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Statement of

Scott M. Polakoff, Acting Director
Office of Thrift Supervision

concerning

Lessons Learned in Risk Management Oversight at Federal Financial Regulators

before the

Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance, and Investment
United States Senate

March 18, 2009

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Testimony on Lessons Learned in Risk Management Oversight at Federal Financial Regulators
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I. Introduction

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

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

II. Overview of OTS-regulated Entities

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

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

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

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

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

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

III. Critical Risk Areas

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

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

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

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

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

Concentration Risk

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

Directors to approve limits and monitor concentrations based on their exposure relative to Tier 1 capital and allowances for loan and lease losses.

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

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

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

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

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

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

By the nature of the thrift charter, savings associations are required to hold a concentration in real estate mortgage or consumer lending-related assets. OTS-regulated savings associations are subject to two distinct statutory restrictions on their assets, which contribute to this inherent concentration in mortgage lending. The first is a requirement that thrifts hold 65 percent of their assets in qualified thrift investments. This ensures that thrifts maintain a focus on mortgage and retail consumer lending activities. The second set of restrictions includes limitations on the ability of savings associations to engage in specific lending activities, including consumer, commercial and small business lending.

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

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

Liquidity Risk

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

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

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

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

Capital Adequacy

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

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

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

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

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

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

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

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

Loan Loss Provisions

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

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

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

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

Fair Value Accounting

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

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

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

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

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

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

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

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

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

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

IV. Regulatory Restructuring

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

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

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

V. Conclusion

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

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

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