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NOTE TO EDITORS:

This is the first in a periodic series of informal letters from the Office of the Comptroller of the Currency's (OCC) Senior Deputy Comptroller for Bank Supervision Policy, Emory W. Rushton, to national bank chief executive officers discussing a variety of banking issues. This letter notes that the OCC is currently preparing guidance for banks on allowance for loan and lease losses, asset securitization, and internal controls.

To follow up on any of these issues, please call the OCC press office at (202) 874-5570.

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The OCC charters, regulates and supervises approximately 2,800 national banks and 66 federal branches and agencies of foreign banks in the U.S., accounting for more than half the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.

June 24, 1997

Dear National Bank CEO:

Since it would be impossible to personally greet the chief executive officers of all national banks at one time, I am writing to introduce myself. I also want to share with you some additional information about banker guidance we have recently adopted or expect to adopt shortly.

The Comptroller appointed me Senior Deputy Comptroller for Bank Supervision Policy on May 5, 1997, after 32 years of service in various positions with the OCC, mostly as a field examiner. I strongly believe one of our most important jobs as bank supervisors is to anticipate change in the banking system in such a way that we can assist bankers in preparing for the future. I also believe in open and direct communication, and that timely, informal channels are an effective supplement to more formal policy missives, Federal Register notices, and the like. Therefore, this is the first in what I anticipate will be a series of informal messages in which I can share with you issues, trends, or concerns that warrant our collective attention.

#### Banking Fundamentals

Today, the banking system is quite healthy, profitable and far better capitalized than at any time in recent memory. But we have to be careful to avoid complacency and overconfidence, no matter how good things seem to be at the moment. This is why I believe it is important for us to take the time now to evaluate and make sure we are emphasizing the time-tested fundamentals of sound banking.

In my 32 years of dealing with banks of all sizes, I have observed two basic principles in banks that remain successful throughout the business cycle -- managing risks well and not letting core standards slip in good times. The products, lines of business, delivery channels, and organizational structures of banking are evolving and changing, but sound banking remains rooted in banks' ability to identify, measure, monitor, and control risks and to maintain reserves and capital adequate to cover those risks. Further, I think we all recognize that good times are the best times for banks to fix or shore up potential weaknesses, rather than resting on current performance.

#### Upcoming Initiatives

In this regard, I'd like to report to you on some initiatives we are working on at the Comptroller of the Currency's Office. These initiatives build on actions we have already taken while at the same time addressing current trends and concerns. I am hopeful they will help you in evaluating your risk management and control systems.

Allowance for Loan and Lease Losses - As you well know,

maintaining an adequate allowance for loan and lease losses at various stages of the business cycle is essential to safe and sound banking. In recent months, the OCC and some industry analysts have become concerned that certain measures of allowance coverage are beginning to decline at the same time certain credit quality indicators appear to be deteriorating. The OCC will soon issue guidance to remind banks of the importance of sound allowance methodologies and adequate allowance coverage. That guidance will discuss weaknesses examiners have seen in some banks' methodologies and will outline steps banks can take to strengthen their allowance processes.

Asset Securitization - Improved risk management tools and information technology are enhancing banks' ability to securitize and fund assets off their balance sheets. Asset securitization programs have become an important component of many banks' funding and fee income strategies. These activities, however, also heighten the need to have sound credit underwriting, liquidity management, and internal control processes. Asset securitization programs make a bank's core processes more transparent to the markets and, as a result, any weakness can have an immediate adverse consequence on bank funding, earnings, and capital.

Later this summer, the OCC will issue comprehensive examination guidelines for asset securitization. Those guidelines will focus on a national bank's role as credit intermediary and issuer of asset-backed securities, and will address the associated liquidity, transaction, and reputation risks. The guidelines will explain asset securitization structures and processes, the key elements of risk management, and critical control points for securitization activities.

Internal Controls - Because bank products and services are becoming increasingly more complex and volume-based, we are reemphasizing the need for banker diligence in seeing that internal controls remain strong. Effective and reliable control systems are the linchpin of sound banking and permeate every line of business or activity. In recent years the consequences of deficient controls at a number of major institutions have been well-documented. The OCC will soon provide additional guidance in this critical area with the release of an updated Comptroller's Handbook section on internal controls that will provide an overview of internal control processes. In addition, future handbook sections will include procedures tailored to testing and evaluating controls governing specific products or activities.

#### Building on Previous Actions

The guidance described above complements our recent policy initiatives in other important areas. Over the last year, Comptroller Ludwig has sounded notes of caution about the effects of competitive pressures on underwriting standards in some business segments, including the syndicated loan market and, more recently, certain retail credit products. Consistent with his message, in March, the OCC issued Advisory Letter 97-8, "Credit

Underwriting Standards and Portfolio Management," which outlined key elements of an effective portfolio credit risk management process. Later this year, we will expand upon those fundamentals as they relate to exception tracking, credit culture, and management information systems.

More recently, we sent you a new section of the Comptroller's Handbook that provides comprehensive guidance on managing interest rate risk. This Handbook section should assist you in dealing with uncertainty about the volatility and direction of interest rates and the growing complexity of interest-sensitive bank products. As they have for other risk areas, advances in technology have provided banks with increasingly sophisticated tools to manage this risk. The handbook section discusses ways to use these tools to identify, measure, monitor, and control interest rate risk.

#### Conclusion

These are exciting times in banking that offer you the possibility of new ways to develop and expand your products, services, and markets to meet the needs of your customers and communities. I believe that by taking proper care today, banks can continue to grow and thrive in the changing market place and weather any challenges that lie ahead. I encourage you to use the various guidance materials the OCC is preparing to help you reassess the adequacy of your bank's fundamentals and ensure that you are well prepared for those opportunities. As always, we remain committed to ensuring a safe and sound banking system, including developing our guidance for examiners and bankers in a way that eliminates unnecessary supervisory burden.

I welcome your comments and thoughts on our current initiatives and on issues that you believe may need additional attention.

Sincerely,

/s/

Emory W. Rushton

Senior Deputy Comptroller for Bank Supervision Policy