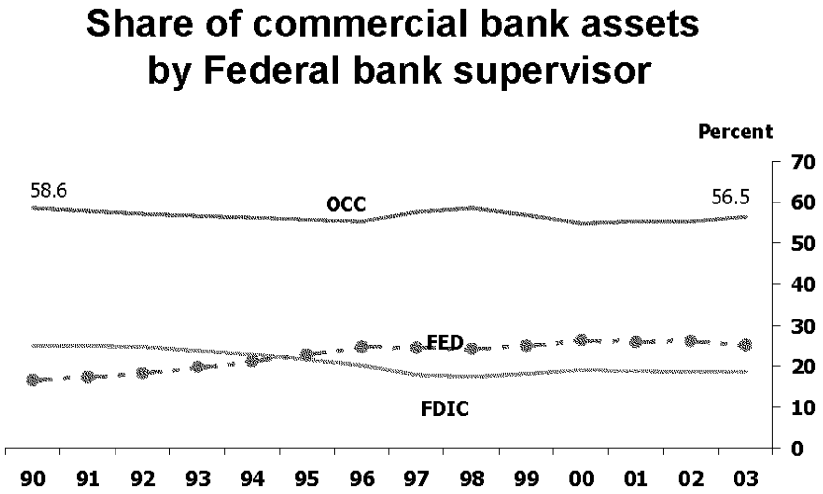
First is the continued strong performance and condition of the national banking system in the face of a changing banking environment. National banks continue to display strong earnings, improving credit quality following the recent recession, and sound capital positions. That continued strong performance reflects, in general, past good lending and investment decisions. In addition, to some extent, that performance reflects changes in business strategies and risk management practices. Banks have adopted better risk management techniques and have benefited from greater geographic diversification. Nonetheless, risks remain, including the growing importance of operating, strategic, and reputation risk as banking companies adapt to change by using technology, different products or strategies, or more complicated business structures.

Second, we continue to adapt supervision to the changes in banking. Among the most important strategies we employ to maximize the effectiveness of our examination and supervision program is our risk-focused approach to supervision, which is designed to address change. That risk-based approach has enabled us to turn increasing attention to operating, strategic, and reputation risk.

The approach that the U.S bank regulators have taken to the effort to reform international bank capital standards, known as Basel II, provides a distinct example of how we are adapting to change. While we recognize that we can improve capital regulation to take into account changes in banking and risk management, we have advocated proceeding with appropriate caution. In my statement today, I will discuss the proposed capital reform and the commitment I have made that any reforms of the regulatory capital rules will be adopted in a prudent, deliberate fashion.

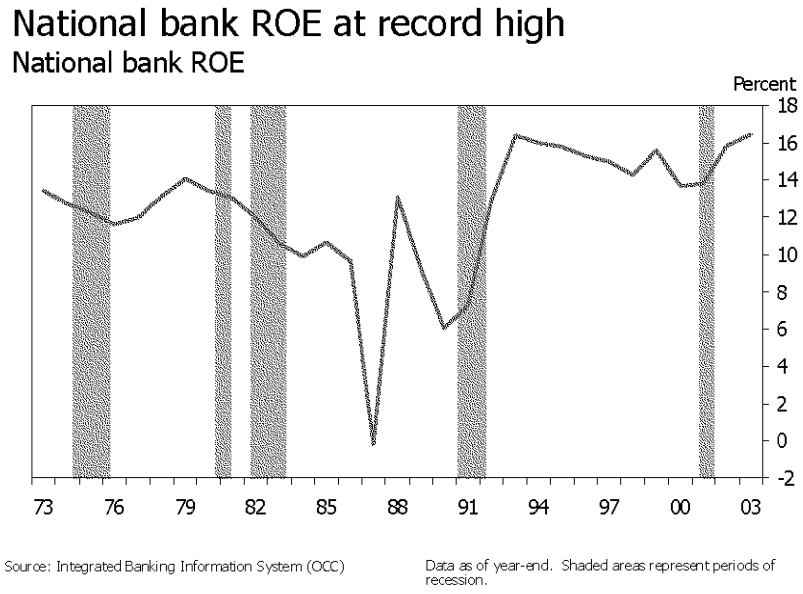
The Condition of the National Banking System

The OCC supervises federally chartered national banks and federally licensed branches of foreign banks. As of year-end 2003, the national banking system consisted of approximately 2,100 banks (26 percent of all commercial banks). Of these, 2001 were FDIC-insured banks, holding total assets of $4.3 trillion. The rest were uninsured bank and trust companies. The OCC also supervises 53 Federal branches of foreign banks. While the number of national banks has declined for nearly two decades, and the assets of the system have steadily increased over the same period, the national bank share of total system assets has remained roughly constant, and now stands at 56.5 percent. The national banking system includes many of the largest banks by asset size, but community national banks are by far the most numerous in the system.



Financial Performance

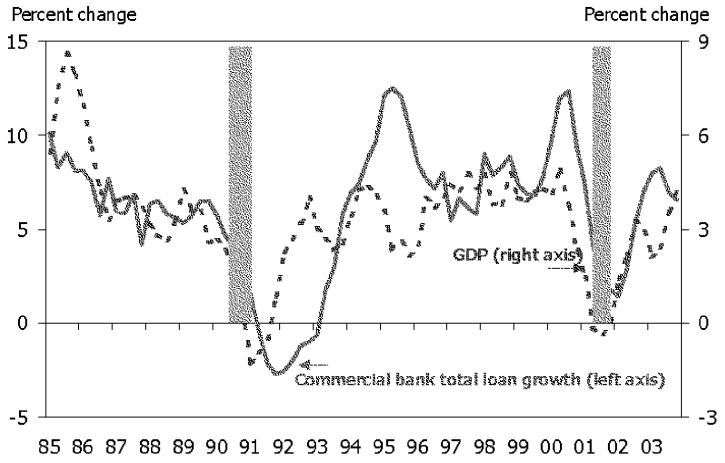
The financial performance and condition of the banking system is strong. Earnings have remained at historically high levels for a decade. Until 2002, aggregate net income for national banks had never exceeded $12.5 billion in a quarter, and the industry's average return on assets had never exceeded 11.5 percent, at least not since the quarterly reporting began in 1984. But since the beginning of 2002, national banks have exceeded both earnings milestones in every quarter but one. In 2003, national banks set new records for both return on equity and return on assets. Although the slow economy led to weakness in some areas, including business lending, the contractions in these areas were more than offset by growth elsewhere.



Total loans held by banks continued to expand throughout the recent economic cycle, growing by 7.8 percent in 2002 and 7.6 percent in 2003. In contrast, starting with the recession of 1990–1991, total loans held by national banks fell for 10 consecutive quarters. Where the earlier recession affected all sectors of the economy, the recent recession was concentrated more extensively in the business sector, in part due to the fallout from the tech/telecomm bubble in the late 1990's. This caused a sharp fall in the demand for business loans, particularly at large banks.

The reduction in corporate lending by banks also was due to the competitiveness of corporate bond issuance due to low interest rates. Many large and even medium-size firms have been able to access the bond market at very low rates throughout this economic slowdown, which has further reduced the demand for larger commercial loans. This has affected especially the lending activity at the largest banks, because they tend to have potential business customers who have greater access to other financial options. Community banks, in contrast, taking advantage of their knowledge of local markets and business needs, have maintained their business lending throughout this cycle, with increases reported in their commercial and industrial (C&I) and commercial real estate loan books.

Loan growth continued throughout this recession



Source: Integrated Banking Information System (OCC); BEA/Haver Analytics

Quarterly data through Q2-2003. Shaded areas represent periods of recession.

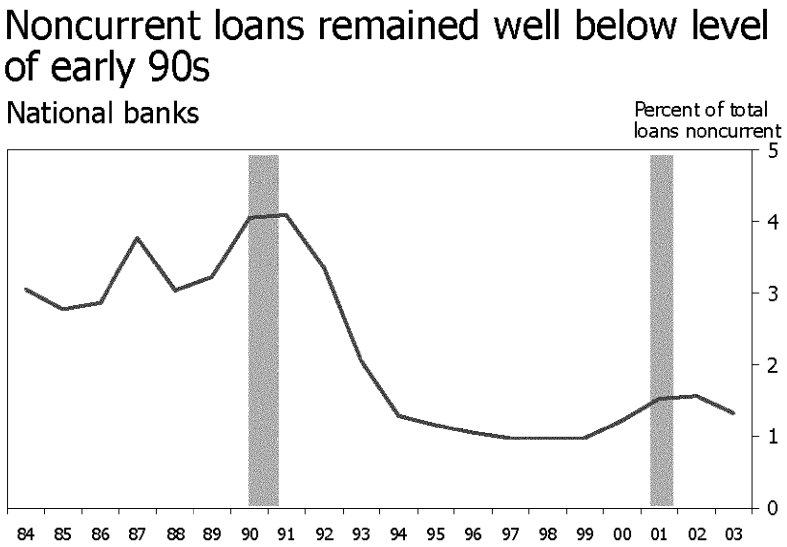
The mortgage and consumer sectors have been a strong source of loan growth for national banks. Residential real estate loans held by national banks rose at an annual rate of about 20 percent in both 2002 and 2003. Within this broad category, home equity lending has grown particularly fast, rising by 21 percent in 2001, 38 percent in 2002, and 37 percent in 2003. Throughout this cycle, consumers have taken advantage of declining mortgage rates to extract funds from the increased value of their homes. Some of these funds from the refinancing and home equity loan activity have been used, however, to pay off higher interest credit card and installment debt.

The low interest rate environment has been a plus and minus for banks. Smaller banks with their greater reliance on retail funding have seen steady erosion in their net interest margins. By contrast, the largest banks, which rely more on wholesale funding, until recently experienced relatively high net interest margins. As of December 2003, the net interest margin for banks in all asset size groups has fallen below their historic averages. Despite the decline in margins, banks have reported continued growth in net interest income due to the strong expansion in household lending. As long as margins remain compressed, however, this growth in income is vulnerable if the volume of activity in the consumer markets falls.

The low interest rate environment also raises concerns about the extent to which banks may be taking on interest rate risk in an effort to maintain their interest income. Effective management of this risk will be important for banks in all asset size

groups as the economy recovers, which is often accompanied by an increase in interest rates. We have alerted national banks to our concerns on this score and provided advice on approaches on how best to address this "low rate set-up."

Deposits have continued to flow into banks, especially large banks, as might be expected when low interest rates hold down returns on alternative money market instruments. Deposits at national banks grew at 6.0 percent in 2001, 7.6 percent in 2002, and 8.6 percent (year-over-year) in 2003. The increase in deposits has fueled growth in bank assets. The assets of national banks grew 9.8 percent in 2003 (year-over-year), as compared to a 0.1 percent decline reported at this point of the recovery from the last recession. Nevertheless, we believe banks must be vigilant in their assessment of the potential sensitivity of their sources of funds to changes in the economic environment or, in some cases, the bank's own performance. The high level of liquidity in the banking system could be reduced rapidly if the relative yield on alternative investments increased sharply or if banks failed to maintain certain performance levels required to retain some sources of funds.



Source: Integrated Banking Information System (OCC) Data as of year-end. Shaded areas represent periods of recession.

While credit quality deterioration is typically an issue during recessions, the most recent experience for national banks was much better than during the previous recession. This may well reflect national banks' response to cautions issued by the OCC to bankers in the late 1990's to be vigilant about their underwriting standards. The noncurrent loan ratio for national banks (loans at least 190-days past due plus nonaccruals) reached a peak of 4.4 percent in 1991Q2; in contrast, at the peak in this economic cycle, reported in 2002Q2, the noncurrent ratio was 1.6 percent. For large banks (over $1 billion in assets), the noncurrent loan ratio has now declined to 1.3 percent, near prerecession levels. Smaller banks (under $1 billion in assets) were not as affected by the stresses in the nonfinancial corporate markets and thus experienced only a modest decline in credit quality during the recession. And while credit quality appears to be improving for the banking industry, the OCC continues to watch developments in areas that remain vulnerable, such as small business lending and certain real estate markets and property types.

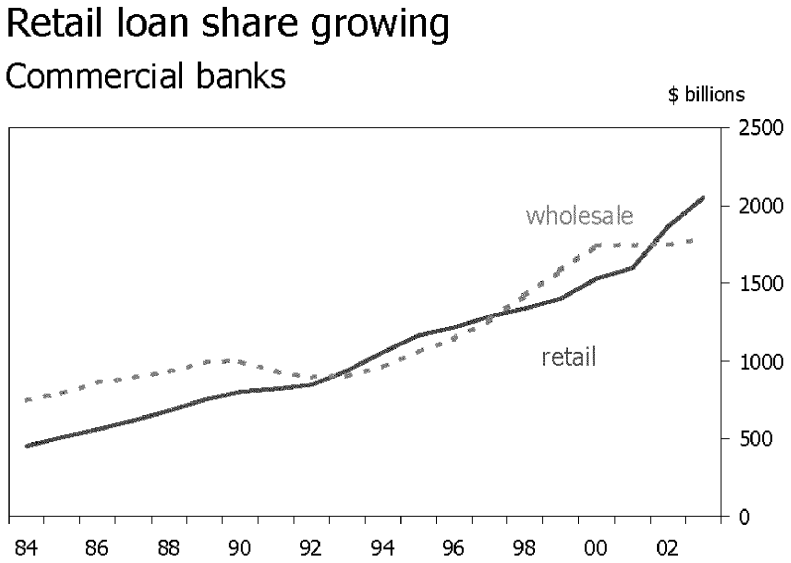
The data on bank failures and new entrants to the commercial banking system also reflects a dynamic and healthy banking system. In 2003, two banks failed—one national and one State bank. By contrast, 100 commercial banks—including 33 national banks and 67 state banks—failed in 1992, the first year of recovery after the 1990–1991 recession. The commercial banking system also had 111 new entrants in 2003; this compares to 40 new banks in 1992.

While the national banking system has displayed strong performance, even during the recent recession, history teaches us that we cannot know for certain what lies ahead, and banks' capital provides important protection against that uncertainty. National banks remain well-capitalized and rest on a much firmer capital base than they did more than a decade ago. In 1990, for example, 6.3 percent of banks had risk-based capital ratios below 8 percent, which we would now consider under-capitalized, and 18.3 percent were below 10 percent. Today, all national wholesale banks, with the exception of a few small banks under special supervision, have risk-based capital ratios above 8 percent, and more than 90 percent of national banks have risk-based capital ratios above 10 percent.

Continued, Gradual Change in Bank Strategies

Like other businesses, banks adjust their strategies in response to the lasting changes in their business environments. Over past decades, bank business strategies in the United States have evolved in response to changes in household financial practices, advances in financial knowledge and information and communication technology, and the relaxation of constraints against interstate banking and allowable bank activities. Since such changes are gradual, they are sometimes hard to recognize. Nonetheless, they result in real changes in the nature of the business.

For example, one change is an increase in the relative emphasis on lending to households, especially among the large banks. Over the last 20 years, large banks have moved increasingly into retail lending to take advantage of cost-saving technologies and geographic diversification in a period of strong growth in the demand for retail products. In 1984, 30 percent of aggregate commercial bank loans were to households—residential mortgages, and loans to individuals. By 2003, that ratio had risen to 46 percent. The increased emphasis on retail lending has been particularly pronounced in the largest banks. Among the largest 10 banks, the retail portion of bank loan portfolios has increased from 22 percent to 55 percent over the last two decades.



Source: Integrated Banking Information System (OCC)

Retail loans are 1-4 family real estate and home equity; wholesale includes C&I loans and business RE (CRE, construction and multi-family lending).

Another strategic change in banking is the improvement in financial risk management—the tools, products, and processes. Since the last business cycle, banks have made substantial investments in this area. A fundamental shift in approach is occurring, from viewing risk on a transaction-by-transaction basis to a more holistic, portfolio view. Advances in technology have enabled banks to harness information to manage more proactively the risks in their portfolios. These include more sophis-

ticated models to help banks underwrite and manage their credit risks and to conduct scenario analyses of their interest rate and liquidity risks.

Concurrent with the adoption of these enhanced tools has been the development of independent risk management units with responsibility for enterprise-wide risks. These units, which typically reside at the highest level of the corporation, oversee portfolio risk, balance the risks and rewards of new business strategies and initiatives, and ensure that business units and the bank as a whole comply with established risk tolerances and limits.

Risk management also has benefited from the broader array of products and tools that banks can use to adjust and manage their risk profiles. These tools help to foster deeper and broader financial markets and ultimately help to allocate risks to participants in accordance with their risk appetite and performance objectives. For example, banks have been particularly successful in reducing their exposures to credit concentrations. The growth of the syndicated loan market has enabled banks to more broadly distribute credit exposures within the U.S. banking system, as well as to foreign banking organizations and nonbanks. Similarly, the expanding asset securitization market has provided banks with another avenue to manage concentration risks and to diversify their funding sources and to provide greater access to underserved markets.

The growth in the derivatives markets has provided banks with additional tools to manage their credit and interest rate risk exposures. Derivatives are also a valuable risk management product to help banks' institutional customers manage a broad array of risks arising from common business activities such as securing long-term funding or protecting the value of importing or exporting commercial goods. Banks' increased participation in residential real estate lending is one example of how derivatives have enabled banks to expand their product offerings while managing their risk profiles. Although residential real estate lending is typically associated with low credit risk as a consequence of diversification, solid collateral, and the borrower's vested interest, it can represent high exposure to interest rate risk. With the advent of products to hedge interest rate risk, such as interest rate swaps and options, banks have been able to expand their lending in this area while managing the risk of potential shifts in interest rates. In the absence of effective mechanisms to hedge such risks, it is unlikely banks would have been able to participate as actively in the growth of this sector.

Growing Importance of Operating, Strategic, and Reputation Risk

Notwithstanding the strong financial performance and condition of the banking industry, and improvements in the management of key financial risks, critical challenges remain. Chief among these is the need for banks to avoid missteps, abuses, or perceptions that could undermine the confidence and trust of their customers or financial markets. Recent events have demonstrated that bank soundness is much more than just a function of financial strength and that the risks facing the banking industry extend beyond the financial risks—credit, liquidity, and interest rate risks—that have traditionally been the focus of bankers and regulators. Increasingly, bankers must be cognizant of and control the operational, strategic, and reputation risks posed by their activities and how their activities will be perceived by the markets and their customers. A thorough evaluation of those risks and their potential impact on a bank's longer-term strategic direction and its relations with its customers is paramount and must override pressures from management, analysts, or shareholders to increase short-term earnings at the expense of fundamental controls and safeguards.

Many of the recently publicized problems facing the industry have stemmed from breakdowns in key governance and control areas: Insufficient oversight and due diligence in reviewing or considering complex financial transactions or new product lines; lapses in security controls and the safeguarding of customer information; over-reliance on third parties for critical services or product generation; and failure to adhere to sound internal audit and control procedures and processes. These breakdowns are not limited to banks of a specific size, market or product niche. Community banks have suffered losses stemming from over-reliance on loans, investments, and services purchased from third-party vendors—often in an effort to augment otherwise lackluster loan demand. Several large banks have faced significant questions about their dealing with customers and alleged improper oversight and management of key product lines.

Keeping Pace with Change in the National Banking System

Change is a consistent theme in the operation—and the supervision—of the national banking system today. National banks must evolve their businesses if they are to remain competitive in today's financial services markets. At the same time,

the OCC must adjust its supervisory and regulatory approaches in order to ensure that national banks can avail themselves of all of the attributes of their charter safely and soundly. Among the most important strategies we have developed to maximize the effectiveness of our examination and supervisory program is our risk-focused approach to supervision.

The OCC's Risk-Focused Approach to National Bank Supervision

OCC's supervision by risk approach dates back more than 10 years and involves supervisory policies and processes that tailor our oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's tolerance for risk. This process provides an effective means for the OCC to allocate our supervisory resources and to better communicate to senior bank management the areas where they may need to correct problems before they become entrenched.

Risk-based supervision begins with an assessment of a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas: Credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation. Based on that assessment, the OCC examiner-in-charge or portfolio manager will develop and implement a detailed, supervisory strategy for the bank, based on its risk profile and the complexity of its lines of businesses. Examiners identify areas of highest risk, assess what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. In performing this evaluation, OCC examiners consider not only the activities of the bank and its operating subsidiaries, but also how the bank's risk profile is affected by the activities of other subsidiaries and affiliates.

Our assessment of the integrity and effectiveness of a bank's risk management systems includes appropriate validation through transaction testing. If this produces concerns, we will "drill down" to test additional transactions. And if this reveals problems, 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. The examination procedures implementing OCC's supervision by risk program are documented in the Comptroller's Handbook.

Supervision by risk provides an effective way to supervise banks in the current rapidly changing environment. It also allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks and bank activities. Because the design of this approach requires that we customize an examination based on a bank's underlying risk characteristics, it allows us to more effectively direct OCC resources to the banks or activities within banks exhibiting the greatest risk.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we have divided our day-to-day supervisory operations into two lines of businesses—our Community and Mid-size Bank program and our Large Bank program.

Our Community/Mid-size Bank line of business oversees over 2,000 national banks and Federal branches and agencies through our network of district, field, and satellite offices. When examining this population of banks, examiners use a core set of examination procedures to draw conclusions about the magnitude of risk and the adequacy of the risk management system for each of the nine areas of risk. Even in low-risk banks, we sample, verify, and test the bank's policies, procedures, and systems. When risks are elevated; when activities, products, and services are more complex or present greater financial or compliance risks; or when issues or problems emerge, examiners will expand the scope of their supervisory activities using more detailed guidance found in topical booklets of the Comptroller's Handbook series. Periodic monitoring of community banks, another key element of the supervisory process, is also designed to identify changes in the bank's condition and risk profile, including new products or services, and to assess bank corrective action on outstanding supervisory concerns between formal onsite examinations. This quarterly monitoring process allows examiners to identify significant changes in the risk profile of the banks they supervise on a timely basis.

Our Large Bank program focuses on the 24 largest national banks. The supervision of each large bank, overseen out of our headquarters office, is staffed by a resident examiner-in-charge and a team of examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, asset management, and compliance. These examiners and specialists track the quantity and quality of risk management in real time so that our assessments are forward-looking, as well as historical. This program allows the OCC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic,

discrete examinations. Over the years, we have also developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex, and globally positioned banks. We are confident that this approach will be effective to supervise the "mega-banks," those with assets of a trillion dollars or more, which are forming as a result of recent acquisition activity in the industry.

Today's national banking system operates not just nationally, but globally. Our large banks all have operations or a presence overseas. The expansion of our large banks' operations across various legal entities and geographic boundaries puts an increased premium on coordinating our supervisory responsibilities with other domestic and foreign regulators. Domestically, we and the other banking agencies build upon each other's supervisory reviews and databases. We routinely share reports of examination and other agency-institution communications and provide each other with access to our organizations' structure, financial, and supervisory information. To help facilitate and coordinate our supervision of large, complex institutions, we share information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those activities. When appropriate, we hold joint meetings with institutions involving matters of mutual interest and may conduct coordinated reviews or examinations where a business activity is conducted across legal entities. Our London office provides us with examiner expertise to interact with foreign supervisors and provides a platform to examine national bank branches overseas. Our London examiner staff provides a critical network to deal with home/host country issues, information sharing issues, and outsourcing issues. We also participate in the Foreign Banking Organization program (along with the Federal Reserve Board) to examine and supervise Federal branches and agencies in the United States.

We also are deeply involved in the development of international bank supervision policy through our participation in the Basel Committee on Banking Supervision and in the Joint Forum, which is an international group of banking, securities, and insurance supervisors; through our regular dialogue with foreign banking regulators; and through our international and technical assistance programs that provide training and internship opportunities to bank supervisors. In fact, not long ago we detailed to the Treasury Department four experienced examiners who are now working in Iraq.

To help meet the challenges of an ever more complex banking industry, our resident and field examiners and specialists are supported by a team of policy specialists, analysts, accountants, and economists in our headquarters office who monitor industry, market and economic trends, provide technical expertise, and develop analytical tools and models to support our examination functions. For example, our "Canary" system monitors and identifies banks that may have high or increasing levels of credit, liquidity, or interest rate risks. Our credit risk and economics staffs have developed various analytical tools that assist examiners to identify portfolio or industry concentrations where risk may be increasing for more in-depth investigation. Our Risk Analysis unit—staffed by Ph.D. economists—provides on-site technical assistance to our resident staff in evaluating banks' quantitative risk models and measurement systems. Our National Risk Committee serves as a coordinating body to gather and disseminate information from throughout the OCC and the financial markets on emerging risk issues and advises me and the OCC's Executive Committee on a quarterly basis of emerging issues and potential policy and supervisory responses.

Our combination of continuous on-site supervision, with the "ground level" intelligence it provides on each individual bank's activities and strategies, coupled with our broader, systemic risk analyses, allows us to quickly adjust our supervisory strategies to emerging risks and issues that may arise at individual institutions, within business segments or across the industry as a whole. It also allows us to leverage the diverse skill sets that are needed to supervise our most complex institutions effectively.

Response to the Growing Importance of Operating, Strategic, and Reputation Risk

To address the growing importance of these nonfinancial risks, we have taken a number of steps to strengthen our supervision and oversight in the critical areas of audit and corporate governance. In April 2003, we issued an updated examination booklet on Internal and External Audits. This booklet sets forth our expectations that well-planned, properly structured, and independent auditing programs are essential to effective risk management and internal control systems. The revised booklet incorporates issues related to recent events related to audit programs, including the independence provisions of the Sarbanes-Oxley Act and the implementing rules and regulations of the Securities and Exchange Commission.

We have also updated our booklet, "Detecting Red Flags in Board Reports—Guide for Directors." This guide provides a bank's board of directors with an overview of information generally found in board reports and highlights various "red flags"—ratios or trends—that may signal existing or potential problems.

In response to the continued evolution of banking products and structures, the OCC's Committee on Bank Supervision has recently directed the formation of an internal group within the OCC to oversee and evaluate how new banking products and structures may affect our supervisory activities. This review committee will function similar to the new product review committees found at some of our larger institutions. The committee will have membership from our various supervisory operations, risk, legal, and information technology units.

We have also taken steps with the other U.S. banking agencies in the areas of audit and corporate governance. For example, in August 2003, the agencies issued final joint rules that strengthen their authorities to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services required by Section 36 of the Federal Deposit Insurance Act. The rules establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more. In March 2003, the agencies issued an updated "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" to reflect provisions of the Sarbanes-Oxley Act and SEC rules regarding auditor independence. The revised policy statement also provides enhanced discussion of the responsibilities of a bank's board of directors and senior management with respect to internal audit and reiterates the need for banks to maintain strong systems of internal controls and high quality internal audit programs.

More recently, the OCC has worked with the Federal Reserve Board and the Securities and Exchange Commission to develop an interagency statement on sound practices for conducting complex structured finance activities. These activities generally involve the structuring of cash flows and the allocation of risk among borrowers and investors to meet the specific objectives of the customer in more efficient ways. They often involve professionals from multiple disciplines within a financial institution and may be associated with the creation or use of one or more special purpose entities designed to address the economic, legal, tax, or accounting objectives of the customer. In the vast majority of cases, structured finance products and the roles played by financial institutions with respect to these products have served the legitimate business purposes of customers, and these products have become an essential part of U.S. and international capital markets. A limited number of complex transactions appear to have been used to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality of the transaction, or to inappropriately reduce a customer's tax liability.

The interagency statement, which we expect to soon publish in the *Federal Register* for comment, describes the types of internal controls and risk management procedures that can assist financial institutions to identify and address the reputation, legal and other risks associated with complex structured transactions. The statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputation and legal risk, to ensure that these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. The statement also emphasizes the critical role of an institution's board of directors and senior management in establishing a corporate-wide culture that fosters integrity, compliance with the law, and overall good business ethics.

While regulatory and supervisory initiatives such as these are important to help banks manage operational, strategic, and reputation risks, it is incumbent on the banking industry to assume primary responsibility for its own conduct in these areas. In a speech last year before the American Bankers Association, where I discussed the issues of fair dealing and treatment of customers, I stressed that the ultimate protection for banks is to instill in all employees a dedication to the highest standards of fairness and ethical dealing; to make clear to employees that no loan, no customer, no profit opportunity is worth compromising those standards; and to take swift and decisive action where those standards are violated. The OCC is committed to be vigilant in this area and has and will continue to take responsive action when we discover abuses or weaknesses. I expect bankers to do the same.

Basel II Developments

Because national banks have international as well as domestic operations, the OCC must—and we do—become involved in the development of approaches to bank

supervision at the international level. Currently, the most significant of these approaches is the ongoing effort to revise the 1988 Basel Capital Accord. Let me just briefly provide you a status report on this effort. There have been a number of articles in the press in recent weeks about positions that U.S. regulators, and the OCC in particular, may be taking that I believe warrant some clarification and amplification.

First, let me stress that my U.S. colleagues and I share an overarching goal that Basel II be implemented in a manner that is entirely consistent with the safety and soundness and continued competitive strength of the U.S. banking system.

As I have said, banks' current financial and capital positions are strong, but as the industry continues to evolve, so does its risk profile. Recognizing and adapting to changing risk profiles and changing risk management practices is critical to maintaining those strengths. These observations inform our approach to negotiations in the Basel Committee on Banking Supervision regarding Basel II. However, while we recognize that we can and should improve capital regulation to take into account changes in banking and risk management, a basic tenet in our negotiations over reform of the international capital standards is to *do no harm.* U.S. banks are world leaders in many aspects of banking—credit cards and securitizations, for example—and we must assure that these important markets are not disrupted or impaired in the name of achieving international conformity in capital rules. In view of the fundamental strength and resilience of the U.S. financial system, we believe that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective fashion.

Thus we are fully committed to three things: First, an open rulemaking process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on the capital of our banks prior to its adoption; and third, a prudent implementation in which we make well-reasoned and well-understood changes to bank capital requirements and incorporate in those changes appropriate conservatism. In this regard, I welcome the questions and issues that Members of this Committee and its staff have raised about this important project and I have repeatedly stressed to the Basel Committee the important role that Congressional oversight plays in our deliberative process.

The U.S. agencies' insistence on a thorough and rigorous deliberative process already has resulted in important modifications to the Basel II proposals. One of the most significant of these issues—and one that U.S. banks were virtually unanimous in criticizing in response to the Basel Committee's third consultative paper (CP–3)—involved the fundamental question of what losses capital requirements should be designed to cover. CP–3 would have calibrated capital to ensure coverage of both expected losses (EL) plus unexpected losses (UL). However, banks in the United States today generally measure and manage their internal economic capital allocations by reference to UL only, and most banks consider EL to be covered by a combination of reserves and credit pricing. As we examined this issue, we became convinced not only that the banks were conceptually correct in their arguments, but that retaining the EL plus UL calibration would have severe ramifications—not the least of which might be to seriously jeopardize the industry's acceptance of Basel II framework as being a conceptually sound framework. While many on the Basel Committee resisted this initially, the Committee ultimately put forth a new proposal in October to modify the calibration of Basel II to UL only. This modification was strongly endorsed by industry participants and has now been agreed to by the Committee.

The Committee announced several other important modifications to CP–3 in January that are responsive to numerous comments we received on CP–3 and the U.S. agencies' advanced notice of proposed rulemaking (ANPR) that was issued last August. These modifications include simplifying the proposed treatment for securitizations and aligning it more closely to industry practice and an agreement to find a prudentially sound solution that better recognizes credit mitigation techniques used by the industry. Other issues are still under discussion by the Committee's various technical working groups and are scheduled to be considered by the Committee at its meeting in May.

Probably the most difficult policy issue remaining involves the appropriate risk-based capital treatment of certain retail credit products—unused credit card lines in particular. This issue is critically important for national banks and for the cost and availability of consumer credit. It is also an area in which consensus has been hard to come by. Given the prominence of the retail lending business for U.S. banks, and for national banks in particular, there is little room for substantive compromise, and the OCC will not accept provisions that are likely to unduly disrupt or disadvantage established, well-functioning business practices. We believe that this

issue will be resolved in a manner that appropriately addresses safety and soundness objectives without altering legitimate business practices.

Notwithstanding the difficulty of these issues, the Committee's goal is to be in a position by mid-year to release a text that will provide the basis for each country's national implementation process. Let me reiterate that point: The release of the next round of proposals does not represent a final agreement or accord; rather, it is the platform from which we will launch our more in-depth domestic deliberative process. In the United States, that process will have several key steps.

First, the U.S. agencies will conduct a fourth quantitative impact study (QIS 4) in the third and fourth quarters of this year. This study will be based on the Committee's mid-year release and will differ in some important aspects from the Basel Committee's earlier quantitative studies. QIS–4 will not only be conducted against the background of a more fully articulated proposal, but will also include a more prominent supervisory role to ensure greater reliability and consistency in survey results than has occurred in the past. We continue to believe that we cannot responsibly adopt final rules implementing Basel II until we have both determined with a high degree of reliability what the impact will be on the capital of our banks, and we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States. We believe the results of QIS 4 will be more useful than any data we currently have in determining the magnitude of the impact of Basel II on bank capital and potential competitive inequities, as well as determining ultimately what to do about them.

Second, in another effort to increase our practical understanding of the effects of Basel, the U.S. agencies have commenced an operational risk benchmarking review at a number of the largest institutions. Information obtained through this effort will enhance agency understanding of current qualitative and quantitative operational risk practices and will assist agency efforts to develop additional supervisory guidance and training materials for banks and examiners on the operational risk component of Basel II. Throughout this period we will continue our dialogue with banks and other interested stakeholders on various issues that Basel II may raise.

Those projects and discussions will help us in the third key step in Basel implementation, developing a joint notice of proposed rulemaking (NPR) that will set forth the proposed regulatory text for Basel II in the United States. Currently we anticipate that such an NPR will be released for public comment in late 2005 or early 2006. At the OCC, we have made a preliminary determination that this rulemaking will be a "significant regulatory action" for purposes of Executive Order 12866. Consequently, we will prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes:

- a description of the need for the rules and an explanation of how they will meet the need; an assessment of the benefits anticipated from the rules together with, to the extent feasible, a quantification of those benefits;
- an assessment of the costs anticipated from the rules together with, to the extent feasible, a quantification of those costs; and
- an assessment of potentially effective and reasonably feasible alternatives to the planned regulation and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

We have begun discussions with the OMB's OIRA regarding how these analyses will be designed and conducted. Our analysis will be published as part of our notice and comment process.

Finally, as the rulemaking process for the domestic implementation of Basel II moves forward, we and the other U.S. agencies are exploring the implications that Basel II may have on nonmandatory banks and what, if any changes we should make to our capital regulations for those banks. Any such changes will, of course, be subject to public notice and comment.

As my testimony conveys, while we have made important strides in trying to develop a more risk-sensitive capital framework for internationally active banks, there is still a long way to go before Basel II is completed and adopted. As I have repeatedly stated before Congress and in the Basel Committee, a new accord cannot be completely finalized until national implementation procedures have been completed and I am committed to a notice and comment process that is open and fair and responsive to public comments. The OCC and other U.S. agencies have recognized the possibility that, even in the late stages, public comments might reveal flaws in the proposal that will need to be addressed before we can issue final implementing regulations. The OCC's ultimate willingness to sign onto Basel II is going to depend on whether we are satisfied with the final product.

Conclusion

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change—by improving the approaches we use to supervise the industry, and by striving to ensure that national banks remain the safe and sound, competitive, and high integrity engines of our economy that they were designed to be. We look forward to working productively with you, with the Members of this Committee, and with State officials as we pursue our efforts to achieve that goal.

PREPARED STATEMENT OF DONALD E. POWELL

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

APRIL 20, 2004

Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding the condition of FDIC-insured institutions and the deposit insurance funds. My testimony will briefly review the recent record earnings and outstanding financial performance of FDIC-insured institutions and the condition of the deposit insurance funds, touch upon potential risks to the industry, and discuss the implications of industry consolidation and some related questions that we believe will drive discussions among banking policymakers going forward.

Condition of FDIC-Insured Institutions and the FDIC Insurance Funds

I am pleased to report that FDIC-insured institutions are as healthy and sound as they have ever been. The industry earned a record $31.1 billion in the fourth quarter of 2003, marking the fourth quarter in a row that earnings set a new high. The results for the fourth quarter also brought the industry's earnings for the full year to a record $120.6 billion, surpassing the previous annual record of $105.1 billion set in 2002. The return on assets (ROA) in the fourth quarter and for the entire year was 1.38 percent, equaling the quarterly record set earlier in the year and easily surpassing the previous all-time annual high of 1.30 percent in 2002.

Underlying the current financial strength of the industry have been the cumulative effects of the 10-year economic expansion of the 1990's and certain factors that tended to insulate banks from the most severe effects of the 2001 recession. Improvements in underwriting and risk management practices helped to limit the effect of credit losses on industry earnings during and after the recession. Meanwhile, strong growth in mortgage loans, a steep yield curve, new sources of fee income and cost containment efforts by banks helped boost the net operating income of the industry. Record earnings 2 years in a row, record returns-on-assets, and a strong capital foundation are all indicators that banks not only weathered the recent economic downturn—but also have been a source of significant strength for the economy and for the American consumer.

This strength is mirrored in the strength of the FDIC's insurance funds. As of December 31, 2003, the balance of $33.8 billion in the Bank Insurance Fund (BIF) represented 1.32 percent of estimated BIF-insured deposits, well above the statutory target reserve ratio of 1.25 percent. The Savings Association Insurance Fund (SAIF) ratio stood at 1.37 percent at year-end 2003, with a balance of $12.2 billion. The BIF reserve ratio rose during 2003 as expected losses fell, while the SAIF reserve ratio remained essentially unchanged from year-end 2002. A combined BIF and SAIF fund would total $46 billion with a reserve ratio of 1.33 percent of estimated insured deposits.

In November 2003, the FDIC Board of Directors voted to maintain the existing BIF and SAIF premium rate schedules for the first half of 2004. The FDIC's analysis indicates that it is unlikely the reserve ratio for either fund will fall below the statutory target of 1.25 percent in the near future. For example, with the BIF ratio at 1.32 percent, assuming no deposit growth, insurance losses on the order of $1.8 billion would be required to drop the ratio to 1.25 percent. For insured deposit growth alone to reduce the ratio to this level, assuming no change in the BIF fund balance, growth of nearly 6 percent would be required. Neither BIF insurance losses nor BIF deposit growth has approached these magnitudes recently, and we do not foresee any combination of insurance losses and deposit growth that would drive the reserve ratio near 1.25 percent in the coming months, although these forces could

result in a decline from current ratios. As a result, we do not foresee a need for additional premium income at this time.

As you are aware, the FDIC's concerns about the deposit insurance system relate to the way it is structured. We cannot price deposit insurance based on risk, we cannot manage the fund's size relative to our exposure, and we maintain two funds even though the historic rationale for doing so has gone away. There is broad agreement on the key elements of a deposit insurance reform package and the FDIC remains willing to work with this Committee to achieve reform as soon as possible.

Potential Risks

We cannot assume that the economic environment of the next decade will necessarily be as favorable to the industry as our recent experience. The world is changing in unprecedented ways and the FDIC continuously monitors economic conditions and emerging risks in the banking industry in order to maintain its preparedness. The primary vehicle for monitoring and addressing risk is the supervisory process, which has been enhanced significantly over the past decade. Moreover, as the banking industry has become more sophisticated, the FDIC has created cutting edge risk management techniques to identify, measure, and manage risk to the insurance funds. The cornerstone of FDIC's risk management philosophy and practice is an integrated, multidisciplinary approach that brings together economists, examiners, financial analysts, and others to analyze and respond to risks in the system.

Using this approach, the FDIC expects continued good performance for the banking sector, based on the industry's solid fundamentals and generally favorable economic conditions. The economy grew at a 6 percent annual rate during the last half of 2003 and is expected to grow at a 4 percent pace this year.

Despite the generally positive recent economic news, our integrated analysis reveals several trends that could pose difficulties for the banking industry and the FDIC in the future. The FDIC analyzes risks that are generally known to exist as well as risks that appear to have a low probability of occurring, but would have a high impact if they did. The intent of our analysis is to ensure we are capturing all risks that could affect the banking industry and the deposit insurance funds.

It is important to recognize the volatility of financial markets and the potential for disturbances to spread throughout the system. In today's interconnected financial system, problems that initially appear to be localized could lead to a more widespread loss of confidence with a resulting impact on liquidity throughout the system. This issue bears watching to ensure that financial market disruptions do not produce significant banking problems going forward. The major actors in the financial markets are large, well-diversified organizations that continue to grow. Later in my testimony, I will discuss the increasing shares of industry assets, deposits, and revenues held by just a few large banking organizations and the implications of this trend for the future of banking.

Another area of concern is household balance sheets. The household sector has been the engine for banking growth through the 2001 recession and beyond, but sources of concern include the near record pace of personal bankruptcies—exceeding 1.5 million in 2003—and rising household indebtedness. Total household debt is at an historical high of 112 percent of disposable personal income. The lowest mortgage rates in more than a generation have prompted households to take out $1.4 trillion in new mortgage debt since the end of 2001. Household indebtedness also increased as a result of a market and technology-driven revolution in consumer lending that created a system with unprecedented access to credit and convenience in its use.

Perhaps even more important than the absolute level of debt is the fact that the amount of money households must pay to keep debts current is increasing. This is occurring despite the prolonged period of low interest rates, which would normally be expected to lower debt service. Homeowners now use about 14 percent of disposable income to meet their major financial obligations, versus about 12 percent in 1993. The increase in renters' financial obligations is even more striking at about 31 percent of disposable income versus about 24 percent in 1993. Escalating household indebtedness raises concerns about the sustainability of the growth in consumer spending, especially when interest rates rise. A trail-off in consumer spending could also occur once the effects of the 2003 tax cut and 2003 mortgage refinancing boom run their course.

Escalating household debt raises concerns about the sustainability of consumer spending and the ability of borrowers to meet obligations when interest rates rise. In particular, households that have a greater exposure to variable rate consumer loans and adjustable rate mortgages, and those with weaker credit histories and balance sheets, could experience some problems meeting their obligations. A related

concern is that rising interest rates could cause some stress in certain housing markets, where prices have been more volatile than the rest of the Nation.

However, this is uncharted territory. The commoditization of credit has created a much more sophisticated financial economy that may be able to tolerate higher and rising debt levels. Our concerns are tempered, however, by the strength of household assets and the strengthening job and wage data we have seen in recent months.

In particular, I am concerned that those at the margins of the credit system will be adversely affected. Households that have greater exposure to variable rate consumer loans and adjustable rate mortgages and those with weaker credit histories and balance sheets could experience some problems meeting their obligations. Often, these are consumers who lack a basic understanding of how money works in our society—and therefore lack the tools necessary to save and manage money. That is why I believe that promoting the financial education of our society's unbanked segment is one of the FDIC's most important goals, and why the FDIC has developed the *Money Smart* financial literacy program.

Since the rollout of *Money Smart,* FDIC has distributed more than 111,000 copies of the curriculum and trained over 5,000 instructors. *Money Smart* is currently available in English, Spanish, Chinese, Korean, and Vietnamese. The FDIC has taken the lead in establishing financial education partnerships with communities and bankers. The FDIC has entered into over 600 local *Money Smart* Alliances across the country, including national partnerships with the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, the Association of Military Banks of America, Goodwill Industries International, the National Coalition for Asian Pacific American Community, and the Internal Revenue Service. Last year, for example, the FDIC's work during the 2002 tax season with the "Back of the Yards" voluntary income tax assistance site in Chicago helped over 600 families file tax returns and receive $1.1 million in earned income tax credit refunds. Many of these families also opened their first bank accounts through this initiative.

Another challenge facing banks is high concentrations in commercial real estate. As of the fourth quarter 2003, national vacancy rates for office, retail, and warehouse space stood at or near historic highs of 17.9 percent, 12.9 percent, and 10.5 percent, respectively, and were even higher in some markets. Nevertheless, commercial real estate concentrations at banks are high and increasing. The national median concentration of commercial real estate to capital is 164 percent, up from 92 percent in 1993. Moreover, concentrations are particularly heavy in the West and Southeast. In our San Francisco and Atlanta Regions, the median commercial real estate concentrations are 327 percent and 284 percent, respectively.

So far, poor commercial real estate fundamentals have not resulted in loan performance problems at banks—national charge off rates are below 0.1 percent and the nonperforming ratio is 0.8 percent. Improved underwriting and regulatory requirements, increased public ownership and transparency of commercial real estate transactions, and low interest rates have all acted to buffer banks from commercial real estate losses. Despite the good performance to date, given the significant problems that resulted from commercial real estate in the late 1980's and early 1990's, the FDIC has implemented enhanced commercial real estate monitoring programs, particularly in areas with very heavy concentrations.

As with the household sector, there are concerns that some commercial real estate borrowers could be affected if debt service increases due to a rise in interest rates. On the other hand, rising interest rates are normally accompanied by resurgence in economic activity. For commercial real estate, that could mean an increase in potential renters and rental rates. Nevertheless, the high and rising "twin deficits"—national and trade debt—coupled with the ongoing fall of the dollar have raised some concerns about a dollar collapse. While a collapse seems unlikely, given foreign reliance on dollar holdings, among other factors, it could lead to a rise in rates without concurrent economic growth.

Implications of Industry Consolidation

The ongoing consolidation of the banking industry means that there are a few very large institutions that represent an increasingly significant share of the FDIC's exposure. Once the recently announced mergers are complete, there will be three banking companies whose assets are in the range of $1 trillion each. Their combined assets will account for approximately 30 percent of the assets of FDIC-insured institutions. The next four largest holding companies will have assets in the range of $200 to $400 billion, and they will account for another 13 percent of industry assets. The top 25 banking companies hold over one-half of industry assets, while the top 100 hold almost three-quarters.

The largest banking institutions are global, highly diversified organizations. They are positioned well to absorb losses from local economic problems or idiosyncratic risks in any particular lines of business. The external risks posed to these firms are essentially macro risks—reflecting the same factors that could threaten the entire financial system. Thus, the major risk the deposit insurance system faces is the risk that the economy or the financial system would suffer extreme deterioration.

In the absence of extreme economic or financial disruption, the risk from these companies arises from the challenges of managing such large, complex organizations. Should these internal risks result in significant problems at a large bank, the situation could also pose risks to the system as a whole. This is why it is so important for owners, managers, and directors of these organizations to adhere to the standards of good corporate governance and risk management and for regulators to ensure that these standards are met.

To enhance our understanding of the risks these institutions may pose, the FDIC has placed dedicated examiners in the eight largest institutions. These dedicated examiners work closely with the resident examination staff of the primary Federal regulator.

One question we face is whether the consolidation of the banking industry has gone too far or will go too far in the future. Or conversely, is the 10 percent deposit cap increasingly an impediment to the appropriate market evolution of the industry?

First, I would note that the degree of consolidation is a relative notion. Compared to the industry 20 years ago, banking is certainly more consolidated. But compared to other industries or banking systems in other countries, it does not appear to be. We are not close to having a banking organization with branches in all 50 States. A standard measure of industry concentration is the market share of the top five firms in an industry. Table 1 provides this measure for major U.S. industries. As the table shows, banking is a relatively unconcentrated industry by this measure. In fact, banking is less concentrated than the table would indicate, since the table compares only publicly traded companies and less than 10 percent of banks and thrifts are publicly traded.

Table 1
Percentage of Market Value of Publicly Traded Firms Held by the Top 5 Firms

	Top 5 in 2002 Market Value
Telecommunication Services	77.5%
Automobiles & Components	73.7%
Securities	70.7%
Software & Services	63.2%
Energy	63.1%
Pharmaceuticals & Biotechnology	63.1%
Technology Hardware & Equipment	60.9%
Insurance	54.6%
Health Care	43.1%
Hotels Restaurants & Leisure	40.5%
Commercial Banks and Savings Institutions	**35.8%**
Transportation	28.2%
Utilities	26.4%

There appear to be several public policy reasons for the 10 percent deposit cap. One purpose of the cap is to protect bank customers from anticompetitive behavior that can result from a highly concentrated industry. This makes sense, but it is not clear why banks should be treated differently in this regard from other firms. The banking industry is highly competitive, and standard antitrust measures appear sufficient to ensure that it will continue to be competitive.

Another purpose for limiting banks to a 10 percent share of national deposits is to limit the concentration of risk that any one bank poses to the deposit insurance system and the financial system in general. As mentioned earlier, the most significant risk to these banks is the risk of severe economic disruption, and I would offer two observations here. The first is that during the past two decades the economy has experienced longer periods of expansion and a milder recession. This reflects: (1) the benefits of what has been called the free-market consensus; (2) the ability of a transformed financial system to absorb economic shocks; and (3) generally sound monetary and fiscal policies. So long as these factors remain in place, it seems reasonable to expect performance over the business cycle to be generally favorable.

Of course, we cannot rule out adverse scenarios. The question, then, is whether it matters under such scenarios if the assets of the industry are largely concentrated in a dozen or so banks or in just a handful.

Putting aside risk stemming from the economy or overall financial system, the next question involves the risk posed by a single banking organization. The risk would seem to hinge on the tradeoff between the benefits of scale and diversification and the challenges of managing large complex organizations. The performance of large banks in recent years suggests the tradeoff has thus far been favorable.

As we move forward, my sense is that regulators, policymakers, and market participants will be able to assess whether the tradeoff remains favorable. Put simply, if these banks show signs of becoming too-big-to-manage, I would expect the market to slow, if not reverse, the course of consolidation and regulators to impose stricter sanctions. Ultimately, if these measures are absent or ineffective, I would expect policymakers to step in. This approach seems to be a better gauge of the appropriate scale of banking organizations than does an arbitrary fixed cap.

My bias is to let market forces determine the evolution of the banking industry. I believe this has served us well in the post-crisis period and I expect that it will continue to be the best way to ensure that banks are meeting the needs of households and businesses.

Having said that, it is apparent that continued consolidation will present challenges to how the FDIC administers the deposit insurance system. The fact that our risk is increasingly concentrated in the largest banks has implications for how we assess risk, the appropriate way to fund deposit insurance, and the implications of problems at, or the failure of, a large bank.

In terms of assessing risk, the FDIC obviously relies heavily on the efforts of the bank examiners and supervisors at the FDIC and our sister agencies. This has served us well and I expect it will continue to do so. From a purely financial point of view, however, it seems that the risk the FDIC faces is not that dissimilar from the risks that the market prices on a regular basis. As large banks evolve, the FDIC could look more to market instruments—like reinsurance contracts or catastrophe bonds—to help us assess our large-bank exposure.

With respect to funding deposit insurance, one question that often arises (and indeed did so the last time this panel appeared before this Committee) is whether the deposit insurance funds are adequate to handle the failure of a large bank. Some rough numbers may be helpful here. We have historical data on the losses per dollar of assets at failed banks. This loss rate has been lower for large banks than for smaller ones. The loss rate for larger banks has been in the neighborhood of 5 to 10 percent, although there are some caveats to note here. The first is that the largest failures involved banks in the range of $40 billion in assets—nothing approaching the size of the largest banks today. Second, this experience is largely from the period before prompt corrective action, least-cost resolution, and depositor preference. With that in mind, assuming a loss rate of 5 percent, the failure of a $1 trillion bank would cost $50 billion. This is just slightly more than the two deposit insurance funds combined.

Of course, if a large bank were to fail, the question arises as to whether it should be handled under the systemic risk exception provided for in FDICIA. As you know, this provision requires that the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury be in agreement that the bank should be handled outside the bounds of the normal "least-cost" manner. I should stress that even if this judgment were made, it does not mean that shareholders and all creditors will be protected from loss.

Suppose that, in our example, the finding of systemic risk resulted in a loss rate that approached the higher end of the range mentioned above. A 10 percent loss rate would result in a cost of $100 billion. Congress in FDICIA made it clear that this additional $50 billion would be funded by an ex-post assessment on the banking industry and placed more heavily on the larger banks.

To put these amounts in perspective, FDIC-insured institutions earned $120 billion last year and hold additional capital above the well-capitalized level in the amount of nearly $200 billion. This capital stands behind the funds and would be available to shield taxpayers in the event of a large failure.

Related Questions for Policymakers

While we are certainly pleased with the current condition of the industry and the strength of the bank safety net, banking is in the midst of a profound transformation. The role of banks in the marketplace has changed in the past 20 years and this transformation continues apace. There are some concerns that banks' share of the financial pie has been shrinking. While some have argued that banks are "dinosaurs," banks actually have been reforming their intermediary role in important ways that have propelled them to a more competitive position in the financial marketplace. They now provide better products and services for their customers, and deliver record earnings for their shareholders. Banking organizations remain a critical part of the modern flow of funds that has broadened the availability of credit in the U.S. economy.

Nonetheless, while banking organizations have prospered, traditional banking—the combination of deposit-taking and commercial and industrial lending—has become a smaller part of the financial system and of banking organizations themselves. Bank commercial and industrial lending has declined sharply relative to total lending, falling from about 25 percent of total nonfinancial business sector debt 50 years ago to slightly more than 15 percent. Traditional business lending also makes up a smaller share of commercial banking's loan portfolio. Operating loans to businesses now constitute less than a fourth of total commercial bank lending—down from 40 percent 20 years ago. Moreover, banks have lost ground in the competition for savers' funds. Since 1980, the total value of money market, mutual fund, and deposit instruments in the United States grew from just under $2 trillion to some $11.6 trillion. During this time, the share of these instruments issued by money market funds and mutual funds increased from 7 percent to 55 percent, while the share issued by banks fell from 90 percent to 41 percent.

Along with the consolidation trend, these developments raise some fundamental questions for policymakers that relate to safety-net arrangements as well as bank regulation and supervision.

Federal deposit insurance was designed specifically to protect traditional bank intermediation. A continuing challenge is how best to protect the stability of the system as savers' choices continue to expand and bank deposits become less important in the overall financial system. Federal deposit insurance works well for traditional community banks. For the largest banking organizations, as they increasingly engage in diverse, nontraditional activities, it makes sense to consider whether different safety-net arrangements might be more suitable for this segment of the industry. Since some aspects of our regulatory system already are tailored to recognize the differences between large and small institutions, we should consider the explicit creation of a two-tiered safety net that better addresses these differences.

In many respects, we already have the makings of a two-tiered approach. First, large banks are supervised by teams of examiners who are in residence year-round while small banks are visited at regular intervals by either Federal or State regulators. Second, large banks are much more exposed to the discipline of the capital markets and the ratings agencies—both of which serve to assist regulators in gauging the banks' conditions. Third, current law permits a two-tiered system of pricing deposit insurance. Fourth, we are negotiating a capital accord, Basel II, which will result in a two-tiered system of capital regulation—one for large, internationally active institutions and one for all others. Finally, if a large bank gets into trouble and threatens the overall system, our laws contemplate the possibility that it could be resolved outside the bounds of our current "least cost" resolution procedures.

We expect the gulf between large and small institutions—and the gulf between the kinds of business they are engaged in—to continue growing. This consolidation of the banking industry will pose interesting questions for policymakers. For example, I believe that we should now begin to think through the merits of moving further toward an explicit, two-tiered system that includes the possibility of having larger institutions in a separate risk pool. There are many issues to consider, including funding arrangements for problems that may arise in the separate risk pool for large institutions. The FDIC could also look more to market instruments—like reinsurance contracts or catastrophe bonds—to help us assess our large-bank exposure.

We also should ensure that regulatory burden does not weigh too heavily on community banks and stifle the innovation and consumer choice that are hallmarks of our system. This can be unduly burdensome for community banks and threatens to deter new entry into banking. Low barriers to entry are key to ensuring continued

innovation and customer service in the industry. From my own personal experience as a banker, I know all too well how heavy this burden can be.

The FDIC is taking action to reduce undue regulatory burden to a minimum for institutions of all sizes. In addition, FDIC Vice Chairman John Reich is leading an interagency effort to identify unnecessary burden, duplication, and outmoded restrictions on both large and small financial institutions. Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), Congress required the Federal banking agencies and the National Credit Union Administration to review all regulations every 10 years for areas that are outdated, unnecessary, or unduly burdensome.

The agencies have jointly published the first two of a series of notices soliciting comment on regulations in a number of areas, and have been conducting outreach sessions with bankers and consumer/community groups. Armed with this input, the agencies will conduct a comprehensive review of banking regulations and will report to Congress on their findings and the actions they have taken, or plan to take, to reduce the level of burden. The agencies also anticipate sending this Committee a list of legislative areas for consideration.

Another broad question facing policymakers will likely be how to handle the convergence of interests between banks and firms operating in the larger marketplace. As pointed out earlier, barrier after barrier has come under pressure over the years as the market provided the means to produce and deliver more innovative products to financial consumers. The repeal of branching laws and the Glass-Steagall Act is part of a market driven continuum that will lead us to the doorstep of the last remaining barrier—the barrier between banking and commerce.

Linkages between banking and commerce exist for a number of grandfathered thrift holding companies, CEBA banks and some industrial loan companies. From a public policy standpoint, the benefits of this limited experimentation with the mixing of banking and commerce include a more competitive banking marketplace, more choices for consumers, and, to a limited extent, the existence of a laboratory for alternative modes of regulation. Concerns also have been expressed about allowing any expansion of the mixing of banking and commerce. These concerns have centered on concentrations of economic power, conflicts of interest, and a transfer of a subsidy from the insured bank to affiliates. These issues are present, of course, for any large financial conglomerate. Conflicts of interest are possible even for standalone community banks, where majority shareholders may have commercial business interests. The challenge is to ensure that supervisory and regulatory structures achieve the best of two worlds—both allowing for continued market innovation and providing adequate protection for the bank safety net.

Just as many structural and procedural concerns were addressed during the development of the Riegle-Neal Act and the Gramm-Leach-Bliley Act, I believe the same is possible in this instance. As the market continues to mature in this area, the appropriate boundaries between banking and commerce will be a significant matter for discussion among policymakers going forward.

A final fundamental question for policymakers in the area of bank supervision concerns the future of capital regulation. Capital is perhaps the single most important part of a bank's balance sheet. It promotes confidence in the organization as a going concern and enhances and diversifies the options available to bank management. Capital allows the bank to continue functioning in the face of unexpected events and errors in judgment, and in times of crisis or systemic difficulty.

The challenge for policymakers, in this dynamic and complex financial services marketplace, is to get capital right. We must actively work to ensure that our definition of capital is limited only to those instruments that are able to effectively cushion the bank during times of distress. And we must ensure capital adequacy—that there is enough to absorb losses, ensure ongoing operations, and promote customer confidence during stressful periods.

As the sophistication of the financial markets grows, and innovations allow for more complex transactions, the regulators must be vigilant and ensure that our core Tier 1 capital elements have the ability to cushion banks against loss on a going-concern basis. Tier 1 should be the regulatory standard reserved for the highest quality of capital, and there is no secret of my concern about continuing to allow trust preferred securities to be included in that select category. Trust preferred securities are issued by bank holding companies and carry a cumulative obligation to pay dividends. Under a recent accounting change, they are now categorized explicitly as debt. For insured institutions, the appeal of these and other similar instruments is that they combine the tax advantages of debt with the regulatory stamp of approval of equity. Community banks that are members of holding companies like the idea of being able to tap capital markets with these securities. Yet they result in a regulatory definition of capital that is, under new accounting rules, more le-

nient than GAAP. If the bank regulators do not acquiesce to allowing banks this favorable capital treatment directly, there is the issue of regulatory capital rules that appear to provide an advantage to holding company membership.

Weaning the banking system from reliance on a previously approved element of Tier 1 capital would, of course, raise a host of difficult transitional and grandfathering issues. We should make these difficult judgments with the benefit of industry comment, and arrive at a conclusion as to what types of hybrid capital instruments provide meaningful capital support against the prism of what truly is in the long-term best interest of banks, the financial system as a whole, and the bank safety net.

With respect to the Basel II negotiations, the FDIC supports the underlying premise of the agreement and is working hard to complete our work and move toward implementation. Nevertheless, there remain some important issues at stake for the bank safety net, the regulatory structure, and Congress. The implementation of the Basel II agreement will certainly trigger an intensive public discussion of the workings of our domestic Prompt Corrective Action (PCA) framework—the underlying law that governs our system of capital regulation in America. I know of no disagreement among my U.S. regulatory colleagues that the outcome of this public debate will be a capital regulatory structure that combines the best elements of the PCA framework with the enhanced risk metrics of Basel II. Indeed, as the FDIC has indicated on many occasions, this must be the outcome.

While policymakers must carefully navigate the intersection between PCA and Basel II in order to protect the safety net, we also believe our banking system would benefit from strong capital adequacy in other ways as well. Our banks are among the most well-capitalized in the world—and they are second to none in competitiveness, innovation, and market share. Yet their complexity seems to be attracting more and more oversight and regulation—and not necessarily only from the consumer protection side. A strong industry capital base will allow the regulators some room to permit the marketplace to take its course—both in terms of innovations that better serve consumers, but also in remaining competitive with firms overseas. Lowering capital in these institutions will increase the risk of an institution's failure and will lead to significant regulatory intrusion into the business of these large firms—and perhaps stifle many of the market driven benefits we have come to expect from the financial services industry.

Conclusion

While America's banks—and the deposit insurance funds—are as healthy as they have ever been, it is nonetheless clear that the industry is undergoing significant structural change. Accordingly, our system of bank regulation will also have to change in order to meet the challenges posed by this dynamic financial environment.

Banks are positioned to continue to play a vibrant role in the free-market economy and perform vital intermediary functions through the development of future products and services that are well beyond anything we can imagine today. As this process evolves, accompanying structural and regulatory changes will be needed to ensure the bank safety net remains effective and able to fully meet its public policy purpose. Further, our role as regulators is to protect consumers from abusive practices and promote safe and sound banking practices. This underlying mission will remain the same regardless of what is occurring in the marketplace, and our job is to ensure the right balance is struck as these innovations continue.

Because so many of these changes could impact the deposit insurance funds, the FDIC will continue to provide this Committee with our analysis and views as we work together in the coming years to ensure the safety and soundness of a changing industry.

This concludes my testimony. I will be happy to address any questions that the Committee might have.

PREPARED STATEMENT OF JAMES E. GILLERAN

DIRECTOR, OFFICE OF THRIFT SUPERVISION

APRIL 20, 2004

Introduction

Good morning, Chairman Shelby, Senator Sarbanes, and Members of the Committee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry. It is my pleasure to report on a thrift industry that

is strong and growing in asset size. While we continue to maintain a watchful eye on interest rate risk in the thrift industry, profitability, asset quality, and other key measures of financial health are at, or near, record levels. The average equity-to-assets ratio is over 9 percent, and 99 percent of thrifts are well-capitalized.

A favorable interest rate risk environment, accompanied by record mortgage originations and sales, has produced strong profitability for the thrift industry for the past 5 years. Equally important to this sustained period of profitability are good stewardship by thrift managers, earnings diversification, and good asset quality. Other important factors that have contributed to the industry's success are the statutory and regulatory reforms initiated to strengthen the banking system. The reforms—including comprehensive capital standards, stronger corporate governance and internal control standards mandated by the Sarbanes-Oxley Act, uniform standards for lending, operations and asset growth, and prompt corrective action (PCA) requirements—have significantly improved our banking system. In addition, the banking agencies have been effective in keeping pace with changes in the institutions we regulate. For its part, the OTS continually works to provide specialized training, rigorous accreditation and professional development programs, and other supervisory tools, to ensure that our staff is capably equipped to supervise a dynamic and growing industry. In addition, our employees are of long tenure and are well-seasoned, with an average 15 years of OTS experience.

Condition of the Thrift Industry

As of December 31, 2003, there were 928 OTS-regulated thrifts, holding assets of $1.1 trillion. In addition, there were 485 State-chartered savings banks that have the FDIC as their primary Federal regulator and the vast majority of which have operating strategies substantially similar to thrifts.[1]

While financial services consolidation continues to reduce the overall number of thrift institutions, industry asset growth remains strong. This is due to growth within existing thrifts and to the fact that various financial institutions continue to choose the thrift charter because of the advantages it provides in the delivery of financial services. Charter choice is a privilege available to American financial institutions, and it continues to flourish as institutions change and adapt their business strategies and focus.

In addition to supervising 928 thrift institutions, OTS supervises thrift holding companies. As of the end of 2003, OTS regulated 605 thrift holding company structures[2] with consolidated assets of approximately $6 trillion. As the only consolidated Federal regulator both chartering the depository institutions and overseeing their holding companies, OTS has a unique supervisory role. This provides us with the opportunity to monitor and regulate all aspects of the institution's operations and holding company affiliate activities. The holding companies we oversee are quite diverse, ranging from large, multinational corporations to small "shell" companies with few assets other than their thrift charter.

The demographics of thrift institutions are also quite diverse. While numerous larger thrifts provide financial products and services nationwide or across sizable regional markets, most thrifts are generally smaller, community-based organizations that provide retail financial services in their local markets. As of the end of 2003, 66 percent of thrifts had assets of less than $250 million. Although small, these institutions reach into many small American towns fortunate to have the option of a local community banker.

Thrifts provide substantial services that encourage homeownership and affordable housing, and contribute to economic growth. Thrifts hold over $730 billion in housing-related loans and securities, including $540 billion in whole single-family loans, which comprise one half of total thrift assets. In addition, the industry maintains 60 million insured deposit accounts. Thrifts compete effectively with other financial services providers to deliver a wide range of products and services to American consumers.

Thrifts utilize the secondary market effectively, selling approximately $769 billion in single-family mortgage loans to Fannie, Freddie and other secondary mortgage market participants in 2003. In addition, as of December 31, 2003, the Federal Home Loan Banks advanced $190 billion to thrift institutions, representing 17 percent of thrift liquidity.

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[1] The number reported in a recent financial publication regarding the ratio of Federal versus State thrifts failed to include State savings banks. In the aggregate, as of the end of 2003, 42 percent of thrifts—including State savings banks—were State chartered and the remaining 58 percent federally chartered.

[2] A holding company structure may contain more than one holding company. As of the end of 2003, these 605 OTS-supervised holding company structures operated 971 holding companies.

EARNINGS AND PROFITABILITY

Recent earnings and profitability of the thrift industry have been strong, with consecutive annual records in 2001, 2002, and 2003. For 2003, the industry reported earnings of $13.7 billion, eclipsing the prior record of $11.8 billion in 2002. Annual earnings were $10.2 billion in 2001.

The industry's annual return on average assets (ROA), a key measure of profitability, was a record 1.29 percent for 2003, breaking the prior record of 1.21 percent posted in 2002. Industry ROA was 1.07 percent in 2001. This was the first time that industry ROA exceeded 1 percent in 3 consecutive years since the mid-1950's.

While the historic level of thrift earnings is partially attributable to record loan origination and sales volume, the underlying strength and stability of thrift earnings has also been driven by diversification of income sources and continued strong asset quality. The industry's success over the past decade in expanding its line of products and services, such as mutual fund and annuity sales, trust activities, and transaction accounts, has enabled it to diversify its income stream and generate more stable earnings. Income from these activities measured 0.94 percent of average assets for 2003, up more than 400 percent from 0.17 percent in 1990. Together with improved risk management techniques, higher proportions of noninterest income have helped stabilize thrift income and provide better insulation against interest rate fluctuations.

The thrift industry was an active participant in the Nation's recent refinancing boom and homeownership expansion. Thrifts originated over $730 billion in single-family mortgages in 2003, accounting for one in every five mortgages made in the United States for this time period. Income from mortgage lending, loan servicing, and other mortgage banking activities helped boost recent earnings, and represented 0.80 percent of average assets in 2003 compared to 0.44 percent in 1990.

Looking forward, we anticipate that mortgage loan refinancing activity will decline from the current high levels, which will dampen loan origination volume and earnings. The level of new home construction starts and sales of existing homes remain strong, however, providing a potential counterbalance to recent declines in refinancing activity. Although interest rate risk is not an immediate threat for thrift institutions, OTS continues to closely monitor for changes in interest rate risk.

ASSET QUALITY

The quality of thrift loan portfolios continues to be very good, with key measures of problem loans relatively low, though up slightly from the historic lows set in 2000. Troubled assets (loans 90 or more days past due, loans in nonaccrual status, and repossessed assets) represented 0.67 percent of assets at the end of 2003. The ratio of troubled assets to total assets has remained below 1 percent since September 1997, but is slightly above the recent low of 0.58 percent reported at September 30, 2000.

As might be expected, the level of delinquent loans generally increased through the duration of the recent economic slowdown. The increase was modest, however, particularly given the record low levels set in 2000. Moreover, the industry's noncurrent loan ratio declined in 2003 to 0.58 percent of assets from a post-2000 high of 0.65 percent in December 2002. Less seriously delinquent loans—those 30–89 days past due—were 0.71 percent of assets as of the end of 2003, slightly lower than the level (0.74 percent) at the end of 2000. Loans 30–89 days past due have generally remained at these levels since 2000 despite some quarterly fluctuations.

Loan charge-off rates have risen since 2000, reflecting the modest pace of economic activity. Net charge-offs as a percent of total assets were 0.26 percent in 2003, up from 0.24 percent in 2002 and 2001, and 0.19 percent in 2000. Thrifts' charge-off rates are typically lower than those of commercial banks since thrift loan portfolios are heavily concentrated in single-family mortgages. Charge-off rates for single-family mortgages are generally very low compared to other types of loans. The charge-off rate on all single-family mortgage loans was just 0.05 percent in 2003, or $50 for each $100,000 in loans.

Thrifts' provisions for loan losses generally increased in response to the rise in noncurrent loans and loan charge-offs. Total loan loss provisions were 0.21 percent of average assets in 2003, 0.30 percent in 2002, and 0.28 percent in 2001—all up from 0.20 percent in 2000. Increased loan loss provisioning kept the industry's total loan loss allowance relatively stable despite increased charge-offs. Total allowances measured 0.60 percent of assets for 2003, down slightly from 0.64 at the end of 2000. The slight declines in 2003 loan loss provisions and loan loss allowances reflect the improved economic outlook and signs of recovery from the most recent recession.

As real estate financing activity surged in recent years due to historically low interest rates, OTS has monitored housing values across the United States. While

there may be some regional pockets in the United States where a "bubble" could exist, this does not appear to be a nationwide problem. Because local economic and demographic factors are the primary influences on home prices, significant home price declines have occurred historically only in markets experiencing severe economic distress. Given the generally improving economic conditions nationwide, a recent FDIC[3] study concludes, for example, "that a widespread decline in home prices appears unlikely, even when mortgage rates begin to rise from current low levels."

This is not to say that mortgage lending is not without its risks, especially when mortgage interest rates rise. For example, highly leveraged borrowers and those in high-priced home markets tend to rely on adjustable-rate mortgages, making them vulnerable to interest rate "shock" once short-term interest rates begin to rise. Likewise, home price appreciation may slow as rising mortgage rates make homes less affordable, especially higher-priced homes.

CAPITAL

Capital measures for the industry are strong, stable, and well in excess of minimum regulatory requirements. While industry growth can often pressure capital ratios, even as industry growth has continued, thrifts have maintained high levels of capital through prudent earnings retention and receptive capital markets. Equity capital was 9.1 percent of assets at the end of 2003. Ninety-nine percent of all thrifts, holding 99.9 percent of industry assets, exceeded the PCA well-capitalized standards. Although the number of undercapitalized institutions fluctuates over time, only two thrifts were less than adequately capitalized at the end of 2003. One of which has since been recapitalized. Consistent with PCA, we are monitoring these institutions to ensure that management responds aggressively to resolve areas of supervisory concern.

FUNDING SOURCES

The industry has become somewhat more reliant on wholesale funding as deposit growth slowed due to changing savings and investment patterns and robust competition from mutual funds. Although deposits remain the primary source of funding for the industry, the ratio of deposits to total assets declined steadily over the past decade. In 1990, deposits funded 77 percent of thrift assets. By the end of 2003, the ratio had declined to 58 percent.

With deposit levels declining, the thrift industry has accessed greater levels of wholesale funding, primarily in the form of Federal Home Loan Bank (FHLB) advances. At the end of 2003, FHLB advances funded 17.4 percent of total thrift assets, up from 7.4 percent in 1991. In addition, other types of borrowings, such as repurchase agreements, subordinated debt, and Federal funds purchased, funded 11.3 percent of assets, up from 5.5 percent in 1991.

PROBLEM THRIFTS

The number of problem thrifts—those with composite safety and soundness examination ratings of "4" or "5"—fluctuates over time but remained low in recent years. There were eight problem thrifts at the end of 2003—the lowest level since OTS's inception. Assets of problem thrifts comprised only 0.1 percent of industry assets at the close of 2003.

Thrifts assigned a composite "3" rating, while not considered problem institutions, also warrant more than the normal level of supervisory attention. At the end of 2003, there were 57 thrift institutions assigned a 3 rating, which is unchanged from the prior quarter and down significantly from 72 one year ago. Of these 57 thrifts, 98 percent were "well-capitalized," and thus have a capital cushion that increases their ability to work through difficulties in an orderly manner.

Supervisory attention is also focused on concerns identified at institutions in the areas of Compliance, Community Reinvestment Act (CRA), and Information Technology (IT). At the end of 2003, there were 46 thrifts rated "3" or below in Compliance, including three thrifts with "4" ratings. Eight thrifts were rated less than satisfactory in their CRA examinations. Reflecting the rapid changes in technology, focus on privacy and security concerns, and increased demand for technological expertise, two thrifts were rated "4" or "5" on their IT exam, and 36 thrifts were assigned "3" ratings. In all cases, we initiated prompt supervisory strategies to effect management corrective actions to address areas of concern. The vast majority of OTS regulated institutions are in compliance for CRA and IT.

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[3] *FDIC Outlook,* March 2, 2004.

Evolving Role of the Thrift Industry

COMMUNITY LENDERS WITH RESIDENTIAL FOCUS

While thrifts provide a wide variety of loan products, including consumer and commercial loans, they continue to focus primarily on residential mortgage lending. Thrifts originated 21 percent of all single-family mortgage loans made in the United States in 2003. Thrifts are major originators of adjustable rate mortgage (ARM) loans. In 2003, about one-third (31 percent) of all new ARM's were originated by thrifts.[4]

In 2003, the industry originated $730 billion in single-family mortgages, the highest annual volume on record, exceeding by more than 50 percent the prior record of $472 billion in 2002. Since 1999, the thrift industry has originated over $2 trillion in single-family home loans; which, at an average home value of $200,000, represents 10 million homes in America. Single-family mortgage loans and related securities comprised about 62 percent of thrift assets at the close of 2003. Thrifts are also active lenders for multifamily lending. In 2003, thrifts originated $20.1 billion in multifamily mortgages. At the end of 2003, thrifts held in portfolio $53.7 billion, or 4.9 percent of their assets, in multifamily mortgage loans. This brings the percentage of assets held in residential-related loans and securities to 67 percent.

Thrifts also provide vital services to other segments of their communities by making commercial real estate loans to hospitals, nursing homes, farms, churches, and stores, and on other commercial properties. Such loans comprised 4.3 percent of thrifts' assets at the end of 2003.

While thrifts continue to focus on mortgage lending, they have steadily expanded their product offerings in the areas of consumer and commercial business lending. The industry's ratio of consumer loans-to-assets was 6.5 percent at the end of 2003, up from 4.5 percent at the end of 1990. Utilizing the expanded small business lending authority granted by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the industry's ratio of commercial loans-to-assets stood at 3.6 percent at December 31, 2003, up from 1.5 percent at the end of 1997. Based on our semi-annual subprime lending survey, there were 32 OTS-regulated thrifts with subprime lending programs as of the end of the third quarter 2003. These thrifts have formal lending strategies directed to subprime borrowers as opposed to lenders that may make an occasional loan to a borrower with a low credit score, for example. Aggregate subprime lending for these 32 thrifts increased 11 percent to $14.8 billion at September 2003 from the prior year.

DIVERSIFIED FINANCIAL SERVICES PROVIDERS

In addition to core lending products, thrifts continue to expand the range of savings and investment products offered to their communities. The thrift charter provides an excellent platform with a comprehensive and uniform regulatory structure that allows for the efficient delivery of a wide range of financial products and services. Thrifts have taken full advantage of the strength of their charter to serve retail customers both in their local communities and beyond.

The success of thrifts in providing a broad range of financial services is evident in the industry's level of trust assets administered, which has risen dramatically over the past 8 years. The facility of the charter in this area has also attracted a number of new firms to use the thrift charter as the vehicle for providing these services. For 2003, trust assets administered by the industry totaled $563.5 billion versus $13.6 billion at the end of 1995.

Risks Facing the Thrift Industry

CREDIT RISK

The thrift industry's sound financial condition permits it to address potential credit quality problems from a position of strength. Thrift industry credit risk is primarily driven by the performance of residential mortgage loans. Given the current strength of the housing market in most areas of the country, single-family residential loan delinquencies and charge-offs have remained at low levels.

Future deterioration in any of the fundamentals that affect housing strength, such as worsening unemployment rates, could adversely affect thrifts' asset quality. As community-based lenders, the majority of thrifts' loans are made to consumers. Direct loans to consumers, including single-family mortgages, measured 55.9 percent of thrift assets at the end of 2003. Given this concentration, thrifts' asset quality is very dependent on stable real estate values and consumers' continued employ-

[4] Based on data from the Mortgage Bankers Association of America and Federal Housing Finance Board.

ment and ability to service their debt. We know of no major problems facing us in either regard.

Thrift credit exposure is not limited to the consumer loan sector. Thrifts are also exposed to the business sector, with 3.6 percent of thrift assets held in commercial loans and another 12.0 percent of assets held in construction loans and nonresidential and multifamily mortgage loans. A slowdown in the economic recovery could pressure the cashflow of commercial borrowers. Alternatively, a strong recovery that spurs a steep rise in interest rates may also impact commercial borrowers, since business loans typically carry floating rates of interest. Credits that are highly dependent on low interest costs for positive cashflow would be most vulnerable to rapid increases in interest rates.

Credit review is a significant priority in our examination process, with the scope of our review formed by economic trends and expectations. Our analysis shows that as interest rates rise after a trough, many mortgage lenders lower credit underwriting standards to maintain high loan origination volumes. Such vintages often significantly underperform other vintages. Consequently, as rates have begun to rise, OTS examiners have begun focusing even greater attention on thrifts' underwriting processes, credit quality, reserve policies, and capital adequacy. The loan monitoring, loan collection, and work-out procedures of thrifts are also receiving increased scrutiny. Our best performing thrifts are diversified and we support the industry looking for ways to be less reliant on interest income. We emphasize, however, that expanding into new areas requires investment in the right people, systems, internal controls, and internal audits.

INTEREST RATE RISK

OTS closely watches interest rate risk given the thrift industry's natural concentration in longer-term mortgage loans, which are generally funded with shorter-term deposits and borrowings. Since interest rates typically rise during economic recoveries, monitoring interest rate risk will be especially important in the upcoming quarters. Interest rate sensitivity can manifest itself in several ways in a rising rate environment, including a declining value of long-term assets with below market rates and increased funding rates which tends to compress thrifts' net interest margin.

OTS maintains an interest rate risk sensitivity model that stress-tests thrift portfolios to evaluate potential exposure to changing interest rates. We are unique in that regard. OTS regulations also require thrift management to monitor and manage interest rate risk on an ongoing basis and maintain exposure at prudent levels. With the OTS model and prudent thrift management practices, the industry is well-positioned to assess and respond to portfolio sensitivity resulting from changes in interest rates.

As of the end of 2003, under a simulated instantaneous 200 basis point rate shock, 80 percent of all thrifts were classified as having low levels of interest rate risk, 15 percent as having moderate levels, and 5 percent as having higher levels of interest rate risk. These numbers have trended higher the past two quarters because of the tendency of some institutions in a steep yield curve environment for institutions to invest in long-term assets (for example, 30-year fixed mortgages) and to fund such investments with short-term liabilities (for example, short-term certificates of deposit and short-term Federal Home Loan Bank advances). Approximately 50 percent of the mortgage instruments held in portfolio by OTS-regulated thrifts were originated in 2003.

Institutions demonstrating higher levels of interest rate risk receive close supervisory scrutiny. Given that interest rates typically move in a more gradual fashion, thrift management often has significant opportunity to institute remedial actions to limit the potential impact of a changing interest rate structure. While the current interest rate environment and yield curve structure are generally favorable for thrifts' operations, the failure to react to rising interest rates that come with economic recovery or changes in the yield curve structure could adversely impact thrift earnings. We see no major problems in that regard at the current time.

In 2003, many thrifts took advantage of the low rate environment to extend liability maturities at favorable terms. The lengthening of liability maturities provides a buffer for thrifts against the impact of rising rates. In addition to strategic funding decisions, mortgage loan demand has shifted thrift loan portfolios increasingly toward holding more fixed-rate loans with shorter-terms (10, 15, and 20 years) than the traditional 30-year product, and higher levels of adjustable-rate loans and hybrid loan types.

Shorter-term fixed rate mortgages amortize principal more quickly than traditional 30-year loans, which provides thrifts with greater cashflow to invest as rates rise. Adjustable-rate mortgage rates will reset to higher levels in a rising rate envi-

ronment. Likewise, hybrid loan products that are fixed for periods of 3, 5, 7, or 10 years and then convert to adjustable rates will reset rates and provide a buffer against rising rates. Collectively, these asset/liability trends could mitigate some of the adverse impact that rising rates typically have on thrifts.

Even with the favorable rate environment and strategic thrift asset/liability management, OTS remains cautious of the potential impact of a rapid increase in market interest rates. OTS employs a scenario-based modeling approach, applied on a quarterly basis, to estimate the potential exposure that thrifts have to various rate change scenarios. In addition, we require thrift management to monitor interest rate risk regularly, set appropriate risk limits, and manage potential exposure at acceptable levels. OTS will remain vigilant in monitoring institutions for adverse trends and ensuring that thrifts are properly focused on the potential impact of changing interest rates.

COMPLIANCE RISKS

Compliance risk is another risk that the industry faces and one that OTS also closely watches. The increased volume of consumer transactions, along with the increase in consumer protection and other regulations governing those transactions, necessitates an active compliance management function within financial institutions and in oversight programs within the banking agencies. Certainly in today's environment, the importance of effective compliance management is elevated by: (1) the need to ensure the privacy and security of consumer financial information as more information is shared and outsourced, and as the threat of identity theft persists; (2) the need to guard against money laundering and terrorist financing activities in a post-September 11 environment; and (3) the need to stem the tide of abusive lending practices and ensure fair and equal access to credit for all Americans.

As with its management of other risks, OTS, due to recent internal examination restructuring and enhancements, is now in a stronger, more proactive position than ever to effectively examine for and address potential compliance problems and risks within a comprehensive examination context. We are training more examiners in the area of compliance, we are conducting compliance reviews more frequently, and we are using a risk-focused approach. The CORE components of all compliance examinations include a review of BSA/USA PATRIOT Act, Privacy and Fair Lending.

Our fundamental examination objective is to ensure that institutions have in place the resources to support an effective compliance management program that is commensurate with the size, complexity, and risk profile of the institution. To promote and reinforce full compliance with these critical laws, OTS routinely conducts in-depth training for OTS examination staff.

INTENSE COMPETITION

Business convergence and continued consolidation in the financial services industry have created an increasingly competitive environment. This stimulates thrift managers to focus on strategies to improve efficiencies in the delivery of financial products and services, customize product offerings to meet customer needs, and ensure quality customer service. Some managers may seek to enter new business lines that are not fully served by the financial community. Subprime lending, whether home equity or credit cards, is one such business. Well-managed subprime lending, with responsible marketing, pricing, and terms, is an important element in improving and expanding credit access. We support subprime lending but are vigilant to assure ourselves that it is not delivered in a predatory manner. Any pattern or practice of predatory lending is immediately criticized and eliminated.

Guiding an institution through lending expansion is, of course, the responsibility of each institution's management and board of directors. The willingness of management and directors to understand and manage risk is one of the primary underpinnings of a safe and sound operation. Thrifts must adopt prudent strategies to operate successfully in an increasingly competitive environment. We emphasize to our examiners and supervisory staff the need to focus on ensuring that thrifts have the requisite managerial expertise, sound policies and procedures, and adequate systems before entering new lines of business. We also encourage institutions to work with our examiners and supervisory staff when pursuing new business activities in order to address problems as they arise and to avoid surprises between examinations. Our best performing thrifts also have strong internal controls and internal audit procedures.

BUSINESS TRANSITIONING

We are closely monitoring how thrifts transition from the current intensive "mortgage-banking" mode to a more diversified lending environment. In recent periods, low mortgage rates have spurred refinancings and record origination volumes, and income from this increased lending has helped boost overall thrift profitability. As

the economy continues to recover and interest rates rise, lending activity—especially refinancings—have declined. At the same time, thrift managers will continue to be pressured by shareholders to maintain current earnings levels despite reduced lending activity. These pressures may include reducing overhead costs to help maintain earnings or entering into new activities or reaching for greater fee income. While we expect some industry staff reductions in response to decreased lending volumes, our examination and supervisory staff will closely evaluate thrifts' responses to ensure that the quality of loan underwriting and internal controls is not compromised. We also follow-up with thrift management to ensure that institutions effectively manage new business lines.

TECHNOLOGY/OPERATIONAL RISKS

Operational risk, including the risk of loss due to technical failures and human error, seems to be an ever-present concern in the financial services industry. Advances in technology have created new opportunities for thrifts, especially in marketing and broadening customer services. Thrifts also utilize technology to increase their understanding of certain credits, enabling better product pricing. The growth of Internet banking, outsourcing of core banking functions, and the rapid pace of technological and financial innovation creates new challenges and concerns for thrift management. The use of technology for these purposes is encouraged.

Our IT examiners, and, increasingly, specially trained safety and soundness examiners, focus on how well thrifts' use of technology is designed and monitored to minimize operational risk and ensure thrift and customer security and privacy. The lessons learned from financial difficulties experienced by many "high tech" companies, the widespread power disruptions in the Northeast last summer, and the impact of the September 11 attacks has illustrated the need for contingency planning. Thrift institutions' contingency planning, back-up, and recovery programs are receiving increased supervisory attention from our examination and supervisory staff.

OTS Regulatory and Supervisory Focus and Strategies

EARLY DETECTION AND RESOLUTION STRATEGIES

OTS uses regular on-site examinations and quarterly off-site financial monitoring to identify thrifts that warrant closer supervision. When problem institutions are identified, OTS acts promptly to ensure thrift management and directors institute corrective actions to address supervisory concerns. In addition to a host of financial analytics and early warning systems, two processes that we use to monitor problem institutions are the Regional Managers Group meetings, which are held 10 times annually, and quarterly high risk case briefings. These meetings enable senior OTS staff and regional managers to discuss high risk or high profile institutions regularly throughout the year. The tools are invaluable to share our collective experiences, develop effective supervisory strategies and enhance consistency across the agency. These processes allow senior Washington staff to closely monitor problem institutions, while the regions retain primary responsibility for ongoing supervision.

We have refined our off-site monitoring process by increasing early warning systems to help identify adverse industry trends and potential problem areas. We maintain dedicated financial analysts at our headquarters and in the regions to ensure that off-site tools are maximized. OTS examiners and analysts utilize our Risk Monitoring System (RMS) to assist off-site financial analysis. This risk identification model utilizes combinations of financial ratios to identify areas that need prompt attention and further analysis. The RMS also provides our examiners and analysts with direct links to thrift websites, thrift stock price data, securities filings, and general economic information, all used to closely monitor and analyze thrift operations between on-site exams. In addition to the RMS, we operate our Net Portfolio Value (NPV) model to simulate the potential interest rate risk exposure resulting from a variety of interest rate shock scenarios.

OTS SUPERVISORY INITIATIVES

Consolidated Examination Structure

Two years ago, OTS began to combine its separate safety and soundness and compliance examinations in order to attain greater efficiencies in its examination process, improve its assessment of risk within the industry, and provide examiners with broader developmental opportunities. OTS views compliance as a safety and soundness issue. Examination teams have recently begun to conduct joint examinations and to issue one examination report on both safety and soundness and compliance matters. OTS is now engaging in a more comprehensive assessment of an institution's risk profile by examining its compliance with consumer laws and regulations simultaneously with its prudential supervisory analysis as an integral part of the evaluation of an institution's business strategy, and over time, it expects to reduce

the costs and burden of examinations on institutions. The majority of responses from institutions has been overwhelmingly favorable.

During this time, safety and soundness and compliance examiners have been actively engaged in an intensive cross-training program to learn the full knowledge and skills needed to lead melded examinations. OTS continues to maintain a cadre of compliance experts, however, to assist examination teams in handling complex compliance matters. In addition, OTS program staff have been working to produce combined examination procedures, policies, and handbook manuals.

OTS Organizational Changes

Following a major restructuring of regional and field operations in 2002, OTS recently reorganized its Washington supervision oversight operations in order to manage the evolving direction of the thrift industry more effectively. OTS established three primary entities within a newly structured Office of Examinations, Supervision, and Consumer Protection. The first oversees the most complex institutions as well as holding companies with significant international operations. A second entity oversees the examination and supervision of all other regulated institutions. The third oversees all policy development affecting examination and supervision of institutions' activities, including capital markets, trust, consumer protection, accounting, and information technology. During the past year, OTS has also begun to participate on the Basel Committee on Banking Supervision in order to ensure that pending international capital standards take into consideration the various needs of thrift institutions. In addition, we are well along the path of securing equivalency status under the European Union's (EU) Financial Conglomerates Directive to provide for coordinated, consolidated supervision of thrift holding companies with European operations.

REGULATORY AND SUPERVISORY COORDINATION

Convergence in the financial services markets has been proceeding at a rapid pace in recent years and will continue as companies attempt to maximize synergies across business lines. OTS has supervisory responsibility for thrift institutions and thrift holding companies, many of which engage in insurance and securities activities. These activities are often conducted by multiple legal entities within a corporate structure and across numerous regulatory jurisdictions. Given the scope of activities in thrifts and thrift holding companies, it is critical that we maintain healthy relationships with all financial regulators and supervisors.

OTS maintains regular contact with State and Federal functional regulators. Our goal is to coordinate supervisory activities and knowledge to limit overlapping regulatory efforts, and to identify regulatory gaps that may exist across functionally regulated business sectors. We have also expanded our regulatory contacts abroad to ensure effective supervision of thrift holding company structures that maintain significant operations in foreign markets.

Functional Regulator Coordination

Domestically, our regional offices have working relationships with insurance and securities regulators in states where these companies conduct operations. Our coordination activities also involve meetings, regular communications, and joint activities and programs, often through various supervisory coordinating entities such as the National Association of Insurance Commissioners (NAIC), the National Association of Securities Dealers (NASD), and the North American Securities Administrators Association (NASAA).

We have worked extensively with the NAIC to minimize regulatory overlap as more insurance companies acquire thrifts. These efforts resulted in the establishment of information sharing agreements with insurance regulators from 47 States and the District of Columbia. Our activities include shared attendance and participation in official agency programs, conferences, and training seminars. These events foster cross sector learning and provide opportunities to cultivate regulatory relationships.

OTS staff also coordinates closely with regional counterparts at the NASD to identify issues of common interest involving securities activities by thrift service corporations engaged in securities brokerage activities. Similarly, we have developed relationships with staff of the NASAA that enable us to coordinate and leverage our resources to achieve success in areas of mutual interest. We continue to work with the Securities and Exchange Commission (SEC) on policy matters (such as the privacy regulations required under the Gramm-Leach-Bliley Act) and, when appropriate, on matters involving specific institutions.

FFIEC and Federal/State Cooperation

Domestic and international financial services supervisors know well that supervisory cooperation produces innovative solutions to industry issues and provides invaluable perspective on cross sector trends and risks. OTS works closely with the other Federal banking agencies (FBA's) and State bank regulators in various forums and capacities. For example, in connection with proposed OTS regulations on mutual savings associations and mutual holding companies, we have met with seven State banking commissioners. The Conference of State Bank Supervisors (CSBS) was very helpful in arranging these meetings. I currently serve as Chairman of the Federal Financial Institutions Examination Council (FFIEC), which has significantly increased uniformity among the FBA's in prescribing principles, standards, and report forms for examinations and the supervision of financial institutions.

Coordination on the Basel Process

Internationally, although we are not currently a member of the Basel Committee,[5] OTS attends—along with the other participating FBA's—the Basel Committee meetings and participates in key subcommittee meetings and working groups. The international community of financial services supervisors provides an excellent forum to share experiences and work cooperatively to develop innovative and effective supervisory guidance. Participation in these forums has been critical in understanding global trends that may impact or threaten thrifts or thrift holding companies.

For example, our involvement in the Basel process has provided us with important insights into the potential domestic impact of the proposed Basel II changes. In particular, we are concerned that Basel II may be adopted in the United States before being sufficiently tested to assess its competitive impact. In addition to concerns regarding competitive equity, the Basel discussions and ensuing debate have highlighted deficiencies regarding the continued application of Basel I to the vast majority of institutions expected to continue to utilize it.

We are particularly concerned about the safety and soundness implications of leaving thousands of small- to mid-sized institutions on a less risk sensitive regime while our largest institutions move to a more risk sensitive system. In such a bifurcated construct, Basel I institutions have an incentive to replace lower-risk assets with higher-risk assets since their capital requirement is apt to be too high for the former and too low for the latter, as measured against Basel II institutions. We therefore believe that FBA efforts and resources should be directed at borrowing from the lessons learned in Basel II to develop a capital adequacy system—applicable to all but the largest internationally active institutions—that is more risk sensitive than Basel I, but less complex and more accessible than Basel II.

In addition to the international Basel Committee meetings, OTS actively participates in all domestic task force meetings on Basel.

OTS Role as Consolidated Coordinating Supervisor

OTS has engaged in active dialogue with representatives from the EU on matters relating to the EU's directive on the supervision of financial conglomerates. The EU is seeking to ensure that financial conglomerates domiciled outside the EU member countries are subject to an equivalent level of consolidated supervision by foreign supervisors and to enhance coordination among relevant supervisors. OTS is the consolidated supervisor of U.S.-based thrift holding companies, including a number of financial conglomerates active in the EU. OTS is seeking equivalency status under the EU's Financial Conglomerates Directive (FCD).

The FCD requires the designation of an equivalent consolidated supervisor to act as regulatory coordinator with the relevant EU supervisors. The FCD sets out certain broad review criteria in the areas of risk management and internal controls, in addition to more specific requirements for the reviews of capital adequacy, risk concentrations, and intragroup transactions. OTS has the regulatory authority and supervisory processes in place to collect relevant information and conduct the necessary supervisory reviews.

OTS has initiated dialogue with several foreign supervisors to determine the scope of their interest thrift holding company activities. We will continue to work closely with relevant EU supervisors to ensure that there are no underlaps or overlaps in the supervision of thrift holding companies that are deemed to be conglomerates under the FCD.

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[5] As noted below (see Items for Legislative Consideration), OTS is actively seeking membership on the Basel Committee on par with that of the other FBA's.

Items for Legislative Consideration

Among the factors that have contributed to the health and profitability of the thrift industry is a vibrant, flexible and dynamic community banking charter. I believe that the thrift charter is the preeminent community retail lending charter. It promotes homeownership while serving the diverse financial needs of retail customers in communities across America. Not only is it a charter worth preserving, but also worth improving. We have identified numerous areas that warrant legislative consideration to improve the thrift charter by reducing regulatory burden and improving OTS supervisory authority. Principal among these are the following:

- Eliminating the disparate treatment of thrifts under the Federal securities laws. This includes eliminating the investment adviser and broker-dealer registration requirements that apply to thrifts, but not banks, under the Investment Advisers Act (IAA) and the Securities Exchange Act of 1934 (1934 Act).
- Amending the International Lending Supervision Act (ILSA) to support adding OTS to the Basel Committee. This includes extending ILSA to thrifts to promote consistency in supervising the foreign activities of insured institutions.
- Enhancing the ability of Federal thrifts to make small business and other commercial loans by increasing the percentage of assets limitations on these categories of lending. This will enhance the ability of thrifts to contribute to economic recovery and provide small and medium-sized businesses greater choice and flexibility in meeting their credit needs. Specifically, we support raising thrifts' aggregate commercial lending limit from 20 percent to 40 percent of assets, and modifying the sub-cap for commercial lending other than small business lending from 10 percent to 20 percent of assets.
- We also urge increasing the $250 million small institution 18-month examination exception up to $500 million.

We look forward to working with you and your staff on these and any other legislative items that you want to address.

Conclusion

The thrift industry has grown and diversified over the past several years while reporting excellent financial results. Thrifts continue to play a vital role in providing mortgage funding and other retail products and services to their communities. At OTS, we will continue to evaluate our policies, staffing, and infrastructure to ensure that the agency is well-prepared to handle new or emerging risks. We strive to provide the appropriate level of supervisory support to the institutions we regulate through guidance, industry training, and regular communications. We are confident the industry will continue to fulfill its primary focus of serving retail customers with mortgage funding and other financial services in a profitable and prudent manner.

PREPARED STATEMENT OF DENNIS DOLLAR

CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

APRIL 20, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for the invitation to testify before you today on behalf of the National Credit Union Administration (NCUA) regarding the condition of the credit union industry in America and the National Credit Union Share Insurance Fund (NCUSIF) that insures the deposits of credit union members nationwide.

Condition of the Credit Union Industry

I am pleased to report to the Committee that the state of the credit union industry remains strong and healthy with all indicators clearly portraying a safe and sound industry serving over 82 million Americans and well-positioned for continued strength and vitality in our Nation's financial marketplace, both now and in the future.

At this point I would like to provide a brief discussion of key ratios and trends compiled from call report data submitted to NCUA by all federally insured credit unions as of December 31, 2003.

- The average net worth-to-assets ratio of all federally insured credit unions remains extremely strong at 10.72 percent, even though there has been significant share growth of 15.27 percent in 2001, 10.77 percent in 2002, and 9.11 percent in 2003. Such a strong share deposit growth would normally bring about a significant decrease in the net worth ratio were not the credit unions managing these increased shares effectively and continuing to build net worth. For example, over

the course of 2003, credit union net worth, which is built solely from the retained earnings of the credit union, has increased in total dollars by 9.57 percent. This growth in actual dollars of net worth results in the highest level in history of total industry net worth, currently at $65.4 billion as of December 31, 2003.

- Return on average assets (ROA) is 0.99 percent which, even with a historically high growth in shares during a low interest rate environment, compares favorably with recent historical trends (1.07 percent in 2002 and 0.94 percent in 2001).
- Asset growth was 9.52 percent and share growth was 9.11 percent in 2003.
- Loan growth was 9.75 percent in 2003. Over the course of 2003, share growth slowed and loan growth increased, resulting in a loan-to-share ratio of 71.2 percent, compared to 70.8 percent in 2002 and 79.5 percent in 2000. Total loans to credit union members totaled $376.1 billion, up $104.5 billion since year-end 1999.
- Credit unions' overall delinquency ratio remains steady at 0.77 percent and is slightly lower than the ratios recorded in the previous 2 years (0.80 percent in 2002 and 0.82 percent in 2001), thus demonstrating effective risk management in the loan portfolios during a period of economic downturn in many industries and communities.
- Savings grew to $528.3 billion in 2003, an increase of 9.11 percent. Despite the increases in lending indicated earlier, much of these increased savings are being placed in the conservative investment options available to credit unions under applicable Federal and State laws and regulations. Investments in Federal agency securities grew 18.6 percent in 2003. Funds deposited in corporate credit unions grew 9.4 percent during the same period, and investments in banks, savings and loans, and savings banks expanded 12.3 percent.
- Total assets grew to an all-time high of $610.2 billion, an increase of 9.52 percent.
- Member business lending in credit unions increased by 32.9 percent to $8.87 billion. Although this category of credit union lending has increased over the past year, member business lending still represents only 2.36 percent of all loans in federally insured credit unions.
- First mortgage real estate loans grew 16.63 percent to $117.5 billion, thus continuing the growth of credit unions as a source of access to the American Dream of homeownership for millions of their members.
- New auto lending increased 5.47 percent in 2003. Reflecting both economic trends and market considerations, used auto loans increased by 12.51 percent to $81.2 billion.

The ratios and trends presented above are not unexpected in the present economic and marketplace environment; however, taken as a whole, they are indeed indicative of a healthy and robust industry.

Emerging Risks and Challenges for the Industry

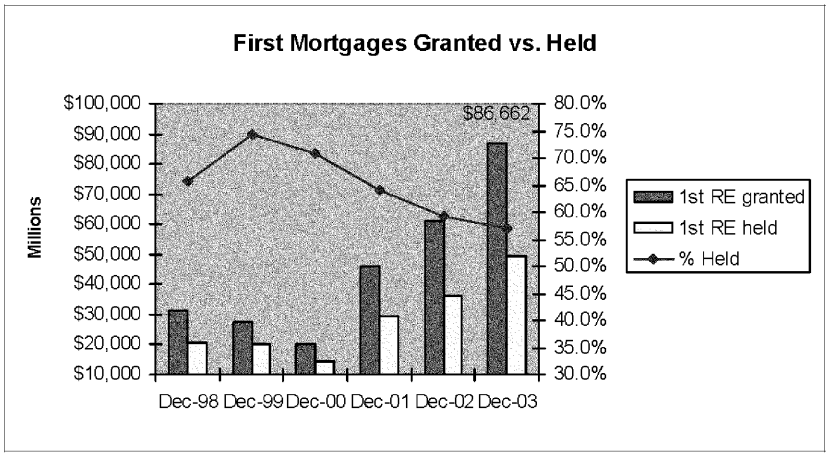
NCUA is closely monitoring a number of key issues and trends specifically affecting the credit union industry, as well as those related to the overall financial marketplace. The following issues are among those we have been closely monitoring:

Interest Rate Risk and Net Margin Compression

Loan growth continues to be concentrated in fixed rate real estate loans being granted at the lowest rates in 40 years. In 2003, total real estate loans grew 13.9 percent and accounted for 44.6 percent of loans outstanding. At the same time, shares grew 9.11 percent, with growth concentrated in short-term, liquid accounts.

The combination of high growth in fixed rate real estate loans and volatile, nonmaturity shares poses potential risk management challenges to credit unions, while also providing unique member service opportunities. If the economy continues to improve, equity market investing increases, consumer borrowing demand returns and interest rates rise, meaning potential interest rate risk, liquidity risk, credit risk, and earnings risk may increase, as well.

While the volume of first mortgage loan originations has increased, so has the percentage of first mortgages sold, increasing from 29.2 percent in 2000 to 43.1 percent as of December 2003. Credit unions sold $37.4 billion in first mortgages in the secondary market in 2003, compared to $25 billion in 2002. This indicates credit unions are appropriately managing, recognizing, and responding to the potential interest rate risk posed by these assets.



To address the potential risks associated with high concentrations of fixed real estate loans held in portfolio, NCUA issued a *Letter to Credit Unions* in September 2003 to highlight these trends and to emphasize the need for prudent and diligent balance sheet management. In addition, NCUA continues to effectively utilize its regional capital market specialists to assist credit unions and examiners alike and to offer ongoing training and guidance to field examiners to address these risks from a safety and soundness perspective.

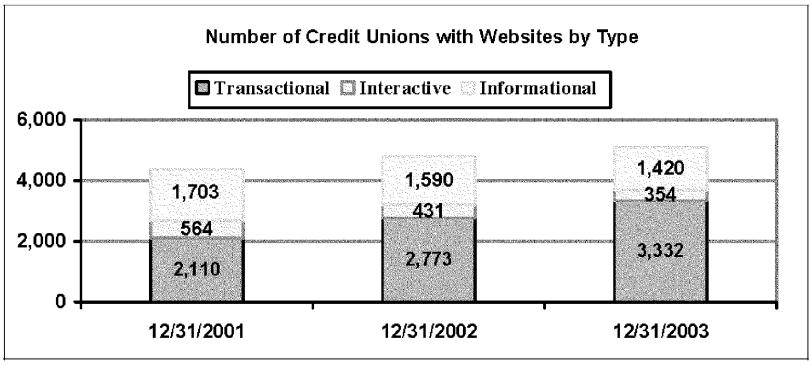
The low interest rate environment likewise has resulted in compressed net interest margins for credit unions. This provides an increased likelihood for credit unions to consider moving out further on the yield curve to maintain net income levels. Interest rate risk and net margin compression in credit unions remain an oversight priority at NCUA and will continue to be closely monitored.

Increased Competition for Consumer Lending

As mentioned earlier, the level of consumer borrowing has slowed somewhat in favor of real estate lending with credit unions continuing to search for new and innovative solutions to serve their members and to retain market share. To remain competitive for consumer loans some credit unions rely on indirect or third party lending which could result in potential risks from third party transactions if not managed properly. In a November 2001 *Letter to Credit Unions,* NCUA provided guidance on the level and degree of due diligence that should be exercised by credit unions when dealing with third party service providers.

Information Systems and Technology Risks

Today more than half of all federally insured credit unions (5,106, representing 54 percent of all federally insured credit unions) have websites with approximately 1,100 more credit unions planning to implement sites in the future. As of December 2003, 15.1 million credit union members conduct transactions via the Internet, up from 5.6 million as of December 2000.



While credit unions are implementing new websites, the number and type of electronic services provided has grown steadily with considerable potential for additional growth. Potential transaction risk continues to increase as more credit unions move to transactional websites and increasingly complex e-commerce services.

Service	2003 Number of FICUs Offering	2003 Percent of FICUs	2002 Percent of FICUs
Account Balance Inquiry	4,983	53.2%	49.4%
Share Account Transfers	4,817	51.4%	47.7%
Loan Payments	4,189	44.7%	40.6%
View Account History	4,086	43.6%	37.3%
Share Draft Orders	4,007	42.8%	37.2%
New Loan	2,840	30.3%	26.6%
Download Account History	3,233	34.5%	28.3%
Member Application	1,944	20.7%	18.3%
Bill Payment	2,253	24.0%	19.7%
Merchandise Purchase	581	6.2%	6.2%
New Share Account	1,037	11.1%	9.5%
Account Aggregation	328	3.5%	2.3%
Internet Access Service	912	9.7%	8.0%
Electronic Signature	68	0.7%	0.5%

NCUA is fully committed to ensuring credit unions are properly prepared to safely integrate financial services and emerging technology in order to meet the changing needs of their members. NCUA implemented its Information Systems & Technology Examination Program (ISTEP) in fiscal year 2000. ISTEP represents a multiprong approach for identifying, measuring, and mitigating risks associated with information systems and technology (IS&T). This approach includes credit union IS&T examinations, credit union vendor reviews and examinations (NCUA and FFIEC), specialized IS&T examiner training and credit union guidance. Ongoing and further IS&T initiatives are outlined in greater detail in NCUA's strategic plan.

Corporate Credit Union Trends

There are currently 30 retail corporate credit unions and one wholesale corporate credit union. Assets for all corporate credit unions total $108.9 billion. Retained earnings equal $2.354 billion with a retained earnings ratio of 2.19 percent. The core capital ratio is 2.95 percent and the total capital ratio equals 6.46 percent. These numbers reflect activity through December 31, 2003.

Based upon the savings growth trends indicated earlier for natural person credit unions, corporate credit unions have found themselves flush with excess liquidity for the past 3 years. Since October 2000, when total assets were at a low of $53 billion, many corporate credit unions have seen their balance sheets double in size. The highest asset level was reported in May 2003, when total assets exceeded $126 billion. Total assets have been fluctuating, but have consistently remained over $95 billion since March 2002. The liquidity trend in corporate credit unions coincides

with consumer confidence in the economy. The flight to safety among investors has resulted in increased deposits in natural person credit unions. Many of these credit unions, seeking a safe place for their excess liquidity, are passing the deposits on to the corporate credit unions.

The high levels of liquidity in the corporate system continue to have a significant impact on the various capital ratios. Even if liquidity should begin to flow out of the system, it will take time for the ratios to recover as they are based on 12-month moving daily average net assets (moving DANA) rather than month-end assets.

Key Issues Facing Corporate Credit Unions

Increased Competition: NCUA expects a continued competitive environment among corporate credit unions. Corporate credit unions that have increased expenses due to expanded authority infrastructure acquisitions or the purchase of expensive item processing/imaging equipment will find it necessary to increase service volume to remain profitable. The increased volume will most likely come through marketing their services to credit unions outside their traditional service areas. The corporate credit unions that lose members to their competitors will have to decide whether to enhance their operations so they can also offer more complex products and services, focus on a niche product or service they can offer at a reasonable price or consider a viable merger partner. Conversely, the impact of competition may be somewhat softened as a number of corporate credit unions are looking at strategic alliances and partnerships as a means of offering some products and services.

Net Worth/ALM: Corporate credit unions have found it increasingly challenging to remain profitable while maintaining a low-risk, highly liquid balance sheet. Economic and competitive factors will continue to put pressure on corporates to seek additional yield wherever possible. NCUA will continue to monitor corporate credit union modeling policies and procedures to ensure the information and reports produced provide reasonable information for decisionmakers of corporate credit unions.

Condition of the National Credit Union Share Insurance Fund

The NCUSIF provides Federal share insurance coverage on credit union accounts generally up to $100,000 per member in a single federally insured credit union. As with FDIC coverage of deposits in banks and thrifts, depending upon the structure of the accounts, there is an opportunity to structure separate account coverage under the NCUSIF based on the number and nature of the accounts established.

As of December 31, 2003, there were $479 billion in insured funds covered by the $6.163 billion NCUSIF, with a 1.27 percent equity ratio. At the end of the first quarter of 2004, the equity ratio in the NCUSIF was 1.29 percent.

Under the Federal Credit Union Act (FCUA), the NCUA Board has the authority to determine the annual operating level of the fund between the statutorily prescribed parameters of 1.2 and 1.5 percent. This year, as in the last several years, the Board has set the operating level at 1.3 percent. If, at the end of the calendar year, the NCUSIF equity level is above 1.3 percent, the Board may declare a dividend. If it is below 1.3 percent, the Board may assess a premium. If the equity ratio falls below 1.2 percent, the FCUA requires a premium to be assessed. However, based upon the limited number of losses in federally insured credit unions, history has proven that in most years the fund level can be maintained without the assessment of a premium through the combination of the 1 percent of insured funds required deposit plus earnings on those deposits.

Since the NCUSIF was capitalized in 1985, only one insurance premium has been assessed. That single premium assessment took place in 1992 when the problems in New England area credit unions and in the real estate markets resulted in significant losses to the NCUSIF. Other than in that extraordinary situation, no premium assessments have been required. In fact, to the contrary, effective management of the NCUSIF and minimal credit union losses has resulted in the end-of-year equity ratio being above the required operating level in an amount sufficient to allow the NCUA Board to declare dividends to insured credit unions for six consecutive years beginning in 1995. Due to the high rate of share growth in 2001 and 2002 during a period of declining earnings on the investments of the NCUSIF, the fund ended the year just below the 1.3 percent operating level and dividends were not paid in those years. This was also the case for 2003.

There are two primary factors influencing the NCUSIF and its equity ratio at this time. First, the low interest rate environment of recent years has reduced the investment income to the NCUSIF. In December 2003, gross income was $10.6 million, while in December 2002 gross income was $16.2 million. Investment earnings have been significantly reduced since many of the fund's older investments which yielded over 6 percent have matured over the past several years. The funds are now being reinvested in Treasury Notes of similar maturities with yields less than 2 per-

cent. During this same period, the yield of the NCUSIF has fallen over 300 basis points to 2.02 percent for December 31, 2003.

Second, in July 2002 the NCUA Board adopted a policy of building its reserves for losses to the NCUSIF by transferring $1.5 million a month to the reserve account for incurred losses not specifically identified, in addition to reserves for specific cases and a pool for CAMEL Code 4/5 credit unions. The final $1.5 million transfer was made as of December 31, 2003 to the reserve account for incurred losses not specifically identified.

Earnings on the fund principal have been sufficient to keep the NCUSIF appropriately funded into the future absent extraordinary losses, but dividends to insured credit unions that are allowable by statute when the fund equity level exceeds the established operating level are not likely to return until interest rates rise sufficiently to allow earnings to return to historical levels.

Losses are anticipated to remain low and extraordinary losses are not anticipated based upon the ongoing examination and supervision of the credit unions NCUA regulates and insures.

As of December 31, 2003, there were 217 problem credit unions coded CAMEL 4 or 5. Of the 217, only 10 are coded CAMEL 5. This number has remained quite constant over the last 4 years. For purposes of comparison, there were 338 problem credit unions in 1999 and, for a 10-year indication, there were 319 in 1994.

For 2003, NCUA was called upon to provide assistance to liquidate, merge or arrange a purchase and assumption for 13 federally insured credit unions. This number is trending lower than in the past 10 years when we averaged 27.8 such cases per year.

Agency Initiatives

Over the course of the last 3 years, NCUA has taken several initiatives to help the agency address a rapidly changing and dynamic financial marketplace as well as bring more efficiency, accountability, and productivity to agency operations. These initiatives have been influenced by several factors. The overall number of credit unions is declining while assets and credit union membership are continuing to grow at record pace. Credit unions are becoming more complex and sophisticated as technology and member demands change and emerge. Economies of scale and availability of resources are likewise impacting the level and types of services offered. In recognition of these and other factors, the agency has taken a number of specific measures to address this changing financial and regulatory environment.

In 2002, NCUA fully implemented a risk-focused examination program in conjunction with a system of risk-based scheduling of examinations. This change in examination emphasis and focus required an agency-wide effort to redesign and update the call report as well as other computer and informational system enhancements. In addition, NCUA embarked upon an aggressive and thoroughly enhanced training program for our field examiners, their supervisors, all regional office staff, and central office personnel in an effort to maximize productivity and to ensure the overall safety and soundness of the program. As a result of the risk-focused examination program, agency resources are now geared more than ever toward institutions and areas of risk requiring the most attention. Likewise, this approach permits examiners to direct their attention to areas of institutional risk and allows them to spend less time on issues presenting minimal or no risk to the credit union and the insurance fund. Risk-based scheduling of examinations has also provided NCUA flexibility to direct more of its resources to those institutions requiring additional supervision according to their individual risk factors while at the same time maintaining integrity in our first and foremost mission of ensuring safety and soundness. Not only has the program allowed NCUA to focus on true areas of risk, but it also has resulted in more efficient use of agency resources with fewer employees than were employed by NCUA 10 years ago.

A key component of the risk-focused examination program was the NCUA Board's action to require the submission of quarterly call reports, known as 5300 reports, from all federally insured credit unions. Previously only credit unions over $50 million in assets were required to submit quarterly call reports. All other credit unions (79.8 percent of the 9,369 federally insured credit unions have less than $50 million in assets) were only required to submit call reports on a semi-annual basis. However, for the risk-focused examination program and risk-based scheduling to be effective and to properly monitor and identify areas of risk, NCUA felt it was necessary to require quarterly call reports from all federally insured credit unions so that the agency, and the State supervisory authority in the case of State-chartered, federally insured credit unions, could have the most current financial information available for analysis and review. In an effort to prevent unnecessary regulatory burden, a short form 5300 report was devised for the smallest credit unions with

less than $10 million in assets for the interim first and third quarter reports. Call report data is analyzed and a financial performance report (FPR) is produced for every federally insured credit union, serving as the basis for ongoing risk analysis.

Another component of the risk-focused examination program involves the designation of subject matter examiners. When areas with a greater opportunity for loss are identified, the risk-focused examination program relies upon staff to act as brokers for problem resolution. The increasing complexity of credit union operations and the advanced knowledge necessary to properly identify risk in some areas have made it increasingly difficult for a generalist examiner to resolve problems without more extensive knowledge and skills. Therefore, NCUA has developed an examiner structure where experienced examiners are designated and trained in a specific subject area of concentration such as IS&T and specialized lending. To further enhance the agency's examination program, NCUA is studying the creation of a large credit union examination specialty program based upon a pilot program now concluding. These programs are intended to ensure the necessary expertise is available to accomplish the more demanding examination skills required when examining more complex or larger institutions. By focusing staff development in certain areas, NCUA is able to accelerate the effective evaluations of technical subjects and maintain a current level of knowledge during periods of rapid industry development. This revised examiner structure will ensure that the sufficient skills and resources are available to timely identify and limit potential risk to NCUSIF.

Beginning in 2001, NCUA initiated an internal agency self-study, known as the Accountability In Management (AIM) study, whereby agency management personnel were tasked with identifying potential areas of NCUA's internal operations where cost savings and greater efficiency and productivity could be realized within the strategic goals of the agency without sacrificing the safety and soundness of the credit union industry. This in-depth process was finalized over a 2-year period in two phases with the first portion focusing on the central office and the second phase focusing on the regional offices. The results of this process have been extremely positive both for agency effectiveness and efficiency. The overwhelming majority of the AIM recommendations have been implemented and others are presently in the process of implementation with a timetable of being fully implemented by the end of 2004.

One of the most significant recommendations stemming from the AIM study was the realignment and reduction of NCUA's regional offices from 6 to 5. Realignment has been accomplished, and in January 2004 one of NCUA's six regional offices closed while another regional office moved to a lower-cost area. This consolidation, along with the restructuring of several offices in both central and regional offices, is expected to save the agency and its stakeholders $27 million over the next 10 years. Additionally, as part of this internal initiative, agency staffing levels have been reduced by 58 FTE's over the last 2 years without any adverse impact on the agency's safety and soundness responsibilities. All of the AIM staffing reductions were accomplished through attrition and without layoffs, forced retirements, or costly buyouts.

The NCUA Board has successfully implemented a number of regulations and updates that are consistent with the spirit and requirements of the Federal Credit Union Act as amended by passage of the Credit Union Membership Access Act of 1998 and are resulting in stronger, safer, and sounder credit unions. These updates in areas such as field of membership, investment options, and member business lending, among others, have served to provide Federal credit unions with much needed diversification options required to remain competitive and financially strong in a constantly changing and rapidly evolving financial marketplace.

Among the more notable initiatives undertaken by NCUA has been the successful Access Across America program which is designed to create economic empowerment for people from all walks of life, particularly those residing in underserved or unbanked neighborhoods and communities. This initiative has seen impressive results as 494 Federal credit unions across the United States have voluntarily adopted over 1,021 CDFI-designated investment or underserved areas into their fields of membership since the beginning of 2000. As a result of their expanding into underserved areas, credit unions are required to be financially able to extend services to the entirety of the community, have an acceptable business and marketing plan to do so and establish a physical presence in the community. The result has been the extension of access to affordable financial services and products to over 64.7 million Americans residing in underserved communities who previously lacked access to a not-for-profit, member-owned credit union as a alternative source of lower cost financial services in their local neighborhoods—neighborhoods which have become the home of countless higher cost lenders such as pawn shops, rent-to-own centers, check cashing outlets, and title loan companies.

NCUA call report data indicates that the 494 Federal credit unions adding underserved areas to their field of membership since 2000 have grown their membership at an annual rate of 4.36 percent, which is 237 percent greater than the annual membership growth rate of 1.29 percent for Federal credit unions overall during the same 4-year period. Lending growth increased at an annual rate of 12.5 percent in those Federal credit unions adopting underserved areas, and savings growth has increased 13.5 percent annually. These loan and savings rates are 58 percent and 30 percent higher than the respective growth rates of these two categories in the Federal credit union community as a whole.

Recommended Regulatory Reforms

In response to a request from Chairman Shelby, and on behalf of the Board of the National Credit Union Administration, I provided the Committee in June 2003 with seven specific recommendations to address unnecessary regulatory burden, improve productivity and other needed regulatory reforms for Federal credit unions. It is my understanding that each of my colleagues from Federal financial regulatory agencies represented here today likewise made their own recommendations in response to your letter. We are pleased that these regulatory relief issues, among others, are being evaluated for possible inclusion in legislation this Congress.

The addendum to this testimony describes NCUA's proposals and the reasons for them. These proposals are consistent with the mission of credit unions and the principles of safety and soundness. They address statutory restrictions that now act to frustrate the delivery of financial services because of technological advances, current public policy priorities or market conditions.

I would encourage the Committee to give serious consideration to NCUA's regulatory relief recommendations. As always, NCUA stands ready to work as a resource to the Committee on these and other matters impacting the delivery of financial services through and the safety and soundness of America's credit unions.

Conclusion

Again, thank you, Mr. Chairman, for the opportunity to appear before you today on behalf of NCUA and my colleagues on the NCUA Board to discuss the state of the American credit union industry. I will be more than pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.

National Credit Union Administration

June 27, 2003

Office of the Chairman

The Honorable Richard Shelby
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Shelby:

In response to your request of May 23, 2003, and on behalf of the Board of the National Credit Union Administration (NCUA), I am pleased to present to you and the Committee on Banking, Housing and Urban Affairs recommendations that we believe serve to remove unnecessary regulatory burden and improve productivity, as well as provide other needed regulatory reforms for federal credit unions (FCUs).

The following recommendations and suggestions were also provided to the House Committee on Financial Services in both the 107th and the 108th Congress as they considered similar legislation. Many of these recommendations, as you may know, were included in H.R. 1375 currently under consideration in the House of Representatives. NCUA continues to believe that legislation to reduce regulatory burden will positively impact our ability to provide a safe and sound regulatory environment for America's credit unions in an ever-changing and dynamic financial marketplace.

These proposals are consistent with the mission of credit unions and the principles of safety and soundness. They address statutory restrictions that now act to frustrate the delivery of financial services because of technological advances, current public policy priorities, or market conditions.

1. Check cashing, wire transfer and other money transfer services

The Federal Credit Union Act authorizes FCUs to provide check cashing and money transfer services to members. 12 USC 1757(12). To reach the "unbanked," FCUs should be authorized to provide these services to anyone eligible to become a member. This is particularly important to the

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overwhelming majority of FCUs whose field of membership includes individuals of limited income or means. These individuals often do not have mainstream financial services available to them and often pay excessive fees for check cashing, wire transfer and other services. Allowing FCUs to provide these limited services to anyone in their fields of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations.

2. The twelve-year maturity limit on loans

FCUs are authorized to make loans to members, to other credit unions, and to credit union organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a twelve-year maturity limit that is subject to only limited exceptions. 12 USC 175(5). This "one-size-fits-all" maturity limit should be eliminated. It is outdated and unnecessarily restricts FCU lending authority. FCUs should be able to make loans for second homes, recreational vehicles and other purposes in accordance with conventional maturities that are commonly accepted in the market today. NCUA should retain the rulemaking authority to establish any maturity limits necessary for safety and soundness.

3. One percent investment limit in CUSOs

The Federal Credit Union Act authorizes FCUs to invest in organizations providing services to credit unions and credit union members. An individual FCU, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations. 12 USC 1757(7)(I). These organizations, commonly known as credit union service organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risk is isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the insurance fund, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation.

4. Branch and service facility "reasonable proximity" statutory mandate

The Credit Union Membership Access Act enacted in 1998 expressly authorized multiple common-bond credit unions. The Access Act provided, however, that an FCU may add a new group to its field of membership only if the credit union "is within reasonable proximity to the location of the group." 12 USC 1759(f)(1)(B). This, in effect, could be interpreted to require a credit union to establish a costly physical presence that might potentially, if unchecked, present long-term safety and soundness concerns and, unfortunately, in many cases serves as a financial deterrent to credit unions who otherwise have a desire to extend financial services to the group. This geographic limitation on FCU services is unnecessary in today's financial marketplace, where most services can be provided electronically. This limitation could prevent NCUA from allowing an FCU and a group to match up when it is their wish to do so, and may even prevent NCUA from adding groups to the FCU best suited to serve them. The statutory "reasonable proximity" mandate is an unnecessary hindrance to providing credit union services and should be removed, thus allowing NCUA to define and implement reasonable "ability to serve" requirements.

5. Investment Authority

The Federal Credit Union Act limits the investment authority of FCUs to loans, government securities, deposits in other financial institutions and certain other very limited investments. 12 USC 1757(7). This limited investment authority restricts the ability of FCUs to remain competitive in the rapidly-changing financial marketplace. The Act should be amended to provide such additional investment authority as is approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state chartered credit unions or other financial institutions.

6. Voluntary merger authority

The Federal Credit Union Act, as amended by the Credit Union Membership Access Act, allows voluntary mergers of healthy FCUs, but requires that NCUA consider a spin-off of any group of over 3,000

members in the merging credit union. 12 USC 1759(d)(2)(B)(i). When two healthy FCUs wish to merge, and thus combine their financial strength and improve service to their members, they should be allowed to do so. There is no logical reason to require, in connection with such mergers, that groups over 3,000, or any group for that matter, be required to spin off and form a separate credit union. These groups are already included in a credit union in accordance with the statutory standards, and that status is unaffected by a merger.

7. Treatment of credit unions as depository institutions under securities laws.

Another matter of significant importance is the need for regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker/dealers when engaging in certain activities. Gramm-Leach-Bliley provided banks with registration relief for certain enumerated activities. The relief sought for credit unions would be more limited in scope and application than that in existence for banks, and proposed for thrifts, because credit union powers are limited by their chartering statutes, and credit unions do not have certain powers, such as general trust powers, that are available to banks and thrifts. The requested parity relief for credit unions would apply only to those activities otherwise authorized for credit unions under applicable credit union chartering statutes, currently including third-party brokerage arrangements, sweep accounts, and certain safekeeping and custody activities.

8. Technical Corrections to the Federal Credit Union Act

NCUA would also request the inclusion of several minor miscellaneous technical corrections which serve to clarify and update specific statutory provisions of the Federal Credit Union Act. A comprehensive list of proposed technical corrections to the Federal Credit Union Act is attached.

9. Other Issues

Other issues of interest that could potentially be raised by the credit union community as you consider regulatory relief legislation this year could mirror many of the credit union provisions included in H.R. 1375

known as the "Financial Services Regulatory Relief Act of 2003." We have reviewed all of the credit union provisions included in H.R. 1375 which were in addition to the recommendations we submitted to the Committee and have no safety and soundness concerns with these additions. Among these are provisions which address criteria for continued membership of certain groups in community charter conversions; leases of land on Federal facilities for credit unions; member business loans for non-profit religious organizations; credit union governance changes; and exemption from pre-merger notification requirements under the Clayton Act. Again, though we recognize these issues as statutory in nature and therefore a public policy decision only the Congress can make, we have carefully examined each and have determined that these provisions, if enacted, present no safety and soundness concerns for credit unions we regulate and/or insure.

Also, among the provisions included in H. R.1375 currently pending in the House is a provision to allow privately-insured state-chartered credit unions to join the Federal Home Loan Bank System. We take no formal position regarding this provision given that NCUA is neither the regulator nor the insurer of state-chartered credit unions whose deposits are not insured by the National Credit Union Share Insurance Fund. However, we do have concerns with language added to the House bill which makes it appear that oversight responsibility for non-federally insured credit unions and certain state regulated private share insurance companies rests with NCUA. NCUA has no legal authority, regulatory or supervisory jurisdiction over these institutions and organizations, nor do we seek it. In the event the Committee chooses to include a similar provision authorizing membership to the Federal Home Loan Bank System by privately-insured state-chartered credit unions, we would strongly argue against the inclusion of any language such as that included in the House bill which requires private insurance providers to submit copies of their annual audit reports to NCUA. In our view, the inclusion of such language can lead to potential consumer confusion and misunderstanding and seems to bring the federal regulatory authority into a role appropriately resting with the state credit union and insurance regulators.

It has been five years since Congress has thoroughly addressed our statute and the regulations that emanate from it. NCUA has now had the benefit of these years of experience working with the changes made to the Federal Credit Union Act by the passage of the 1998 law, as well as many additional years with other provisions we identified as in need of statutory reform or revision.

As the Committee begins work on this legislation, it is our belief that, where appropriate and dictated by efficiency and overall concerns for safety and soundness, it would be advisable for the Committee to consider the option to authorize the appropriate regulatory agency to address many of these issues from a regulatory perspective rather than by addressing them specifically in the statute. Such an approach would make it possible for the regulators to adjust, where appropriate, to changing conditions in the marketplace or evolving safety and soundness considerations without the necessity of a statutory revision.

Our goal at NCUA, as we implement any regulatory relief provisions the Congress ultimately chooses to enact, will be to take any and all actions with an eye towards removing unnecessary regulatory burden while maintaining, as is proven by the historical strong performance of America's credit unions, our first and foremost priority and commitment to both safety and soundness and necessary regulation to protect the American public.

On behalf of the NCUA Board, I want to express our appreciation for your consideration and support of NCUA's recommended provisions.

Sincerely,

Dennis Dollar
Chairman

Enclosure

Technical Corrections toThe Federal Credit Union Act (12 U.S.C. 1751 et seq)

(1) In section 101(3), strike `and' after the semicolon.

(2) In section 101(5), strike the terms `account account' and `account accounts' each place any such term appears and insert `account'.

(3) In section 107(a)(5)(E) (as so designated by section 303 of this Act), strike the period at the end and insert a semicolon.

(4) In paragraphs (6) and (7) of section 107(a) (as so designated by section 303 of this Act), strike the period at the end and insert a semicolon.

(5) In section 107(a)(7)(D) (as so designated by section 303 of this Act), strike `the Federal Savings and Loan Insurance Corporation or'.

(6) In section 107(a)(7)(E) (as so designated by section 303 of this Act), strike `the Federal Home Loan Bank Board,' and insert `the Federal Housing Finance Board,'.

(7) In section 107(a)(9) (as so designated by section 303 of this Act), strike `subchapter III' and insert `title III'.

(8) In section 107(a)(13) (as so designated by section 303 of this Act), strike the `and' after the semicolon at the end.

(9) In section 109(c)(2)(i), strike `(12 U.S.C. 4703(16))'.

(10) In section 120(h), strike `under the Act approved July 30, 1947 (6 U.S.C., secs. 6-13),' and insert `chapter 93 of title 31, United States Code,'.

(11) In section 201(b)(5), strike `section 116 of'.

(12) In section 202(h)(3), strike `section 207(c)(1)' and insert `section 207(k)(1)'.

(13) In section 204(b), strike `such others powers' and insert `such other powers'.

(14) In section 206(e)(3)(D), strike `and' after the semicolon at the end.

(15) In section 206(f)(1), strike `subsection (e)(3)(B)' and insert `subsection (e)(3)'.

(16) In section 206(g)(7)(D), strike `and subsection (1)'.

(17) In section 206(t)(2)(B), insert `regulations' after `as defined in'.

(18) In section 206(t)(2)(C), strike `material affect' and insert `material effect'.

(19) In section 206(t)(4)(A)(ii)(II), strike `or' after the semicolon at the end.

(20) In section 206A(a)(2)(A), strike `regulator agency' and insert `regulatory agency'.

(21) In section 207(c)(5)(B)(i)(I), insert `and' after the semicolon at the end.

(22) In section 207(c)(8)(D)(ii)(I), insert a closing parenthesis after `Act of 1934'.

(23) In the heading for subparagraph (A) of section 207(d)(3), strike `TO' and insert `WITH'.

(24) In section 207(f)(3)(A), strike `category or claimants' and insert `category of claimants'.

(25) In section 209(a)(8), strike the period at the end and insert a semicolon.

(26) In section 216(n), insert `any action' before `that is required'.

(27) In section 304(b)(3), strike `the affairs or such credit union' and insert `the affairs of such credit union'.

(28) In section 310, strike `section 102(e)' and insert `section 102(d)'.

PREPARED STATEMENT OF KEVIN P. LAVENDER

COMMISSIONER, TENNESSEE DEPARTMENT OF FINANCIAL INSTITUTIONS
ON BEHALF OF THE
CONFERENCE OF STATE BANK SUPERVISORS

APRIL 20, 2004

Good morning, Chairman Shelby, Senator Sarbanes, and Members of the Committee. I am Kevin Lavender, Commissioner of Financial Institutions for the State of Tennessee, and Chairman of the Regulatory Committee of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to testify on the condition of the State banking system.

CSBS is the professional association of State officials who charter, regulate, and supervise the Nation's approximately 6,400 State-chartered commercial and savings banks, and nearly 400 State-licensed foreign banking offices nationwide.

CSBS gives State bank supervisors a national forum to coordinate, communicate, advocate, and educate on behalf of the State banking system. We especially appreciate this opportunity to discuss the state of our Nation's banking system in general, and the state of the State banking system in particular.

Condition of the Industry

As you have heard from my colleagues on this panel, the general health of the banking industry is excellent. State-chartered banks, which make up approximately three-quarters of the Nation's commercial banks, have shared in the industry's record levels of prosperity.

Net income of State-chartered commercial and savings banks at year-end 2003 reached $44.2 billion, an 18 percent increase over the previous year's record levels. State banks' aggregate equity capital ratio stands above 9 percent, a level that exceeds the industry aggregate and regulatory requirements, and has risen steadily over the past 3 years. State banks' core capital, or leverage ratios, are equally strong, and slightly higher than those of their federally chartered counterparts. State banks' ratio of nonperforming assets to assets continues to decline, and stands even lower than the industry's overall level.

As regulators, we look for areas of concern, but even some of these areas have shown improvement over the last several quarters. We saw deposits in State-chartered banks grow from year-end 2001 to 2002, and again from year-end 2002 to 2003. And our banks are still finding good loans to make, and we saw strong growth in earning assets in 2003.

We never forget that these record levels of prosperity are occurring in an environment of historically low interest rates, and examiners pay special attention to the vulnerability of our banks' portfolios to interest rate volatility. My colleagues and I have also been particularly concerned about banks' internal controls systems, because experience has shown us that nothing disguises bad management as well as a good economy.

Consolidation of the banking industry continues, raising concern about concentration of risk and the range of meaningful choices available to consumers. The pace of consolidation slowed in 2003, but consolidations continue among the very largest institutions. The Nation's 50 largest banks now hold almost 63 percent of banking assets nationwide. In Tennessee, the six largest banks hold more than 50 percent of local banking assets; this percentage jumps to more than 80 percent in Davidson County, the area around Nashville.

We expected consolidation in the wake of the Riegle-Neal Interstate Banking and Branching Efficiency Act. Consolidation has benefited not only the institutions involved, but also customers who live and work in more than one State or metropolitan area. In some cases, though not all, consolidation seems to have led to lower costs for consumers and more convenient access to services.

My colleagues and I worry, however, about declining diversity in our banking system, and about the forces driving this latest round of consolidation. I will discuss these concerns at greater length later in my testimony.

The number of State-chartered banks declined by just over 1 percent in 2003, compared with a consolidation rate of just over 2 percent in 2002. A steady stream of new bank charters and conversions has partially offset the number of institutions lost to mergers over the past several years. Of the 117 new banks chartered last year, 100 chose a State charter. This rate—85 percent—shows that the banking industry and the business community continue to believe in the value of the State charter. Ten years after the enactment of the Riegle-Neal Interstate Branching Efficiency Act, the State banking system remains a vibrant and essential part of our Nation's financial services infrastructure.

State-chartered banks make up just over 74 percent of all commercial banks nationwide. They tend to be smaller than national banks, holding in the aggregate just under 44 percent of U.S. banking assets.

The State system does, however, include several large and complex institutions that operate across State lines. Over the past 10 years, State banking departments have worked with the FDIC and the Federal Reserve, as well as other relevant State and Federal regulators, to develop a seamless supervisory system that ensures oversight while minimizing supervisory burden. This system continues to evolve.

Our Nation's financial system—and our Nation's financial services policies—have always emphasized the need for balance, diversity, and opportunity. Americans have traditionally been wary of monolithic authority in any form, whether it is a single oppressive ruler or one gigantic corporation. Chairman Greenspan has noted on many occasions that the diversification of our financial system has been an essential element in preventing the kind of lingering crises we have seen in Asia and Europe. Our State banking system encourages entrepreneurship in the banking industry, creating opportunities for new credit providers to enter the market and find new ways to serve their communities.

As we have seen time and time again, however, not only in the banking industry but also in the business world at large, even the most entrepreneurial environment needs oversight, especially when public confidence is at stake.

The State banking departments supervise and regulate a wide range of financial businesses in addition to commercial banks and savings banks. Most State banking departments, including my own, supervise State-chartered credit unions as well as thousands of nondepository financial businesses.

The Tennessee Department of Financial Institutions, for example, licenses and supervises 749 industrial loan and thrift offices, 63 insurance premium finance companies, 1,287 mortgage companies, 390 check cashers, 1,196 deferred presentment services companies (payday lenders), and 42 money transmitters, as well as 159 State-chartered banks, 10 trust companies, two Business Investment Development Companies, and 129 State-chartered credit unions.

Our mission is to provide the citizens of Tennessee with a sound system of State-chartered financial institutions. We do this by monitoring compliance with the State laws and regulations that promote sound business practices and safeguard depositors and consumers. We conduct onsite examinations not only of our depository institutions, but also of our nondepository licensees. An entire division of our department was recently formed and is dedicated to consumer resources; in fact, the department resolved 500 complaints in 2003.

Senators, State banks in Tennessee and nationwide are healthy. The State banking system, however, faces a grave threat, and I ask your help in restoring the balance that makes it possible for my department to fulfill its mission.

Role of Preemption in Maintaining the Health of the Banking System

The balance between Federal and State authority over banking activities, and between large and small institutions in the marketplace, continues to evolve. If nearly 140 years of history have shown us anything, it is that the health of the American banking system depends on competition and meaningful choice: The availability of a wide range of options for both consumers and financial institutions.

The Conference of State Bank Supervisors is committed to maintaining the competition and choice that have characterized our dual banking system. Competition and choice in our banking system remain strong despite the industry's consolidation, and the availability of the State charter is crucial to this balance. The largest institutions can and should grow to serve their customers and reach new competitive levels in a global market. As big institutions become even bigger, *de novo* chartering—again, primarily at the State level—continues to guarantee local banking options to all consumers. Even in this global economy, it remains true that one size does not fit all.

A key element of this dynamic balance is the question of Federal preemption of State authority. My colleagues and I believe that Federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity.

Few matters of Federal preemption meet this high standard. One that does is the permanent extension of the amendments to the Fair Credit Reporting Act, which we congratulate you on enacting last year. The CSBS Board of Directors determined that these amendments served the national interest, and we applaud the careful consideration that both houses gave that legislation.

Many State banking departments and other State agencies have consumer protection mandates that they take just as seriously as their Federal counterparts do. As Securities and Exchange Commission Chairman William Donaldson has noted, Fed-

eral authorities "cannot be everywhere." Our State-level consumer protection initiatives serve the public interest in their own right, but also complement Federal law enforcement efforts in a very important way.

Many of the nondepository financial businesses that my office licenses have some affiliation with a larger, deposit-taking financial institution. In the wake of the Comptroller of the Currency's recently promulgated rules that preempt Tennessee authority over operating subsidiaries of national banks, these businesses have a powerful incentive to change their corporate structure for no reason other than to escape state oversight.

The Comptroller of the Currency's recent regulations preempt almost all State laws that apply to these businesses, if they are operating subsidiaries of national banks. This regulation also tries to shield all national banks—and their operating subsidiaries—from oversight, inspection, and enforcement actions by any State authority, including the State attorneys general.

The Comptroller has said repeatedly that these new regulations present no fundamental shift in the OCC's roles or responsibilities. He has called these regulations merely the next logical step in the OCC's interpretation of the National Bank Act, the Riegle-Neal Interstate Banking and Branching Efficiency Act, and Gramm-Leach-Bliley. The Comptroller has also said that these changes are incremental in nature and unlikely to have major effects on the banking industry or on consumers' experiences with financial institutions.

These claims are simply not true. These regulations are not minor or incremental changes. Their scope is nearly unlimited, and their implications are potentially enormous. These regulations exceed the OCC's statutory authority and disregard Congressional intent. They effectively discard the oversight and consumer protection structure already in place for these businesses, and they ignore Congress's design for functional regulation.

The OCC adopted these regulations over the strong objections of CSBS, the National Governors Association, the National Conference of State Legislatures and all 50 State attorneys general. The OCC also ignored requests from Members of Congress for extra time to consider their implications. Instead, the OCC issued a set of regulations that will affect millions of consumers across the country without a public hearing and without meaningful consultation with the parties these regulations would affect. We object strongly to the OCC's process in issuing these regulations, and we look forward to the findings of the General Accounting Office's study of this process.

Technology is changing the delivery of financial products. Many large banks and some small banks look less like the old commercial bank and more like the diversified financial services providers envisioned by the Gramm-Leach-Bliley Act. We appreciate that the largest financial services providers want more coordinated regulation that helps them create a nationwide financial marketplace. These goals are understandable. The State of Tennessee and CSBS support coordinated regulation in order to promote modernization of financial services, healthy competition among providers, and greater availability of financial services to the public.

The OCC's new regulations, however, usurp the powers of the Congress, stifle States' efforts to protect their citizens, and threaten not only the dual banking system but also public confidence in our financial services industry. They challenge the functional regulatory structure created by Gramm-Leach-Bliley and set the Office of the Comptroller of the Currency as the Nation's dominant regulator of financial institutions. They also seem to encourage consolidation among our largest institutions, concentrating financial risk in a handful of gigantic institutions that may become—if they are not already—not only too big to fail, but also too big to supervise effectively.

Importance of Decentralized Supervision

Maintaining a local role in consumer protection and a strong State banking system is more important than ever in the wake of the current round of mergers among our Nation's largest financial institutions. These mergers make economic sense for the institutions involved, and may offer the customers of these institutions a larger menu of products and services at prices that reflect economies of scale. But the strength of our banking system is its diversity—the fact that we have enough financial institutions, of enough different sizes and specialties, to meet the needs of the world's most diverse economy. Centralizing authority or financial power in one agency, or in a small group of narrowly regulated institutions, would threaten the dynamic nature of our economy.

State supervision and regulation are essential to our decentralized system. State bank examiners are often the first to identify and address economic problems, including cases of consumer abuse. We are the first responders to almost any problem

in the financial system, from downturns in local industry or real estate markets to the emergence of scams that prey on senior citizens. We can and do respond to these problems much more quickly than the Federal Government.

The Comptroller has argued that the laws and rules States have enacted to protect their citizens are burdensome to national banks. We are sensitive to regulatory burden, and constantly look for ways to simplify and streamline compliance. Your own efforts in this area, Senator Shelby, have greatly reduced unnecessary regulatory burden on financial institutions regardless of their charter. The industry's record earnings levels suggest that whatever regulatory burdens remain, they are not interfering with banks' ability to do business profitably.

Dual Banking System and History of Preemption

The dual banking system is part of our democratic heritage. The phrase "dual banking" refers not only to the parallel systems of State and Federal banking regulation, but also to the interaction of State and Federal laws for the benefit of our national and local economies. Since the creation of our dual banking system in 1864, all banks, regardless of their charter, have been subject to a combination of Federal and State laws. The balance of State and Federal authority has evolved, shaped by new State and Federal statutes and by a growing body of case law.

The 10 years since the passage of Riegle-Neal have transformed the financial services industry, and in this transformation we have seen the value and strength of our dual banking system. Many believed that nationwide banking would mean the end of the State regulatory system—that the States would become irrelevant or be unwilling to compromise in order to supervise multi-State institutions. Instead, the State banking system is now stronger, in many ways, than it was 10 years ago. Interstate branching and financial modernization have compelled all of us at the State level to answer the hardest questions: What is the purpose of State supervision? What do we need to do to protect our citizens, and what have we been doing just because "we always did it that way"? How can we leverage the resources of other agencies to improve our own performance and reduce regulatory burden? What authority do we truly need, and what is just a battle over turf?

Senators, these are issues that all regulators struggle with daily. Because so many powers originated at the State level, because the States were the first to pass interstate branching laws, and because Congress let the States control the phase-in to interstate branching, we have developed models for interagency information sharing, cooperation, and coordination that benefit the entire financial services industry.

Many, even most, of the new Federal powers under Riegle-Neal and Gramm-Leach-Bliley originated at the State level. Over the past 10 years, however, we have seen a new aspect of the dual banking system's value. As new products and services have emerged, so too have new opportunities for consumer confusion and, in some cases, abuse. The explosion of the mortgage industry created a new class of lenders for nonprime borrowers, and in some cases, these lenders engaged in predatory and fraudulent practices. Many States sought remedies through enforcement of existing State laws, new legislation, and financial education campaigns. Our efforts have reached thousands of borrowers and potential borrowers, punished and discouraged predatory lenders, and brought a national spotlight to this problem.

Our experience in this area shows that the dual banking system is not a museum artifact, but a vital and essential dynamic for promoting new financial services while offering new approaches for consumer protection.

Ten years after the passage of nationwide banking, the dual banking system is more important than ever. It ensures diversity in our financial services system, and it ensures that the regulatory system addresses local concerns as well as national concerns. In this case, that specifically means the interests of local borrowers and consumers.

The traditional dynamic of the dual banking system has been that the States experiment with new products and services that Congress later enacts on a nationwide basis. We generally discuss this history in terms of expanded powers, but the States have been innovators in the area of consumer protection, as well. States enacted CRA and fair lending statutes before the Federal Government did, and States are now leading the way on predatory lending, identity theft, regulation of overdraft protection products, and privacy initiatives. These State laws, which the OCC sees as burdensome to national banks, are in fact providing all of us the opportunity to see what works and what does not, and find the appropriate balance before seeking legislation on a national level.

Conclusion

Our highly diverse financial system is the envy of the world. American markets are flexible and responsive, and American banks are competitive globally as well as locally, in large part because of our decentralized regulatory system.

We believe that our dual banking system acknowledges the needs of multi-State banks and financial services firms while protecting consumers. We have worked hard, within the State system and with our counterparts at the Federal banking agencies, to develop a system of supervision that allows for innovation while ensuring safety, soundness and economic stability. The strong condition of our 6,400 State-chartered banks and 400 State-regulated offices of foreign banks is the best evidence of our success.

CSBS looks forward to working with the Congress to find additional ways to address the needs of an evolving nationwide financial services system in a way that maintains this strong condition, minimizes unnecessary regulatory burden, and ensures that all Americans retain their access to the broadest possible range of financial opportunity.

We thank you for this opportunity to testify, and look forward to any questions you and the Members of the Committee might have.

RESPONSE TO A WRITTEN QUESTION OF SENATOR SANTORUM FROM ALAN GREENSPAN

Q.1. Chairman Greenspan, in the summer of 2002, I expressed concern with the potentially adverse competitive impact that the operational risk-based capital charge in the Basel Capital Accord will have on U.S. banks. Last fall, the leadership of the House Financial Services Committee also raised concerns with the charge for operational risk. What steps are being taken to ensure that these concerns, as well as other concerns raised by Members of Congress, are getting the attention this issue warrants? Can we expect to see any of these concerns addressed in the next version of the Accord?

A.1. The Federal Reserve Board and other Federal banking agencies take very seriously the concern about potential competitive effects the operational risk-based capital charge in Basel II will have on U.S. banks. Accordingly, the agencies have several initiatives underway to address this issue.

The agencies are currently performing extensive reviews of the large U.S. banks' own internal assessment of the operational risks they face and the capital that they estimate would be needed to support those risks, using the proposed Advanced Management Approach (AMA). This benchmarking exercise will help U.S. supervisors better understand the preparedness of these banks to employ the AMA for estimating their operational risk capital charge. The three reviews performed to date indicate strong bank management support for the flexible implementation of internal processes and data collection efforts consistent with the AMA for operational risk.

In addition to the extensive benchmarking exercise, staff from the banking agencies continue to evaluate the comments received on the Advanced Notice of Proposed Rulemaking and through subsequent discussions with banks' management. Based on the revised capital framework that the Basel Committee is planning to release in June, the agencies plan to perform a comprehensive quantitative impact study of all the components of Basel II capital charges for the large U.S. banks. The resulting analysis of this information should be useful in understanding the implications of the new framework on the overall capital requirements of banks as well as the competitive impact. This analysis may also lead to recalibration and revisions to the framework that would serve as the basis for a Notice of Proposed Rulemaking in 2005.

In light of the concerns regarding potential competitive effects that an operational risk-based capital charge may have on U.S. banks, the Federal Reserve is also in the process of conducting an empirical study of such possible effects. The study will specifically address the potential competitive disadvantage that an explicit pillar one operational risk capital charge might create for U.S. banks vis-á-vis nonbank competitors, non-Basel II, U.S. banks, and foreign banks whose regulators allegedly might be less aggressive in applying Basel rules than the U.S. regulators. The results of this study should be available by the end of the year.

In response to your final question on whether competitive concerns will be addressed in the next version of the Accord, the U.S. regulators note that the AMA has been included in the framework at the insistence of U.S. banks. In effect, the capital requirement for operational risk under the AMA would be based upon the

banks' own internal economic capital estimate for such risk, as long as their processes are comprehensive and well-reasoned.

RESPONSE TO WRITTTEN QUESTIONS OF SENATOR SCHUMER FROM JOHN D. HAWKE, JR.

Q.1. Did any of the 16 Saudis who were in the United States under diplomatic cover, but in actuality worked in a Virginia school that was teaching terrorism, or a Saudi consular official in Los Angeles who was deported in 2003, have accounts at Riggs or receive money from these accounts and, if so, how much?

A.1. Riggs has conducted a search of its account records and has identified a total of 17 accounts in the names of 11 of the 16 Saudis that you reference. Five of these accounts have been closed leaving 12 open accounts in the names of 9 of the 16 Saudis that you reference. The Virginia school that you reference had five accounts at Riggs that have recently all been closed. The Saudi consular official in Los Angeles did not have an account at Riggs. Riggs is conducting a review of transaction activity for each of the accounts identified, subject to the OCC's oversight. The OCC is in process of reviewing Riggs' actions relating to these accounts and determining whether their conclusions were adequate and consistent with the OCC's enforcement actions.

Q.2. In your enforcement action on July 16, 2003, Riggs Bank was tasked with filing suspicious activity reports within 150 days in relationship to these accounts. Have these reports been filed? If so, how many?

A.2. I am precluded by law from disclosing the content or even the existence of a SAR. However, I can tell you that pursuant to the July 2003 cease and desist order, Riggs hired KPMG to conduct a study of its Saudi Embassy accounts and, as part of that study, identify transactions that were suspicious in nature and which required SAR filings.

Q.3. What are you doing to tighten things up so that there are no future Riggs Bank situations?

A.3. We have taken and we are in the process of taking a number of actions to improve our supervision in the anti-money laundering area. These include supplemental directions to our examiners and implementation of new systems that will enable us to enhance identification of high-risk banks, and flag situations that warrant follow-up supervisory or enforcement actions. I have described these steps in more detail in my written testimony that was provided to the Committee for the June 3 hearing. A copy is enclosed.

Q.4. It is my understanding that there were two checks on Riggs in relation to Bank Secrecy, one in 2000 and one in 2003, and that most of the bad stuff occurred between. Is it that you are understaffed? If I am right about this, would you say that would not have been enough?

A.4. Riggs has been under a great deal of scrutiny for several years. In fact, between 2000 and 2003, the OCC conducted nine examinations and reviews that were BSA-related. More information about these examinations and the history of our supervision of Riggs is set forth in more detail in my written testimony that was

provided to the Committee for the June 3 hearing. Neither the number nor the scope of the examinations that we performed at Riggs during the period in question was driven by staffing issues.

V. RIGGS BANK ENFORCEMENT ACTIONS

As previously mentioned, the OCC and FinCEN recently assessed a $25 million CMP against Riggs Bank N.A. for violations of the BSA and its implementing regulations, and for failing to comply with the requirements of an OCC C&D order that was signed by the bank in July 2003. Also, in a separate C&D action dated May 13, 2004 to supplement the C&D we had issued in July 2003, the OCC directed the bank to take a number of steps to correct deficiencies in its internal controls, particularly in the BSA/AML area. Among other requirements in this separate action, the OCC directed the bank to:

- Ensure competent management. Within 30 days, the board of directors must determine whether management or staff changes are needed and whether management skills require improvement.
- Develop a plan to evaluate the accuracy and completeness of the bank's books and records, and develop a methodology for determining that information required by the BSA is appropriately documented, filed and maintained.
- Adopt and implement comprehensive written policies for internal controls applicable to the bank's account relationships and related staffing, including the Embassy and International Private Banking Group. Among other requirements, the policies must mandate background checks of all relationship managers at least every three years and must prohibit any employee from having signature authority, ownership or custodial powers for any customer account.

- Develop and implement a policy that permits dividend payments only when the bank is in compliance with applicable law and upon written notice to the OCC.
- Adopt and implement an internal audit program sufficient to detect irregularities in the bank's operation, determine its level of compliance with applicable laws and regulations and provide for testing to support audit findings, among other requirements.

These actions were based on a finding that the bank had failed to implement an effective AML program. As a result, the bank did not detect or investigate suspicious transactions and had not filed SARs as required under the law. The bank also did not collect or maintain sufficient information about its foreign bank customers. In particular, the OCC found a number of problems with the bank's account relationship with foreign governments, including Saudi Arabia and Equatorial Guinea. Riggs failed to properly monitor, and report as suspicious, transactions involving tens of million of dollars in cash withdrawals, international drafts that were returned to the bank, and numerous sequentially-numbered cashier's checks. The OCC will continue to closely monitor the corrective action that the bank takes in response to the Order and we are prepared to take additional actions if necessary.

These actions are the most recent of a series of escalating supervisory and enforcement reactions to ongoing deficiencies in Riggs BSA/AML compliance program. Since this matter involves an open bank and open investigations, there are limitations on what can be said without disclosing confidential supervisory information and potentially compromising future criminal, civil and administrative actions. With that caveat, we have tried to set out below a summary of our supervision of this institution in the BSA/AML area, dating back to 1997.

The OCC first identified deficiencies in Riggs' procedures several years ago. Beginning in the late 1990's we recognized the need for improved processes at Riggs and for improvements in the training in, and awareness of, the BSA's requirements and in the controls over their BSA processes. Prior to 9/11, the OCC visited the bank at least once a year and sometimes more often to either examine or review the Bank's BSA/AML compliance program.

Over this timeframe OCC examiners consistently found that Riggs' BSA compliance program was either "satisfactory" or "generally adequate," meaning that it met the minimum requirements of the BSA, but we nonetheless continued to identify weaknesses and areas of its program that needed improvement in light of the business conducted by the bank. We addressed these weaknesses using various informal, supervisory actions. Generally, this involved bringing the problems to the attention of bank management and the board and securing their commitment to take corrective action.

During this period, it was clear that the bank's compliance program needed improvement but we determined that the program weaknesses did not rise to the level of a violation of our regulation or pervasive supervisory concern. The OCC identified problems with the bank's internal audit coverage in this area, its internal monitoring processes, and its staff training on the BSA and customer due diligence requirements. Repeatedly, management took actions to address specific OCC concerns but, as is now clear, the corrective actions being taken often were not sufficient to achieve the intended results. The bank was continually taking steps to respond to OCC criticisms, but failed to take action on its own to improve its overall compliance program,

especially with regard to high-risk areas. Due to the lack of an effective and proactive management team, additional weaknesses and deficiencies were continually identified by the OCC over this time period, but bank follow-up on these weaknesses ultimately proved to be ineffective and the problems continued longer than they should have.

As various changes occurred in the regulatory expectations for banks relative to BSA compliance and related issues over this period of time, our scrutiny of the bank was adjusted accordingly. For example, when the Financial Action Task Force and FinCEN identified "uncooperative" countries, we conducted an examination at Riggs that specifically focused on account relationships with those countries and determined that the bank did not have extensive transaction activity with any of the countries on the list. In addition, Treasury issued its guidance on "politically exposed persons" in January 2001, and, as a result, the OCC's focus on the risks associated with the Riggs' embassy banking business began to increase and our supervisory activities were heightened accordingly. However, at that time, the Kingdom of Saudi Arabia was not viewed as a country that posed heightened risk of money laundering or terrorist financing, and Equatorial Guinea had just begun to reap the financial benefits of the discovery of large oil reserves in the mid-1990s.

After 9/11, the OCC escalated its supervisory efforts to bring Riggs' compliance program to a level commensurate with the risks that were undertaken by the bank and we believed that we were beginning to see some progress in this regard. In fact, the bank was beginning the process of a major computer system conversion that would address many of the shortcomings in the existing information systems that the bank was relying on. Unfortunately, bank management had

to adjust the timeline repeatedly. This caused significant delays in the implementation date, pushing it from the original target of year-end 2002 to September 2003. Thus, the bank was not able to fulfill many of the commitments that it made to the OCC to correct our concerns pertaining to their BSA compliance program. Also, as previously mentioned, the OCC conducted a series of anti-terrorist financing reviews at our large or high-risk banks, including Riggs, in 2002. As a result of these reviews and other internal assessments, plus published accounts of suspicious money transfers involving Saudi Embassy accounts, our concerns regarding Riggs BSA/AML compliance were heightened. Thus, we commenced another examination of Riggs in January of 2003.

The focus of the January 2003 examination was on Riggs' Embassy banking business, and, in particular, the accounts related to the Embassy of Saudi Arabia. Due to its Washington D.C. location, its extensive retail branch network, and its expertise in private banking, Riggs found embassy banking to be particularly attractive and had developed a market niche. In fact, at one time, 95% of all foreign embassies in the U.S., and 50% of the embassies in London conducted their banking business with Riggs. The OCC's examination lasted for approximately five months and involved experts in the BSA/AML area. The findings from the January 2003 examination formed the basis for the July 2003 C&D order entered into with the bank. The OCC also identified violations of the BSA that were referred to FinCEN.

During the course of the 2003 examination, the OCC cooperated extensively with investigations by law enforcement into certain suspicious transactions involving the Saudi Embassy relationship. These transactions involved tens of millions of dollars in cash withdrawals from

accounts related to the Embassy of Saudi Arabia; dozens of sequentially-numbered international drafts that totaled millions of dollars that were drawn from accounts related to officials of Saudi Arabia, and that were returned to the bank; and dozens of sequentially-numbered cashier's checks that were drawn from accounts related to officials of Saudi Arabia made payable to the account holder. There was regular contact with the FBI investigators throughout this examination. We provided the FBI with voluminous amounts of documents and information on the suspicious transactions, including information concerning transactions at the bank that the FBI previously was not aware of. The OCC also hosted a meeting with the FBI to discuss these documents and findings. Throughout this process we provided the FBI with important expertise on both general banking matters, and on some of the complex financial transactions and products that were identified.

The July 2003 C&D order directed the bank to take a number of steps to correct deficiencies in its internal controls in the BSA/AML area and to strongly consider staffing changes. Among other requirements in this action, the OCC directed the bank to:

- Hire an independent, external management consultant to conduct a study of the Bank's compliance with the BSA, including, training, SAR monitoring, and correcting deficiencies and conduct a risk assessment for compliance with the BSA throughout the bank.
- Evaluate the responsibilities and competence of management. In particular, the consultant's report to the board of directors must address, among other things, the responsibilities and competence of the bank's BSA officer, and the capabilities and

competence of the supporting staff in this area. Within 90 days, the board of directors must determine whether any changes are needed regarding the bank's BSA officer and staff;

- Adopt and implement detailed policies and procedures (including account opening and monitoring procedures) to provide for BSA compliance and for the appropriate identification and monitoring of high risk transactions;
- Ensure effective BSA audit procedures and expansion of these procedures. Within 90 days the board of directors must review and evaluate the level of service and ability of the audit function for BSA matters provided by any auditor; and
- Ensure bank adherence to a comprehensive training program for all appropriate operational and supervisory personnel to ensure their awareness and their responsibility for compliance with the BSA.

The OCC began its next examination of the bank's BSA compliance in October 2003. The purpose of this examination was to assess compliance with the C&D order and the PATRIOT Act, and to review accounts related to the Embassy of Equatorial Guinea. It was clear from this examination that the bank had made progress in complying with the order and in improving its AML program. Another notable accomplishment was the successful implementation of the long planned system upgrade that significantly improved the information available to bank staff and management to monitor account activity and identify suspicious activity. Notwithstanding, there were significant areas of noncompliance noted by our examination. The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures and controls to identify suspicious transactions concerning the bank's relationship with Equatorial Guinea.

These transactions involved millions of dollars deposited in a private investment company owned by an official of the country of Equatorial Guinea; hundreds of thousands of dollars transferred from an account of the country of Equatorial Guinea to the personal account of a government official of the country; and over a million dollars transferred from an account of the country of Equatorial Guinea to a private investment company owned by the bank's relationship manager. The findings from this examination, as well as previous examination findings, formed the basis for the OCC's recent CMP and C&D actions.

In retrospect, as we review our BSA/AML compliance supervision of Riggs during this period, we should have been more aggressive in our insistence on remedial steps at an earlier time. We also should have done more extensive probing and transaction testing of accounts. Our own BSA examination procedures called for transactional reviews in the case of high-risk accounts, such as those at issue here, yet until recently, that was not done at Riggs in the Saudi Embassy and the Equatorial Guinea accounts. Clearly, the types of strong formal enforcement action that we ultimately took should have been taken sooner. This is not a case where the deficiencies in the bank's systems and controls were not recognized, nor was there an absence of OCC supervisory attention to those deficiencies. But we failed to sufficiently probe the transactions occurring in the bank's high-risk accounts and we gave the bank too much time, based on its apparent efforts to fix its own problems, before we demanded specific solutions, by specific dates, pursuant to formal enforcement actions. As described below, we have reevaluated our BSA/AML supervision processes in light of this experience and we will be implementing changes to improve how we conduct supervision in this area. I have also directed that our

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM DONALD E. POWELL

Q.1. Concerns have been raised about the fact that the owners of industrial loan banks are not regulated as bank holding companies by the Federal Reserve. Some critics have charged that industrial banks, their depositors, and perhaps the deposit insurance system are endangered by the banks' affiliation with "unregulated" parent companies.

Q.1.a. Can you describe the regulatory regime that applies to industrial loan banks and their parent companies? What authority do the FDIC and State bank regulators have to look into the activities of industrial banks' holding companies and affiliates?

A.1.a. The FDIC and State bank supervisors regulate industrial loan companies and industrial banks in the same manner as other State nonmember banks. Industrial banks are subject to the FDIC's safety and soundness regulations (with the exceptions discussed below), as well as Federal consumer protection regulations. The FDIC's authority to pursue formal or informal enforcement actions against an industrial bank is the same as the FDIC's authority with respect to any other State nonmember bank, with limited exceptions pertaining to cross-guaranty and golden parachute payments (although legislative corrections are being pursued in the proposed Financial Services Regulatory Relief Act of 2003).

Like all insured depository institutions, industrial banks receive regular examinations, during which compliance with regulations is reviewed and overall performance and condition are analyzed. For FDIC-insured, State-chartered banks that are not members of the Federal Reserve System, the FDIC, or the State authority conducts the examination. The FDIC has agreements with most States to conduct examinations under alternating schedules, although in the case of larger or troubled institutions, the FDIC and the State authority generally conduct joint or concurrent examinations.

Aside from the differences noted above for which legislative corrections are being pursued, the FDIC's authority over insured industrial banks is essentially the same as its authority over other State nonmember banks, and is considered adequate to protect the deposit insurance funds.

Although companies that control industrial banks are generally not regulated by any Federal banking agency,[1] the FDIC and chartering State authorities directly supervise an insured institution's activities and other relationships with the parent company. An industrial bank must comply with Sections 23A and 23B of the Federal Reserve Act, which restrict or limit transactions with a bank's affiliates—including parent companies—and with established Rules and Regulations, including:

- Part 325 pertaining to capital standards,
- Part 364, which requires safe and sound standards of operation,

[1] An industrial bank can be owned by a bank holding company, in which case the parent company is subject to Federal Reserve supervision. Under a proposed rule, broker-dealers that own ILC's may soon be able to choose consolidated supervision by the Securities and Exchange Commission. See Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 62 Fed. Reg. 62872 (proposed November 6, 2003, to be codified at 17 CFR Part 240).

- Regulation 0, governing credit to insiders and their related interests, and
- Consumer protection and CRA regulations.

As with all insured depository institutions, if an industrial bank becomes undercapitalized, its parent company must guarantee that the bank will comply with the capital restoration plan that the bank must submit under the Prompt Corrective Action provisions of the Federal Deposit Insurance Act. An industrial bank's parent company, however, is not subject to the penalties imposed on a financial holding company if a subsidiary bank has an impairment of capital or receives a less than satisfactory CRA rating. The industrial bank itself would be subject to standard administrative actions to resolve a capital impairment issue or a less than satisfactory CRA rating. The parent company of an industrial bank would not be subject to forced divestiture or legal restrictions that may be imposed on financial holding companies with such problems at the bank level.

In examining any insured depository institution, the FDIC has the authority (under 12 U.S.C. § 1820(b)(4)) to examine any affiliate of the institution, including its parent company, as may be necessary to determine the relationship between the institution and the affiliate and to determine the effect of such relationship on the institution. Consequently, the FDIC has the authority to examine the parent company of an industrial bank for the purposes of determining (i) the relationship between the industrial bank and its parent and (ii) the effect of such relationship on the industrial bank. In the case of a parent company that is subject to the reporting requirements of another regulatory body covered under the Gramm-Leach-Bliley Act of 1999, such as a State insurance commissioner, the FDIC has agreements in place to share information with the functional regulator.

The vast majority of industrial bank parent companies are subject to the examination authority of their respective State supervisor. The States of Utah, California, and Nevada, which collectively supervise 47 of the 55 FDIC-insured industrial banks, have direct authority to conduct examinations of parents and affiliates. The Utah Department of Financial Institutions (DFI) requires all parent companies to register with the State under Section 7–8–16 of the Utah Code, and has authority to examine such companies under Section 7–1–510. California law no longer makes a distinction between banks and industrial loan banks; currently both entities are subject to the California State Financial Code. The California DFI has authority to examine parent organizations though Chapter 21, Section 3700 (specifically Section 3704) of the California Financial Code and to require reports and information through Section 3703 of the California Financial Code. In the State of Nevada, holding companies are required to register with the Secretary of State. The Financial Institutions Department for the State of Nevada has authority to conduct examinations of parent organizations in Section 658.185.

Q.1.b. Does the FDIC use its authority to examine industrial banks' parent companies? What is the nature of this review? What has been the agency's experience?

A.1.b. As noted earlier, the FDIC has the authority to examine an industrial bank's parent for the purpose of determining (i) the relationship between the industrial bank and its parent and (ii) the effect of such relationship on the industrial bank. When it has been deemed necessary to review such relationships, the existence of this examination authority has greatly enhanced the FDIC's success in obtaining the information needed to make such determinations without any resistance from the parent organization. As a result, the FDIC has had only two cases where it had to use its authority to examine industrial banks' parent companies on-site. These cases were problem situations that involved securitization activities run through the parent organization.

It is important to note that industrial banks that have been rated 3, 4, or 5 had problems that are not unique to their charter, nor have troubled industrial banks had a history of unusual influence from parent companies or affiliates. The issues facing the troubled institutions have not been dissimilar from those encountered by the industry at-large, including those in a traditional bank holding company framework.

Q.1.c. Does the relationship of an industrial loan bank to its holding company involve risks that are not present with regard to commercial banks and bank holding companies? If so, what does the FDIC do to address them?

A.1.c. Most existing industrial banks are generally operating under a business model that is not dissimilar to those of commercial banks and bank holding companies. These models can be grouped into the following broad areas:

- Institutions serving a community niche—these institutions often provide credit to consumers and small- to medium-sized businesses. In addition to retail deposits, funding sources may include commercial and wholesale deposits, as well as borrowings. Institutions that operate within a larger corporate organization also may obtain funding through the parent organization.
- Institutions that focus on specialty lending programs, including leasing and factoring-funding sources for this relatively small number of institutions may include retail and commercial deposits, wholesale deposits, and borrowings.
- Institutions that are embedded in organizations whose activities are predominantly financial in nature, or within the financial services units of larger corporate organizations—these institutions may serve a particular lending, funding, or processing function within the organization. A few institutions restrict themselves to facilitating corporate access to the payment system or supporting cash management functions, such as administering escrowed funds.

However, a few industrial banks do operate under a business model that does involve activities that directly support the parent organizations' distinctly commercial activities. These institutions largely finance retail purchases of parent company products, ranging from general merchandise to automobiles, fuel for rental car operations, and heating and air conditioning installations. Loan products might include credit cards, lines of credit, and term loans. Funding is generally limited to wholesale or money center oper-

ations, borrowings, or other options from within the parent organization. The FDIC ensures that these risks are addressed by the bank's risk management practices through the examination process and regulatory controls over affiliate transactions, requirements for safe and sound operations, minimum capital standards, and the other supervisory and regulatory authority described earlier.

Q.2. Concerns have also been raised about whether liberalized interstate branching authority, if approved by Congress for commercial banks, should also apply to industrial loan banks.

Q.2.a. Isn't it true that industrial loan banks currently have the same branching authority (and the same branching limitations) as other banks? To what extent have they used this authority in the past? Is any industrial loan bank operating a network of bank branches in the States where they are permitted to do so?

A.2.a. Industrial banks, like other State banks, get their power to branch from their chartering authority. Generally, industrial banks have the same branching authority (and are subject to the same branching limitations) as other State banks. Currently, the majority operate in Utah and California, which provide essentially the same branching authority to industrial banks as to other State banks. This authority has not been used to any significant extent.

There are a few industrial banks with a relatively small network of branches (2,030 branches); however, these branches provide limited services (such as purchasing auto loans from local auto dealers) and do not operate as typical commercial bank offices. As of year-end 2003, industrial banks were either: (i) community focused with few, if any, branches; (ii) focused on specialty lending programs, such as credit cards, leasing, or factoring; or (iii) embedded in organizations whose activities are predominately financial in nature.

All the largest industrial banks are subsidiaries of large financial firms (such as Merrill Lynch) and serve a specific lending, funding, or processing function within the organization. These entities tend to have very limited branching or none at all. For example, Merrill Lynch Bank USA has two branches. American Express Centurion Bank, UBS Bank USA, BMW Bank of North America, Volkswagen Bank USA, and Volvo Commercial Credit Corp of Utah have no branches.

Q.2.b. Has branching by industrial loan banks been harmful has there been injury to depositors, competitors, or the deposit insurance system?

A.2.b. Since branching by industrial banks has been limited, there are no identified problems in this area that have been harmful to depositors, competitors, or the deposit insurance system. While branching by industrial banks is limited, some industrial banks still engage in activities that are statewide, regional, or national in scope. However, these serve a narrow customer niche. This group of industrial banks has had few problems during their existence. Likewise, branching activity by this group has not been harmful to depositors, competitors, or the deposit insurance funds.

Q.2.c. If industrial loan banks, along with other banks, were given expanded *de novo* branching authority, would the FDIC and State

regulators have the power to prevent abuses of this authority? Would this authority give industrial loan banks a competitive advantage over other banks or over bank holding companies? If it would create inequalities, could the FDIC do anything to address them?

A.2.c. The FDIC's ability to deal with potential abuses arising from expanded *de novo* branching authority for industrial banks would be the same as for any other State nonmember bank. Any branching activities by an industrial bank would be subject to the same application and approval process with the FDIC and State authorities as any other state nonmember bank. The FDIC and State bank supervisors regulate industrial banks in the same manner as other State nonmember banks. Industrial banks are subject to the FDIC's safety and soundness regulations (with the three exceptions discussed in the answer to question 1.a., above), as well as Federal consumer protection regulations. The FDIC's authority to pursue formal or informal enforcement actions against an industrial bank is the same as the FDIC's authority with respect to any other State nonmember bank.

Q.3. What would be the impact of legislation allowing industrial loan banks to pay interest to corporate owners of NOW accounts (which did not repeal the current prohibition against offering checking accounts)?

A.3. If legislation is passed to allow industrial loan banks to pay interest on corporate NOW accounts, we would anticipate that some would offer these accounts. Currently, some industrial banks can and do offer demand deposits, and it is likely that if allowed to do so, some would offer corporate NOW accounts. The issue is one of competitive concern rather than one of regulatory concern.

If legislation is passed that allows only commercial banks to offer interest-bearing demand deposits to their corporate customers, but does not repeal the current prohibition on industrial banks from offering NOW accounts to corporate customers, it would create disparity in the treatment of industrial banks and commercial banks. Currently, small industrial banks (those under $100 million) and those grandfathered under the Competitive Equality Banking Act of 1987 (CEBA) may offer demand deposits. Such legislation would exclude them from being able to compete with commercial banks as they currently may do.

Q.3.a. Does the business model of industrial loan banks suggest that providing corporate NOW accounts is now, or would become, widespread? If so, does this raise regulatory concerns, and does the FDIC have the ability to address them?

A.3.a. The business model of most industrial banks precludes them from providing corporate NOW accounts because NOW accounts are only available to individuals, certain nonprofit organizations, and governmental units. Further, most industrial banks cannot offer demand deposits, either because their size precludes them from doing so or they were not grandfathered under CEBA.

As one would predict from the restrictions cited above, the data on industrial loan companies show that few fund themselves through either demand deposits or NOW accounts. As of year-end 2003, only 4 of 52 industrial banks funded more than 10 percent

of their assets through noninterest bearing deposits. Another 11 funded between 1 percent and 10 percent of their assets with noninterest bearing deposits. The vast majority of industrial banks did not rely on these deposits as a source of funding.

The group of industrial banks offering NOW accounts was even more constricted. Only 14 industrial banks showed any NOW account activity. Of these, 8 funded more than 1 percent of their asset base with NOW accounts, and no institution funded more than 5 percent of assets with these accounts.

Whether a change in the legislation would lead industrial banks to offer NOW accounts to corporate customers is unknown, as their current business models would not be focused on this as a source of funding.

Q.3.b. Would the offering of interest bearing NOW accounts to corporations raise regulatory concerns? If so, does the FDIC have the authority to address them?

A.3.b. As mentioned above, allowing industrial banks to provide corporate NOW accounts is an issue of competitive concern rather than one of regulatory concern. As with thrifts in the late 1970's and early 1980's, the ability to provide products that are similar to checking accounts brings new competition into the banking sector. Moreover, eliminating the prohibition would lead to greater economic efficiency for both banks and industrial banks as they would be able to charge explicitly for services they now provide for free or at a discount. The time and expense associated with transactions designed to circumvent the prohibition, such as interest-rate sweep accounts, would be reduced or eliminated.

The FDIC does not anticipate that there would be any safety and soundness issues posed by the payment of interest on NOW accounts held by businesses. Extending the ability to pay interest on corporate NOW accounts will not pose a threat to the stability of the financial system. The FDIC currently supervises industrial banks and State-chartered, nonmember banks that offer NOW accounts. There should be no particular concern with these accounts beyond the normal supervisory concerns of requiring institutions to know their customers and manage the accounts in a safe-and-sound manner.

Q.4. Concerns have been raised about Wal-Mart acquiring a bank charter. Last summer, the FDIC conducted a symposium on banking and commerce to explore this issue.

Q.4.a. Is Wal-Mart an applicant for an industrial loan bank charter or any other bank charter?

A.4.a. We are not aware of any pending charter application by Wal-Mart. Neither Wal-Mart Stores, Inc., Bentonville, Arkansas, nor any of its subsidiaries, have filed an application or notice with the FDIC.

Q.4.b. Would the FDIC be involved in the process of approving such an application?

A.4.b. The FDIC would be involved in approving deposit insurance for any newly chartered bank. Although an application for a charter and for deposit insurance may be filed under a single inter-

agency application, the FDIC retains full authority with regard to deposit insurance determinations.

If a retail company sought to acquire control of any existing State, nonmember bank, under Section 7(j) of the FDI Act, 12 U.S.C. § 1817(j), it would have to provide the FDIC written notice of that transaction. The FDIC would review and have authority to disapprove the proposed acquisition within the notice period provided under the law based on several statutory factors.

Q.4.c. Do the FDIC and State regulators have the authority to impose conditions on the approval of such an application (for example, limitation on the bank's activities or its branching authority)?

A.4.c. In approving deposit insurance, the FDIC has the authority to, and generally does, impose conditions on the approval. The FDIC's "standard" conditions, among other more routine requirements, require final approvals from other appropriate regulatory agencies and reserve authority for the FDIC to alter, suspend, or withdraw approval before consummation should any interim development be deemed to warrant such action.

The FDIC also may impose restrictions or prudential conditions in addition to standard conditions. Examples of such safeguards include requiring adequate capital and liquidity, a business plan appropriate to the nature and complexity of activities conducted by the bank, on-site management, an independent board of directors, and policies and controls to ensure arm's-length transactions with the parent and other affiliates. In regard to branch authority specifically, the FDIC normally relies on the broad statutory framework governing branching activities embodied in Section 18(d) of the FDI Act, 12 U.S.C. § 1828(d).

The specific conditions imposed generally depend on the purpose and placement of the institution within the overall organizational structure and reflect the statutory factors of Section 6 of the FDI Act, 12 U.S.C. § 1816, that must be considered in reviewing all applications for deposit insurance. These factors are:

- The financial history and condition of the depository institution;
- The adequacy of its capital structure;
- Its future earnings prospects;
- The general character and fitness of its management;
- The risk presented by such depository institution to the deposit insurance fund;
- The convenience and needs of the community to be served by the depository institution; and
- Whether its corporate powers are consistent with the purposes of the FDI Act.

The FDIC supports provisions in the Financial Services Regulatory Relief Act of 2003 that would clarify its existing authority to approve or disapprove a change in control notice. Specifically, Section 405 of the bill clarifies the Federal banking agencies' authority under Section 8 of the FDI Act, to enforce written conditions in connection with, among other things, any notice concerning a depository institution. Section 409 clarifies the FDIC's authority to consider the risks inherent in a proposed business plan and to use that information in determining whether to disapprove a notice of change in control.

Q.4.d. What has the FDIC learned from its experience with other retailers who have owned banks in the past, such as Sears, Montgomery Ward, and JC Penny? What type of banking services did these banks provide? Did their relationship with their holding companies endanger consumers, communities, competitors, or the deposit insurance system?

A.4.d. Generally, our experience indicates that insured institutions owned by retail companies can be satisfactorily served by their relationships with their parent organizations, both financially and otherwise. Benefits include access to capital and liquidity, operational support and expertise, and an established pool of potential customers. Overall, these benefits flow to the communities in which the organization operates in the form of expanded financial options for both deposit and loan products. However, in our experience, these benefits have not proved so great that competitors—either banking or retail—have been endangered. Overall, our experience is that such relationships generally serve as a source of strength to the insured institution and the deposit insurance fund.

The universe of insured institutions currently includes, as it has in the past, institutions controlled by retail organizations. These banking subsidiaries conduct traditional banking activities, generally operate from a single location, and market products and services through the parents' locations or operations. Receivables, predominantly credit card balances, are generally held by the institution or periodically sold to the parent organization. Deposits are comprised of parent company accounts, certificates of deposit solicited from the parent's customers, and/or funds acquired through the national markets.

Q.4.e. What regulatory concerns would arise if a retailer were to acquire an industrial loan bank? Is the FDIC empowered to address these?

A.4.e. The risk posed by any insured depository institution, whether owned by a retailer or otherwise, is a factor of the appropriateness of the business plan and model, management's competency in administering the institution's affairs, and the quality and implementation of risk management programs. Commercial firms have been allowed for many years to operate, or to acquire and control, existing or newly formed financial institutions exempted from the Bank Holding Company Act (BHCA). This exemption applies to institutions chartered as industrial loan companies as well as certain institutions covered by the Competitive Equality Banking Act (CEBA). Congress, in passing the Gramm-Leach-Bliley Act, lifted certain restrictions on the affiliations of banks and financial-services firms, and left in place the existing exemptions from the BHCA applicable to both industrial banks and CEBA institutions.

Control of an institution by a retailer does raise the questions surrounding the mixing of banking and commerce. The FDIC believes that if adequate safeguards are in place, there is no compelling safety and soundness reason to preclude retailers from owning an industrial bank. To ensure safe and sound operations that protect the interests of industrial banks, their depositors, and the insurance fund, examinations necessarily involve a more complex analysis to ensure that the institution is especially diligent to:

- inform its customers of products that are not FDIC-insured;
- maintain physical separation in offering insured and uninsured financial products; establish policies against prohibited tying arrangements; and
- comply with the restrictions limiting transactions between banks and their affiliates.

As with any other insured institution, existing and newly insured industrial banks are subject to on-site examinations and other supervisory activities of the FDIC as well as the appropriate State chartering authority. Even if the institution is controlled by a commercial enterprise, a well-developed supervisory strategy can effectively insulate an insured institution from potential abuses and conflicts of interest.

The FDIC's regulatory regime and supervisory authorities that apply to industrial banks and their parent companies are described in the answers to question 1.