For Release Upon Delivery
10:00 a.m., March 13, 1996

Statement of

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before the

Committee on Banking and Financial Services

United States House of Representatives

March 13, 1996

Summary

Risk assessment is the essence of bank and thrift supervision. Accurately assessing risk can be difficult, however, because the environment in which depository institutions operate is constantly changing. As supervisors, we must remain alert to changes in the institutions we supervise and to changes in the environment in which they operate. Our examination approaches must evolve with changes in markets, products, and technology.

There are broad similarities in the risks encountered by all depository institutions. Consequently, the basic approaches of the federal banking agencies in carrying out their supervisory responsibilities are also similar.

There are also differences among institutions. Institutions may vary significantly in terms of size and range of activities, rendering a "one size fits all" approach to supervision inappropriate. Each regulator must tailor its approach to the particular mix of risks presented by the institutions it regulates.

The OTS identifies risks at thrift institutions through a comprehensive program of risk-focused supervision and examination. The program is designed to evaluate the level of risk presented by an institution, the ability of the thrift institution's management's to control the risk, and the thrift's ability to absorb any losses that may result from such risk taking.

The supervision process uses a combination of on-site examination and off-site monitoring. Each OTS individual examination is designed to focus on the most significant risks associated with each thrift's business strategies, financial condition, and unique history and circumstances. Detailed off-site evaluation procedures track thrift performance between examinations.

OTS-regulated thrifts tend to focus on long-term lending, primarily residential mortgage lending. A long-term residential mortgage lender will encounter greater interest rate risk than a short-term consumer or commercial lender. Consequently, we

have devoted significant resources to developing a sophisticated interest rate risk monitoring system to supplement the standard risk assessment tools.

This program has enabled the OTS to quantify and compare the interest rate risk faced by individual thrift institutions on a consistent basis. It also facilitates a regular assessment of the quality of each institution's procedures for managing interest rate risk. The goal of OTS is to monitor and examine the systems and controls in place at individual institutions that are designed to protect the institution against unexpected adverse movements in interest rates.

To quantify interest rate risk, the OTS built a comprehensive interest rate risk model. The benefits of the model include:

- Providing a means of identifying institutions with high levels of interest rate risk exposure;
- Helping examiners better understand changes in risk exposure within the thrift industry while facilitating a dialogue between examiners and thrift managers; and
- Generating quarterly interest rate risk exposure reports that provide thrift managers with an independent assessment of the thrift's interest rate risk profile.

The OTS model serves as a supplement to -- not a substitute for -- in-house modeling and risk measurement. We require that each thrift develop written policies and procedures governing interest rate risk, to set exposure limits, to monitor compliance, and to generate regular internal reports.

OTS-regulated thrifts are subject to many other risks such as credit risk, operational risk, liquidity risk, legal and compliance risk, and strategic risk. Through on-site and off-site monitoring, the OTS carefully monitors and evaluates the efforts of thrift management to control these risks. OTS places special emphasis on ensuring that institutions adopt and implement sound risk management policies and procedures, strong internal controls and security, and adequate information systems.

The OTS is committed to the continual improvement of its own risk assessment process. Any innovations or new approaches advanced by other regulators that will help in the effective and efficient supervision of thrift institutions will be adopted promptly.

The OTS is also committed to ensuring that its supervisory and examination approaches are consistent and compatible with those of the other banking agencies. The bank regulators must continue to share ideas and work toward the development of consistent and complementary examination and inspection practices for use in evaluating depository institutions and their holding companies.

Risk assessment is a dynamic process that calls for continuous innovation. The OTS will continue to seek out ways to enhance supervision of the thrift industry, working in partnership with the other federal banking agencies.

I. INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. I appreciate this opportunity to testify on how the Office of Thrift Supervision (OTS) monitors and assesses risk at thrift institutions. This oversight hearing provides a timely forum for the Committee and the regulatory agencies to review and compare their supervisory processes.

Risk assessment is the essence of bank and thrift supervision. It is, and has always been, the heart and soul of the statutory mission of the OTS and the other federal banking agencies. Accurately assessing risk, however, can be difficult at times because the risks facing depository institutions are constantly changing. As a result, supervisors must be alert to new risks and to shifts in the environment in which institutions operate.

Unfortunately, often over the last 50 years, bank and thrift regulators have been surprised by problems in the banking and thrift industries. With the benefit of hindsight, we can see that often, there were early signs of emerging problems that we missed. As a result, none of us are complacent. We all are constantly striving to hone our supervisory and monitoring activities so that we can identify the next big problem earlier than the last one.

The tools used to monitor risk have evolved over time. The agencies have made significant improvements in their supervisory tools since the days when we sent examiners into institutions to count the cash at each teller window. Although the tools employed in the examination process have changed, examinations have always been directed at risk assessment.

The risks faced by depository institutions are constantly changing. Rapid changes in the local economy and financial markets, the creation of new financial products, the development of new technology -- all of these pose a challenge both to the institutions and to their regulators. Our task as supervisors of depository institutions is to keep up with these changes. We must strive to have our examination approaches evolve with changes in markets, products, and technology.

There are broad similarities in the risks encountered by all depository institutions. Consequently, the basic approaches of the federal banking agencies in carrying out their supervisory responsibilities are also similar.

Nevertheless, there are also differences among institutions. Because institutions vary significantly in terms of size and range of activities, a "one size fits all" approach is not appropriate. Each regulator must tailor its approach to the particular mix of risks presented by the institutions it regulates. OTS-regulated thrifts, for example, tend to focus on long-term lending, primarily residential mortgage lending. Clearly, long-term lenders present a different -- not greater, but different -- risk profile than institutions that specialize in short-term lending. A long-term residential mortgage lender will generally encounter less credit risk, but greater interest rate risk, than a short-term consumer or commercial lender. For this reason, the OTS has devoted significant resources to developing a sophisticated interest rate risk monitoring system to supplement the standard risk assessment tools.

We are constantly looking for ways to improve our supervision. Recently, both the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) announced new risk assessment initiatives. The constant exchange of ideas among the federal banking agencies helps ensure that the agencies' risk assessment strategies remain timely and effective. We welcome these initiatives.

At the same time, as the risk assessment strategies of the banking agencies continue to evolve, it is important that the agencies work toward maintaining uniformity to the extent possible. The development of compatible examination and inspection procedures is of particular importance when, as is often the case, depository institutions and their holding companies are subject to examination and inspection by more than one banking agency.

My testimony today will be devoted to describing how the OTS approaches interest rate risk and other specific risks common to depository institutions. To provide a context for this discussion, however, I will first give a brief overview of the dramatic changes in thrift regulation in recent years and of the OTS supervision and examination process.

II. OTS PROCEDURES FOR MONITORING RISK IN THE THRIFT INDUSTRY

A. Over the past decade, there has been a sea change in how thrifts are supervised and regulated.

Thrifts today operate in a vastly different regulatory environment than in the 1980s. As a result of Congressional reforms prompted by the thrift crisis, significant differences in the safety and soundness regulation of thrifts and banks have been eliminated.

In the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress mandated that all savings associations conform to the same safety and soundness standards as are applicable to banks in key areas such as capital requirements, loans-to-one-borrower restrictions, and constraints on transactions with affiliates. Building on this improved regulatory structure, Congress also enacted statutory prompt corrective action standards in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that apply uniformly to all banks and thrifts.

Consistent with the concept underlying FIRREA and FDICIA -- that all banks and thrifts should be subject to comparable safety and soundness regulation -- the OTS and the other banking agencies have been steadily moving toward greater uniformity in all aspects of examination and supervision. For example, in 1993 OTS joined the other banking agencies in the use of a common examination rating system -- commonly referred to as "CAMEL" (Capital, Asset quality, Management, Earnings, and Liquidity).

The conversion of the OTS to a CAMEL rating system was important for several reasons. First, the CAMEL system provides an established basis for communications among the various banking agencies regarding the financial condition of insured depository institutions. It has been used for years by examination staff and is commonly understood and applied. Recent analysis conducted by staff of the Federal Deposit Insurance Corporation (FDIC) and the OTS on the accuracy and consistency of the CAMEL ratings assigned to FDIC-insured banks and thrift institutions fully confirms the value of this system.

Second, the CAMEL system is used as the basis for communicating the condition of insured institutions to the Congress and the public. Institutions receiving a CAMEL rating of 4 or 5 are considered problem institutions. Both the level and any changes in the number of problem institutions are important indicators of the health of the industries. Having a consistent and accurate basis for reporting the condition of insured institutions adds to public confidence.

Third, consistent and accurate CAMEL ratings are important because a low rating triggers a variety of supervisory responses. Institutions with poor CAMEL ratings are restricted in what they can do, have increased audit requirements and are subjected to a much higher level of supervision and monitoring.

Finally, the introduction of risk-based insurance premiums makes it important that the banking agencies retain a consistent basis for ranking the supervisory risks of different institutions. Both from an insurance perspective as well as in fairness to insured institutions, the insurance premiums charged institutions must accurately reflect the relative risk an institution poses to the funds.

I believe the current CAMEL system works well. While any system can be improved, and the OTS fully supports the current interagency efforts to enhance the

CAMEL rating system, I believe it is extremely important that any changes to the system be made in a coordinated fashion and adopted by all of the agencies.

B. The OTS supervision and examination process emphasizes risk analysis and prioritization.

Since its inception in 1989, the OTS has made a concerted effort to identify risks at thrift institutions through a comprehensive program of risk-focused supervision and examination. This program is designed to evaluate the level of risk presented by an institution, management's ability to control the risk, and the thrift's ability to absorb any losses that may result from such risk taking. This process utilizes a combination of on-site examination and off-site monitoring.

On-site examinations. Examiners custom design (scope) each examination to focus on the most significant risks associated with each thrift's business strategies, financial condition, and unique history and circumstances. For instance, if an institution is engaged in significant credit card lending, commercial lending, or derivatives, these activities will be identified for special attention during the examination.

Once on site, the examiner employs a "top-down" examination approach. This "top-down" approach provides for graduated depth of review of key operational areas based on the risks presented and the internal controls that management uses to manage those risks.

The OTS places the responsibility of managing risk squarely on the shoulders of the management and board of directors of the institution. Consistent with this policy -- and because OTS examiners cannot possibly review every transaction processed by an institution -- OTS examinations focus primarily on the effectiveness of management in controlling the level of risk.

Because risks are primarily managed through effective internal controls, one of the first steps of any examination is the evaluation of an institution's internal controls and of the extent to which these controls are being faithfully followed. By "internal controls," I mean primarily those policies and procedures regularly employed by management in making decisions, safeguarding the assets of the institution, and maintaining reliable financial records. If there are areas where internal controls are inadequate or not being faithfully implemented, the scope of an exam will be expanded to determine whether the deficiencies have resulted in material problems such as high delinquencies or excess concentrations.

Upon completion of an examination, an examiner's overall assessment of an institution is captured in the uniform CAMEL rating system, the results of the examination are communicated to the institution's management and board, and, if required, corrective measures are directed.

Off-Site Monitoring. The OTS utilizes detailed off-site evaluation procedures to track any changes in the risk profile of individual institutions between regular examinations. The goal of this off-site monitoring is early identification of any significant changes in an institution's financial condition or business activities, so as to permit a timely and effective supervisory response.

Off-site monitoring includes the review and analysis of current Thrift Financial Reports, industry and regional trends, and other detailed information. To assist in this analysis, OTS staff utilizes various tools including:

- The Uniform Thrift Performance Report (UTPR), an in-depth comparative financial performance report based upon the quarterly Thrift Financial Reports;

- The Thrift Monitoring System, which uses UTPR data to generate reports for individual thrifts and for groups of thrifts; and

- The Risk Assessment Model (RAM) which tracks key performance ratios, ranks thrifts by relative risk of failure and provides a cross-check for CAMEL ratings.

Special attention is paid to institutions that have CAMEL ratings of 3, 4 or 5, a high RAM score, heavy exposure to high risk loans or investments, high loan delinquencies, nonaccrual loans or real estate owned, or high levels of interest rate risk.

III. INTEREST RATE RISK ASSESSMENT

As I noted at the outset, we believe risk assessment strategies should be tailored to the particular mix of risks faced by the industry being regulated. Institutions holding the same charter may present different risk profiles. As a consequence, risk assessment strategies must take account both of industry trends and trends at individual institutions.

There are common risk elements within the thrift industry. As I stated earlier, thrift institutions tend to specialize in long-term residential mortgage lending. The volume of mortgage lending as well as the value of the underlying assets (mortgage loans, mortgage servicing, and securitized mortgage loans) are very sensitive to the level of and changes in interest rates. For this reason, the OTS has placed a premium on developing an effective method for monitoring and assessing interest rate risk.

Interest rate risk is the risk that an institution's earnings and capital will be adversely affected by changes in interest rates. Because thrifts make long-term mortgage loans which are generally funded with short-term liabilities, interest rate risk results from the bàsic business of the thrift industry. A mismatch between the duration of assets and liabilities gives rise to interest rate risk.

We are all aware of the damage that can be caused by excessive interest rate risk exposure. In the late 1970s and early 1980s interest rates rose dramatically and the thrift industry experienced sharply higher funding costs. As a result, the industry lost nearly $9 billion in reported earnings in the two-year period from 1981 to 1982. In terms of the economic value of thrift balance sheets, the loss has been estimated to exceed $150 billion. These losses -- caused by interest rate risk -- set the stage for the worst financial institutions crisis in our nation's history.

Against that background, the OTS placed interest rate risk monitoring and control at the top of its supervisory agenda.

A. The OTS has developed an effective interest rate risk monitoring system.

OTS has developed a comprehensive interest rate risk program. This is preventive medicine. Our goal is, and has been, to prepare thrift management to protect their institutions against unexpected adverse movements in interest rates.

We began in 1989 by issuing a thrift bulletin providing guidance to directors and officers on their responsibility to monitor and control interest rate risk. That bulletin, which laid the groundwork for our interest rate risk program, contained several key elements.

- First, it required all institutions to adopt written policies and procedures governing the management of interest rate risk.

- Second, it required large institutions -- those with assets over $500 million and those with investments in higher-risk mortgage derivative securities -- to have computer models to monitor their interest rate risk.

- Third, it required institutions (not the OTS) to set interest rate risk exposure limits for alternate interest rate scenarios, thereby ensuring that senior management and boards of directors defined in quantitative terms their tolerance for risk under different scenarios.

- Finally, it required management to monitor compliance with the limits developed by their institution and to report exposure positions to their board of directors on a regular basis.

In short, the bulletin laid out a framework that covers the critical elements of risk management: identification, measurement, monitoring, and control.

Recognizing that these critical elements of risk management are also the elements of an effective supervisory program, we saw a clear need to strengthen our surveillance and monitoring efforts. Indeed, one lesson we learned from the thrift crisis is that risk measurement is vital in bank supervision. An essential task of the supervisor is the detection and prevention of excessive risk taking by institutions.

Consequently, the OTS set out to create an interest rate risk program that would enable us to: (a) quantify the interest rate risk faced by individual thrift institutions; and (b) assess the quality of each institution's procedures for managing its interest rate risk.

To quantify interest rate risk, the OTS built a complex interest rate risk model. The model was completed in 1991 and is known as the OTS Net Portfolio Value Model (OTS Model or Model). We use the Model to conduct a type of scenario analysis known as "stress testing" to measure the vulnerability of thrift institutions to different interest-rate environments.

Nature of the Model. The OTS Model is a type of "value at risk" model, where the value at risk is the net economic value of the institution's portfolio of assets and liabilities. The Model estimates the current value of the institution's balance sheet and how much that value is expected to change under different interest rate scenarios. Because thrifts hold mortgages and other assets with embedded options, a fairly sophisticated model is required to measure the interest rate sensitivity of their balance sheets. The OTS Model employs what interest-rate risk specialists refer to as

Monte Carlo simulation and option-adjusted spread technology to value certain financial instruments.

The OTS Model enables us to monitor the interest rate risk exposure of individual thrift institutions quarterly. Each quarter, thrift institutions submit fairly detailed financial data on key characteristics of their portfolios of assets and liabilities. We believe this detailed information is necessary. For example, a 15-year fixed-rate mortgage has significantly different interest rate sensitivity than a 30-year fixed-rate mortgage, and a 7.5 percent mortgage differs significantly from one with a 10 percent rate of interest. The OTS Model uses this type of information to generate interest rate risk exposure reports for individual institutions. These customized reports contain information reflecting the interest rate sensitivity of the institution's assets, liabilities and off-balance sheet contracts based upon the characteristics reported by the institution for each type of instrument. Information on the institution's derivatives positions is available in the off-balance sheet section of the report.

Benefits of the Model. The OTS Model has proven to be a valuable supervisory tool with numerous benefits.

First, the OTS Model provides OTS with a means of identifying institutions with high levels of interest rate risk exposure. Once identified, such institutions receive close supervisory attention.[1]

Second, the OTS Model has improved our understanding of interest rate risk and helped us to better understand changes in the level of risk exposure within the thrift industry. For instance, the Model has enabled the OTS to address some of the risk measurement challenges posed by the growing use of financial derivatives. In

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[1]In the event management of an institution refuses to take appropriate corrective measures, the OTS has authority to impose an "Individual Minimum Capital Requirement" (IMCR). On a case-by-case basis, the OTS can require institutions to hold extra capital to offset abnormal levels of interest rate risk.

particular, the Model has enabled the OTS to distinguish between the speculative and non-speculative use of derivatives.[2] Derivatives can be useful hedging vehicles when used properly. They can be dangerous if not used properly or if used for speculative purposes. Examiners need to be able to understand the role an institution's derivatives play in the context of an institution's entire portfolio -- a daunting task if the examiner does not have access to a model that shows the effects of changing interest rates on the derivatives and the rest of the institution's portfolio.

Third, and perhaps most importantly, the Model has greatly facilitated constructive dialogue between examiners and thrift managers. Using the results of the OTS Model as a point of departure, OTS examiners can direct their inquiry to those areas that warrant the most attention. By comparing the results of the OTS Model with those of an institution's in-house model, examiners can better work with management to arrive at a more complete understanding of the institution's risk profile.

With access to the OTS Model, examiners are not totally dependent on an institution's self-assessment of its own risk exposure. The Model permits examiners to rank and assess the risk of different institutions using the same standards, a single methodology and common assumptions. OTS examiners have found it valuable to be able to apply common standards to different institutions to achieve meaningful comparability. Without a supervisory model to measure interest rate risk, it would be much more difficult for the OTS to rank institutions according to risk exposure and to identify those that are taking the most risk.

Finally, the OTS Model is used to generate quarterly interest rate risk exposure reports. These reports provide management with an independent assessment of the thrift's interest rate risk profile and have proven to be a valuable tool -- particularly to management at smaller institutions that may lack the resources to generate, on a regular basis, an assessment of this complexity.

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[2]The quarterly information provided by each thrift includes the type of derivative, the amount of the position, the maturity date, and other pertinent information.

Industry Reaction to the Model. Recognizing the reporting burden arising from the reports that institutions need to file each quarter, the OTS decided to exempt small institutions (those that hold less than $300 million in assets) that have risk-based capital ratios in excess of 12 percent. Despite this exemption, 87 percent of these exempt institutions submit data to OTS on a **voluntary** basis.

This suggests that the OTS Model and the customized analyses that it provides are useful not only to OTS, but to thrifts as well. By producing a product that is useful to the institutions we regulate, we implicitly reduce the regulatory reporting burden associated with the Model.

The OTS Model has served OTS well and has been well received by the financial and academic communities. We do not believe, however, it can serve as a substitute for in-house interest rate risk models. We view the OTS model as a supplement to -- not a substitute for -- in-house modeling and risk measurement. Risk management is ultimately the responsibility of each thrift institution. For this reason, we strongly encourage all institutions to develop an in-house modeling capability.

B. Thrift institutions have improved their internal management of interest rate risk.

Most thrift managers have a healthy respect for the perils of interest rate risk. The lessons of the 1970s and 1980s were painful. But the industry has made great strides in understanding, managing, and controlling its exposure to interest rate risk. In addition, because of regulatory reforms and financial innovations, interest rate risk has become more manageable.

In the 1970s, the typical thrift institution was subject to controls on both lending and borrowing. On the lending side of the business, federal policy forced thrift institutions to invest the bulk of their assets in long-term residential mortgages. Federal thrifts were not authorized to make adjustable-rate mortgages (ARMs). In addition, laws in some states imposed interest rate ceilings on home loans and prohibited thrifts from exercising due-on-sale clauses. On the borrowing side of the business, thrift institutions were subject to federal deposit rate ceilings that restricted their ability to attract and retain deposits.

When it became clear that the regulatory restrictions on lending and borrowing were exacerbating the interest rate risk problems facing the thrift industry, Congress moved to enact reforms. State laws imposing interest rate ceilings on home loans and prohibiting due-on-sale clauses were preempted by federal law. Thrift institutions were authorized to make adjustable rate mortgages and interest rate ceilings on deposits were phased out. These reforms make it easier for thrifts to manage their interest rate risk exposure. Although the reforms came too late to head off the crisis of the 1980s, their benefits are now being realized.

New tools are also available today for interest rate risk management. The dramatic increase in interest rates and interest rate volatility that characterized the late 1970s and early 1980s created a strong demand for better and more varied tools for managing and controlling interest rate risk. The financial markets responded to that need with a host of new financial instruments, including new financial futures contracts, interest rate swaps, and interest rate options (caps, floors, and collars). These new instruments have made it possible for financial institutions to manage interest rate risk effectively and efficiently.

The interest rate pressures of the late 1970s and early 1980s also prompted thrifts to rethink their operating strategies. Most thrifts now offer adjustable-rate mortgages. In addition, some thrifts have changed their operating strategies to sell all conforming fixed-rate mortgages they originate. Only their adjustable-rate mortgages and non-conforming loans are retained. As a result, adjustable-rate mortgages today account for 65 percent of the total dollar volume of single family mortgages held by the thrift industry. These strategies serve to reduce the mismatch between duration of assets and liabilities of the typical thrift institution, and thus to reduce interest rate risk.

In addition to new risk management products and operating strategies, the ability of financial institutions to measure and monitor their interest rate risk exposures has improved significantly. Simulation analysis and stress testing, once tools of only the most sophisticated financial institutions, are now widely used in the management of interest rate risk throughout the thrift industry.

Notwithstanding the progress made in monitoring and controlling interest rate risk, there is no room for complacency on the part of thrifts or the OTS. The dangers of interest rate risk have been identified, not eliminated. To this end, the OTS will continue to examine other regulatory strategies to combat excessive interest rate risk. We will continue to work with industry experts as well as the other banking agencies to refine and enhance the OTS Model.

IV. ASSESSMENT OF OTHER RISKS PRESENTED BY THRIFT OPERATIONS

OTS-regulated thrifts are subject to a number of other risks such as credit risk, operational risk, market risk, liquidity risk, legal and compliance risk, and strategic risk. These are risks that are common to most retail-oriented insured-depository institutions. I will separately address each risk and the specific supervisory procedures that the OTS uses to monitor them.

Credit Risk. Credit risk is the risk that borrowers, counter parties, or issuers of securities will not repay their obligations as contractually agreed.

OTS procedures require examiners to evaluate the quality of a thrift institution's lending policies, including standards for credit underwriting and loan documentation and management reporting systems. Management is expected to establish and utilize an independent loan review and classification system. OTS examiners review these systems to determine their adequacy.

Examiners also review management's strategy for ensuring that an institution's assets are diversified among different borrower groups, locations, and to the extent a thrift makes commercial loans, among different industries.

Thrifts are also subject to several statutory requirements that have the effect of limiting exposure to credit risk. For example, thrifts are limited in their authority to make non-mortgage-related loans. The qualified thrift lender test effectively forces thrifts to focus on traditional single-family mortgage lending, which typically carries less credit risk than commercial or other types of lending.

Operational Risk. Operational risk is the risk of loss flowing from inadequate system information, breaches in internal controls, inconsistent application of an institution's policies and procedures, or operational problems. Operational risk is managed by the maintenance of sound policies and procedures, strong internal controls and security, adequate information systems, and staff training. OTS examiners carefully review each institution's policies, procedures and internal controls. Weaknesses in this area are often an indication of a broader problem in the management of the institution.

The OTS assessment of operating risk may be supplemented by the audit and related reports prepared by independent auditors and by the internal auditing program established by the institution. These two audit functions provide a useful resource in both the identification and assessment of an institution's operational risk.

The external audit provides an independent third party's assessment of how management identifies, monitors and controls risks. In addition to providing a useful assessment of the institution's internal control systems, the independent audit and related reports also assist examiners in the financial analysis of thrifts, the identification of areas of supervisory concern, and the detection of trends or other information not otherwise revealed by off-site monitoring of institutions. Accordingly, all independent audits and related reports are reviewed by OTS staff.

Like the other banking agencies, the OTS does not require independent audits at all institutions. External audits are required for savings associations that either have assets of $500 million or more or receive a CAMEL rating of 3, 4 or 5. Additionally, the OTS may require any institution to obtain an external audit for safety and soundness reasons. All other thrifts are encouraged to obtain independent audits voluntarily, which the vast majority do as a matter of sound business practice.

OTS policy also requires large thrifts or thrifts with complex operations to maintain an internal audit department. Virtually all thrifts, as a matter of good business practice, maintain internal audit departments. Like the external audit, the examiner's review of the internal audit function assists in the evaluation of the institution's operational risk, including its system of internal controls.

Market Risk. Market risk is generally defined as the risk to the economic value of an institution's balance sheet resulting from changes in interest rates, exchange rates, or commodity prices. For thrift institutions, market risk is virtually synonymous with interest rate risk, which is addressed by the OTS Model.

Liquidity Risk. Liquidity risk is the risk that a thrift does not maintain liquid assets or sufficient, ready access to funds to meet its obligations in a timely manner.

OTS examiners review each institution's asset/liability management policies and evaluate the internal systems and controls for monitoring cash flows. Such systems must provide assurance that the thrift can maintain adequate liquidity reserves and meet its funding requirements on an ongoing basis.

The liquidity risk of most thrifts is moderated by the fact that they tend to place less emphasis on wholesale funding sources and more on retail sources such as insured deposits. Thrifts may also access funding via Federal Home Loan Bank advances and through the sale of readily marketable residential mortgage loans and mortgage-backed securities in the secondary mortgage markets.

Legal and Compliance Risk. Legal or compliance risk refers to the possibility that contracts, lawsuits or adverse judgments may negatively affect operations, capital, or profitability. OTS examinations include a review of significant contracts, contingent liabilities, and potential losses from foreseeable litigation. Moreover, the OTS conducts regular compliance examinations to ensure that management has in place adequate procedures to ensure conformity with consumer laws and regulations, including nondiscrimination laws, the Community Reinvestment Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Bank Secrecy Act. To mitigate losses from legal risks, OTS requires thrifts to maintain adequate fidelity bond coverage, liability insurance, and director and officer insurance.

Strategic Risk. Strategic risk addresses the risk of loss from business decisions or investments that the board of directors and management do not adequately evaluate or control.

Directors are responsible for establishing a business plan that documents the institution's major business policies and strategies. This business plan should address such areas as asset/liability management, product and market development, investment policies, and interest rate risk management practices. Examiners evaluate these business plans for adequacy and reasonableness, paying special attention to new business and new activities initiated by thrifts since the last examination. Where a thrift engages in such new enterprises, the examiner will scrutinize whether the institution performed a thorough due diligence review and evaluation of risks before commencing the activity. An examiner will also evaluate the training and level of expertise of the staff conducting the new activity.

Any analysis of strategic risk must also focus on how management addresses external factors that impact the future prospects of the institution. For instance, today's thrift managers are faced with a huge external risk factor -- the potential competitive impact of the disparity between the deposit insurance premiums of the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF).

V. COORDINATION OF RISK ASSESSMENT PROGRAM

As I noted at the outset, the risk assessment strategies of the federal banking agencies must keep pace with changes in the markets for financial services. Each of the agencies benefits from innovations of others. We applaud any efforts to review and enhance the various supervisory approaches. The OTS is committed to the continual improvement of its own risk assessment process. Any innovations or new approaches that we can apply to the thrift industry and that will assist us in supervising thrift institutions more effectively or efficiently will be adopted promptly.

The OTS is also committed to ensuring that its supervisory and examination approaches are consistent and compatible with those of the other banking agencies. Increasingly, financial companies are being formed that are comprised of institutions supervised by two or more of the federal banking agencies. It is important that the agencies be in a position to conduct joint interagency examinations or inspections when appropriate.

To avoid unnecessary regulatory burden while ensuring that important areas of risk do not slip between the cracks, the bank regulators must continue to share ideas and work toward the development of complementary examination and inspection practices for use in evaluating depository institutions and their holding companies.

The Federal Financial Institutions Examination Council (FFIEC) was set up by the Congress for the express purpose of facilitating interagency coordination and the exchange of ideas. We, along with the other banking agencies and the National Credit Union Administration, are active participants on the FFIEC. The FFIEC provides a practical and established forum to facilitate a full exchange of risk assessment ideas, and furthers Congress' mandate that the agencies strive for uniformity wherever possible in their regulatory approaches.

VI. CONCLUSION

By each of the key measures of financial health -- capital, profitability, and asset quality -- the thrift industry today is sound. OTS-regulated thrifts are posting record levels of capital and steady earnings. Asset quality has returned to levels common before the thrift crisis. The recovery of the thrift industry is good news, but this does not mean that we can lower our guard. The seeds of a future crisis are often sowed during a period of relative financial health.

Accordingly, since its inception, the OTS has made a concerted effort to identify risks through a comprehensive program of risk-focused supervision and examination. As part of this effort, OTS has devoted significant resources to developing a program for monitoring and assessing interest rate risk. But we recognize that our efforts cannot stop there.

Risk assessment is a dynamic process that calls for continuous innovation. The OTS will continue to seek out ways to enhance supervision of the thrift industry, working in partnership with the other federal banking agencies.