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TESTIMONY OF

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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

of the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U. S. HOUSE OF REPRESENTATIVES

October 8, 1997

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Madam Chairwoman and members of the Subcommittee, I appreciate this opportunity to testify on bank examination and supervision systems at the Office of the Comptroller of the Currency (OCC). As you are aware, direct supervision is a regulator's primary method for ensuring bank safety and soundness, which is crucial to maintaining stability in our nation's financial markets. In turn, a healthy banking industry is critical to the accomplishment of important public policy objectives established by Congress.

In your letter of invitation, you noted that the hearing would focus on how regulatory agencies are assessing the risks depository institutions take in today's financial marketplace, whether staffing is sufficient to assess safety and soundness concerns, and whether supervisory practices would need to be modified if Congress passes a financial services modernization bill. Specifically, you asked that I address a number of questions about the OCC's supervisory process. I will address your questions in the course of my statement today within the context of changes in the banking industry, how the OCC has addressed concerns resulting from these changes, my assessment of the future of the industry, and my thoughts on how the OCC will adapt to carry out its supervisory mission.

Introduction

The banking industry has changed significantly since the OCC was founded in 1863. Over the past 130 years, the industry has evolved in response to advances in technology, enhanced competition, and changes in consumer preferences. New risks have arisen, and traditional risks have emerged in new forms. Even with all of these changes, the mission of the OCC remains constant: to charter, regulate and supervise national banks to ensure a safe, sound and competitive National Banking System that supports the citizens, communities and economy of the United States.

In question 1 of your letter of invitation, you asked about the factors that contributed to bank failures in the 1980s. During that time, regulators learned some hard lessons about traditional credit risks, particularly in agricultural and commercial real estate lending. Sometimes traditional risks are exacerbated by unanticipated economic shocks that disrupt even the best risk management plans. In the 1980s, several significant economic events, including the collapse of energy prices and the precipitous decline in the value of farmland, contributed to difficult times. The OCC and other bank regulatory agencies faced three main supervisory problems in addressing the consequences of these economic shocks to the banking system.

First, the agency faced competition for its seasoned employees, and attempts to hire new examiners were frustrated by our inability to offer competitive salaries--a problem that has since been rectified with a much-needed change in federal law. Second, with the improvement in our off-site monitoring capabilities, we initially reduced our emphasis on maintaining a regular cycle of on-site examinations at all banks. But perhaps most important, our supervision was still largely retrospective, analyzing how the risks of a bank had been mishandled, rather than a forward-looking assessment of what problems were on the rise and what should be done to manage them. Put simply, we were treating the disease instead of practicing preventive medicine.

The industry was feeling the aftershocks of the 1980s and still going through challenging times when I took office four and one-half years ago. There had been numerous bank failures, complaints from small businesses and consumers about a credit crunch, and concerns in the banking industry and Congress about excessive regulatory burden. Community organizations were concerned about fair lending compliance, and both community organizations and banks agreed that the Community Reinvestment Act (CRA) regulations were not as effective as they should be.

We have worked hard over the past few years to refocus and retool the OCC's supervisory process. History has taught us the importance of on-site, hands-on bank examinations. We recognize now that there is no substitute for regular on-site examinations, and we have increased the number of banks in which we maintain a full-time, on-site dedicated examiner staff. At the same time, history also taught us that our supervisory policies and practices must enable us to respond to industry changes. In response, the OCC developed a program of risk-based supervision that is forward-looking and aimed at improving our ability to identify and address potential problems before they become crises, and is sufficiently adaptable so that we can analyze risks across different products and activities. The OCC has also been able to hire talented people from a variety of disciplines and has trained examiners effectively to ensure that we can address industry changes in a timely manner.

The combination of the strong economy, the legislative changes mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the results of the modifications and innovations we made to our approach to supervision are evident today in the performance of the National Banking System. Today, we find a banking system that is not only highly profitable, but also far better capitalized. From the passage of FDICIA through June 1997, the aggregate commercial bank equity-to-total asset ratio increased from 6.75 percent to 8.44 percent--its highest level since the 1960s--while the risk-based capital ratio increased from 10.67 percent to 12.46 percent. Bank failures in 1996 were at a 20-year low. Credit is flowing smoothly--total commercial bank loans have increased nearly 39 percent over the four years ending June 1997.

We also find a National Banking System that has expanded access to financial services for all Americans, in part in response to increased efforts to enforce fair lending and community reinvestment laws. Before my arrival at the OCC, the OCC had referred only one fair lending case to the Department of Justice (Justice). Since 1993, we have held numerous informal discussions and formally referred 24 cases to Justice and the Department of Housing and Urban Development (HUD). We revised the CRA regulations, and there has been a dramatic increase in mortgage lending to low- to moderate-income individuals. Since CRA became law in 1977, we have witnessed over $215 billion in loan commitments for community development. Remarkably, $175 billion--more than 80 percent of the total--was made in the past three and one-half years alone.

Although we are pleased with the overall health of the industry and proud of our contributions to enhancing the safety and soundness of banks and enhancing access to financial services, we cannot be complacent. Now, while the industry is healthy, we must remain vigilant to address emerging risks. As I will discuss later, that is why I just announced a series of steps designed to help banks address any problems in their loan portfolios while capital and earnings are strong. It is also an appropriate time to reflect on the purpose of the banking industry, how it is changing, and what we as regulators must do to maintain its long-term safety and soundness.

The remainder of my statement today will describe our supervisory process and summarize significant actions taken over the course of my tenure. Throughout the statement, I specifically indicate when I have addressed one of the questions or issues raised in the invitation letter for this hearing. I will begin by discussing the changes affecting the banking industry, and offer some thoughts on future challenges facing the industry. Next, I will describe some of the measures taken by the OCC over the past four and one-half years to ensure that our supervision remains relevant to changes in the financial marketplace in order to safeguard the safety and soundness of the industry. Finally, I will summarize the initiatives the OCC is taking to ensure that our staff has the skills necessary to supervise the banking industry of the 21st century.

Changes in Banking and Bank Supervision

Banking Industry Changes

As I noted above, over the years, the banking industry has changed in ways that could not have been anticipated when the OCC was founded. For example, at the time of the creation of the national bank charter in 1863, the law restricted national banks to loans that could be readily turned into cash. In that era, public confidence in banking was synonymous with liquidity. Accordingly, most home mortgages were forbidden by law, and OCC examiners, consistent with the intent of Congress, were quick to criticize commercial loans that extended for more than the customary 30 or 60 days.

Today, no one would deny that sound mortgage lending, medium-term business lending, farm lending, and many other activities that would once have been frowned upon are necessary and proper activities for commercial banks. Had national banks been unable to respond to businesses' and consumers' demands and to the competitive challenges of other financial providers, they would not exist as they do today, and American businesses and consumers would be disadvantaged by that result. But because the laws, regulations, and supervision have been amenable to change, national banks have been able to continue making important contributions to the growth of our communities and our Nation.

The banking industry of the 21st century is being shaped by an unprecedented combination of pressures. Today's information-driven economy is decreasing banks' traditional, core, competitive advantage in certain key areas. The information needed to make prudent and profitable loans often is more easily available, and less costly to access, than ever before. As technological changes alter the production, packaging, and delivery of financial services, banks face competition not only from finance companies, mortgage bankers, and investment houses, but also from non-traditional competitors, such as telecommunications companies and software development firms. Moreover, many of banks' traditional, core customers--commercial and industrial firms--can now bypass insured depositories and access the capital markets directly.

Similarly, distinctions among different types of financial products have blurred. Although core lines of business within the financial services industry remain distinct, firms in different sectors of the financial services industry offer products to their customers that are close substitutes, but bear different labels. There is no longer a sharp distinction between a syndicated loan and privately placed commercial paper, between an interest-bearing NOW account and a money market mutual fund, or between a mutual fund and a variable annuity. In short, technological and financial innovation, together with market pressures to offer consumers a wider array of services, have eroded the traditional segmentation of the financial marketplace. This change is manifesting itself through a recent wave of acquisitions and mergers. Banks are acquiring brokerage and securities firms. Several insurance companies and brokerage firms have acquired and others have announced that they are contemplating establishing or acquiring insured depository institutions. Recently, one of America's largest insurance companies announced its intention to acquire one of the country's largest wholesale securities firms.

Driven by technological change, economic globalization also has made financial services markets increasingly competitive. Within the United States, commercial bank assets held by foreign banks increased from 10 percent in June 1990 to 14 percent in June 1997. Foreign banks' share of total U.S. commercial banks' commercial and industrial loans increased from 19 percent to 27 percent over that same time.[1]

In addition, the mix of products and services that consumers demand has changed and will continue to change with increasing consumer sophistication and demographic shifts. The aging baby boomer population understands it has a variety of investment options and opportunities for its retirement savings. Correspondingly, there has been a migration of savings from insured deposits to mutual funds that offer an array of investment and

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[1]Source: "Assets and Liabilities of Commercial Banks in the United States," H.8, Federal Reserve Board.

risk/reward profiles. In 1995, for the first time in the history of the United States, assets held in mutual funds exceeded assets held in deposits. Net assets of mutual funds were $4.2 trillion at the end of August 1997,[2] while total domestic deposits at commercial banks and savings institutions were $3.5 trillion at the end of June 1997.[3]

Amid these changes, the organizational structure of the banking industry is being altered as well. Some banks have responded to this increased competition by seeking to merge with other banks to obtain the benefits of economies of scale or scope, or geographic diversification. The continuing trend toward bank consolidation has seen the number of commercial banks fall to 9,308 as of June 1997 from 11,462 when I took office in April 1993. Consolidation also seems to be leading to a bifurcation among banks into community banks and larger institutions, with relatively fewer medium-sized banks as a result.

The OCC's Supervisory Response

The rapid pace of change in the financial services business presents new challenges to bank supervision. As the banking industry adapts to a dynamic economy, so too must bank supervision evolve. Just as a failure to change would make banking less relevant to the needs of the economy, a failure by the OCC to adapt to changing circumstances would make bank supervision less effective. In my term as Comptroller, we have taken and continue to take many steps to modernize our supervisory policies and practices. Let me highlight the most significant actions we have taken over the past four and one-half years.

I strongly believe the key for bank supervisors to carry out their responsibilities effectively is to identify the risks incurred by banks, to assess their systems for managing those risks, and to ensure that the banks' risk management systems are, in fact, identifying, measuring, monitoring and controlling risks. At the OCC, we are doing this through a forward-looking program called supervision by risk. We have also issued guidance or advisories on a number of current issues and followed up to ensure that our guidance is being implemented by the banking industry. We have established specialized committees to monitor emerging risks and communicate relevant findings to the banks.

In addition, we have improved our direct communications with the banking community. Shortly after I became Comptroller, we initiated annual meetings between myself and the largest national banks in an effort to improve communication between the agency and the industry. I also encouraged OCC senior management to increase their meetings with bankers, and I revived nationwide "Meet the Comptroller" sessions throughout the country.

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[2]Source: Investment Company Institute.

[3]Source: Call Report Data.

Supervision by Risk. In January 1994, we initiated the Bank Supervision Review Program to focus relatively more of our supervisory resources on those banking activities and those banks that pose the most likely threats to the safety and soundness of the banking system. Our review resulted in supervisory policies and processes that tailor our oversight to the key characteristics of a bank, including size,[4] products offered, markets in which it competes, and management's tolerance for risk. Supervision by risk is a dynamic process that not only allows us to tailor our oversight to the risks of a particular bank, but also to change the way we supervise that bank in light of its risk profile. This process also provides an effective means for the OCC to communicate to senior bank management the areas where they may need to correct problems before they become severe and how we intend to allocate our supervisory resources. The OCC's current, risk-based approach to supervision therefore has adapted the fundamental elements of on-site, hands-on examination of banks to incorporate lessons learned from supervision of the past.

Supervision by risk does not replace the interagency framework the agencies use to rate banks' capital adequacy, asset quality, management, earnings performance, liquidity, and sensitivity to market risk (CAMELS). Rather, the two systems work in tandem, yielding an assessment of the bank's current condition and a forward-looking analysis of its risk. Under the CAMELS system, examiners assess a bank's performance to draw conclusions about its current condition. Supervision by risk focuses our attention on areas of current and emerging risk, and focuses our examination resources on areas of prospective higher risk.

Although the centerpiece of supervision remains on-site bank examinations, OCC supervision is a complex cycle of planning, examining, and follow-up that involves cooperation and communication among the supervisor, other regulators, and the institution being supervised. In other words, supervision is much more than the actual time spent on-site in the bank. For example, a supervisory team spends significant time determining what the examination will focus on prior to entering the bank. While on-site, examiners sample, test, and verify policies, procedures and systems. At the conclusion of an examination, matters requiring board and management attention are included in the report of examination, and examiners are responsible for following-up with bank management to ensure that the bank addresses these weaknesses and concerns. Furthermore, National Bank Examiners are responsible for continued, year-round monitoring of each national bank.

The Risk Assessment System. Under supervision by risk, the OCC uses a risk assessment system to measure and assess the risks at each bank we supervise. The first step in

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[4]The OCC's supervision by risk examination procedures differentiate between large banks and community banks. The OCC defines a large bank as a national bank with total assets of $1 billion or more or a national bank that is part of a multibank holding company that has a national bank with over $1 billion in assets. We define a community bank to be a national bank with total assets of less than $1 billion or one that is part of a holding company where none of the national banks' assets exceed $1 billion.

our supervision of an individual bank or in evaluating a new product or activity is to identify the key associated risks.[5] Having identified the risks for an individual bank, we evaluate and measure the quantity of risk and the quality of risk management to form an overall conclusion about the bank's risk profile. Because market conditions and company structures vary, there is no single risk management system that works best for all banks. However, we do expect each bank to have a system that is commensurate with the risks it assumes and that addresses each of the four aspects of effective risk management: to properly identify, measure, monitor, and control risks.

The OCC's large bank and community bank risk assessment systems are different. During a large bank examination, an OCC examiner rates each risk category by the quantity of the risk and the quality of risk management. Next, the examiner assigns an aggregate or composite risk rating based on his judgment of the level of supervisory concern considering both the quantity of risk and the quality of risk management. Finally, we assign a rating of the expected 12-month direction of the quantity of the risk.

Community banks, however, receive only an aggregate or composite risk rating and a rating on the expected direction of the risk. The community bank risk assessment is meant to focus attention on areas that historically have posed the greatest risks to banks. Examiners use a core set of procedures that cover all major areas of safety and soundness for low-risk and moderate-risk/stable-expected direction areas of the bank. Even in the areas of lowest risk, we sample, verify and test the bank's policies, procedures, and systems. Examiners may expand the procedures if supervisory concerns emerge while using the core procedures. For areas of higher risk, examiners use customized procedures that focus on the risk and the bank's risk management processes. We are fully committed to ensuring the safety and soundness of community banks. In fact, when the OCC conducts a full-scope, on-site examination in 1997, it spends on average 60 percent more workdays per bank than it did for a comparable on-site review in 1985.

Because of the greater systemic risk posed by the largest banks, we have assigned examiners full-time to each of the 32 largest national banks. We recently increased the number of national banks in which we maintain examiners permanently on-site in recognition of the supervisory benefits we receive by having a constant presence in the bank. We now have about 250 examiners in these 32 banks, and we expect to have an additional 50 examiners on-site by early next year. This program allows the examiners to develop a more thorough knowledge of the bank, including its activities and risks, than is possible through the traditional regime of periodic examinations. As a result, our examiners are better able to identify increases in risk or deterioration in risk management so that we can act quickly to ensure that weaknesses are corrected.

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[5]The OCC has defined risks as credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risks. Most bank activities contain one or more of these risks.

Benefits of the Supervision by Risk Program. Many of the questions you raise in your letter of invitation deal with the benefits of our supervision by risk program. Let me address them in this section of my statement.

In Question 5 in the invitation letter, you asked whether prompt corrective action (PCA) policies complement the supervision by risk approach. We believe that the two are complementary, because the knowledge that reductions in capital will trigger the prompt corrective actions required by FDICIA creates a healthy caution within the industry and appears to have resulted in many banks increasing their capital levels to avoid the supervisory consequences of PCA.

Question 3 of the letter requested information about the extent to which our national banks have come under supervision by risk, and whether there were adequate guidelines and training for our examiners. Supervision by risk is currently being used in examining all national banks for safety and soundness. We will expand the supervision by risk approach to include several specialty areas through the rest of 1997 and into 1998, including bank information systems and fiduciary activities. The examination procedures implementing supervision by risk are documented in the *Comptroller's Handbook*, and we have provided targeted training to all of the examiners in the field. We have also revised certain in-house training courses to incorporate the principles of risk-based supervision.

Questions 2 and 4 asked about the measures that we have initiated to ensure that examiners effectively assess the financial condition of a bank, and how, overall, we measure the effectiveness of our examinations. First, I would note that the OCC has organized its activities in such a way as to promote the ongoing review of examination effectiveness. For example, we have periodic meetings involving the examiners-in-charge of our large banks, and senior management at headquarters holds weekly discussions with the deputy comptrollers in the district offices to discuss examination issues. Second, we will soon complete an overhaul of our quality assurance program for bank supervision. For the past two years we have reviewed a sample of work papers from each field office completed during community bank examinations as part of our Community Bank Quality Assurance Program. This quality assurance review will be extended to our large bank examinations by the end of the first quarter of 1998. These two functions now report to our newly-established Director for Quality Assurance within our bank supervision operations area. His job is to ensure that the goals and objectives of our bank supervisory process are applied in a consistent and cost effective manner throughout the OCC, all in the interest of ensuring that our examiners effectively assess the financial condition of a national bank.

Third, as part of our supervision by risk program, we are in the process of refining our large bank supervision program, including examining the effectiveness of our risk assessment system. We continue to strive to improve the process. Senior management will review staff recommendations by year-end, and then will implement procedural changes as warranted.

Finally, we are in the midst of implementing a pilot program of effectiveness measures for ensuring safety and soundness. Based on the results of the pilot, we expect to implement several effectiveness measures of examinations as part of our ongoing quality assurance efforts.

In Question 7, you asked how we have improved examination procedures to provide regulatory effectiveness and protect the deposit insurance funds. I strongly believe that supervision by risk is the best way to supervise banks in the current rapidly changing environment. Our supervision by risk program allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks that engage in an increasingly diverse set of 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 direct OCC resources to the banks or activities within banks exhibiting the greatest risk. The supervision by risk framework allows us to be more efficient in our examination planning, yet it is still sufficiently flexible to allow us to verify and test our assessments and devote additional time to following up with the bank after an examination to ensure compliance with our requirements. We believe that our supervision by risk program would be readily adaptable to changes Congress may decide to make in the financial services industry in the context of a financial modernization bill, but we cannot answer definitively without knowing the bill's final requirements.

You inquired in question 6 whether our risk assessment examinations were adequate when operations are on an interstate or global basis. We believe that supervision by risk is an effective method for supervising interstate and multinational banks, given their size, reach, and complexity. The focus of supervision by risk is forward-looking and strategically oriented. We feel prepared to address issues raised by the increasingly global focus of national banks. We have an OCC office in London with examiners devoted to supervising the overseas branches of national banks. Technological advances have enhanced our information on a bank's consolidated operations and geographic exposures, and our examiners regularly travel to a bank's international sites when appropriate. The determination to go on-site is based on factors such as whether an adequate assessment can be made from the head office, the examiners' knowledge of the bank's risk in a particular location, the relation of the overseas operation to the overall risk of the company, and the length of time between exams in an area/operation of high risk. Since the OCC formally adopted its supervision by risk program, other U.S. regulators have embraced the concept, and the United Kingdom's Bank Supervisory Service and other international regulators are developing similar systems.

Guidance and Advisories Issued. Our supervision by risk philosophy, implemented through individual bank examinations, is reinforced and supplemented by our public statements and formally issued policy guidance and advice to the industry to address emerging risks. Our policy guidance focuses on the risks posed by activities and the critical elements of prudent risk management, and typically contains a series of follow-up actions that the OCC will take to ensure that national banks are heeding our warnings. For example, our ground-breaking issuance and examination procedures on derivatives activities stressed the need for board and senior management oversight, timely and accurate market and credit risk measurement systems, and effective operational and risk controls. We issued guidance on stored value card systems that described emerging electronic cash systems and the associated risks to banks investing or participating in those payment systems. We revised *The Director's Book: The Role of National Bank Directors*. The revised book provides guidance to bank directors on how to meet their responsibilities in the increasingly complex financial services industry. Furthermore, we revised a number of sections of the *Comptroller's Handbook*, including sections on mortgage banking, credit card lending, risk management in derivatives, and, most recently, on interest rate risk. These revisions provide guidance to examiners and help keep them informed about new procedures.

As I have noted, we are constantly on the alert for emerging problems, and we issue advisories to national banks when we identify issues of concern. This year, we have issued advisories on a range of topics, including credit underwriting, credit scoring models, affordable mortgage portfolios, and loan loss reserves. Our advisory letter on credit underwriting and credit portfolio risk management reminded national banks of the effects that changes in loan underwriting standards may have on portfolio credit risk and highlighted the major elements of an effective portfolio credit risk management process. At the same time we issued this advisory letter, I urged banks to focus on three potential problem areas: cuts in banks' internal controls to boost earnings, consumer credit quality, including credit card losses, and managing the overall credit risk in bank loan portfolios. We alerted national banks to the potential benefits and risks of credit scoring models, and advised banks to carefully develop, implement, evaluate, and maintain their models to ensure their proper use. We issued an advisory letter offering information about effective techniques and strategies banks may want to consider to improve the quality of their affordable mortgage portfolios. We issued an advisory letter asking national banks to perform a quarterly review of loan loss reserves after we became concerned that the amount of loss allowance coverage was beginning to decline at the same time certain credit quality indicators appeared to be deteriorating. All of these issuances keep national banks informed of emerging risks and highlight the steps we intend to take to ensure that banks heed these warnings.

Interagency Policies and Guidance. In Question 8, you asked about the coordination of our efforts with the other bank regulators. The effectiveness of the OCC's examination program is enhanced by our ongoing coordination with the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC) (collectively, with the OCC, the bank regulatory agencies). As mandated by statute, the OCC has worked with the other bank regulatory agencies to make our regulations and policies uniform. With the Office of Thrift Supervision (OTS), the bank regulatory agencies issued an Interagency Statement on Examination Coordination, in which we set forth procedures to be followed in planning and conducting joint interagency examinations, as well as sharing information and coordinating enforcement actions. In 1996, the bank regulatory agencies issued a uniform interest rate risk policy. In the fall of 1996, we issued our final market risk rule. Last December, the Federal Financial Institutions Examination Council[6] (FFIEC), which I currently chair, revised the uniform bank rating system, putting additional emphasis on the quality of risk management practices and adding a new component on sensitivity to market risk. In April 1997, the OTS and the bank regulatory agencies issued joint guidance on the sales of 100 percent loan participations.

The bank regulatory agencies and the OTS issued a joint Notice of Proposed Rulemaking on the treatment of servicing assets for regulatory reporting and capital purposes in August 1997. Most recently, in September 1997, the FFIEC issued a request for comments on changes to the 1980 Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status (1980 policy). The 1980 policy is used by the agencies for classifying retail credit loans of financial institutions on a uniform basis. The FFIEC is currently reviewing and soliciting comments on the 1980 policy to determine where revisions may be necessary to reflect more accurately the changing nature of risk in today's retail credit environment.

We are working aggressively with the other banking agencies to make the Year 2000 computer conversion problem a priority with bankers and their vendors and service providers. The banking agencies first alerted the financial services industry to our concern over the Year 2000 problem in a June 1996 FFIEC statement. In that statement, we strongly encouraged depository institutions to complete an inventory of core computer functions and to set priorities for compliance changes, keeping in mind that testing should be underway for mission-critical systems by no later than December 31, 1998. In May of this year, the OCC and other agencies issued a second statement through the FFIEC, together with interagency guidance for banks and examiners, on Year 2000 project management. In that statement, we listed steps that OCC examiners would take in their initial assessment of banks' Year 2000 preparations prior to the conduct of actual examinations, which will be completed by mid-1998. Furthermore, the FFIEC will issue guidance on Year 2000 testing this fall.

In addition, the banking agencies are coordinating a number of capital-related initiatives. We recently issued a joint notice of proposed rulemaking (NPR) on recourse and direct credit substitutes, small business loan recourse, servicing rights, collateralized transactions and unrealized gains. We are also preparing to issue a joint NPR proposing various unifying capital amendments to implement section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the banking agencies to work jointly to develop uniform regulations that implement common statutory or supervisory policy. Finally, the FFIEC is sponsoring a one-day conference in December 1997

[6]The OCC, the FDIC, the FRB, the OTS, and the National Credit Union Administration (NCUA).

to examine the current regulatory capital framework in today's evolving financial services environment.

Securities Activities. National banks are engaging increasingly in the sales of mutual funds and other securities-related activities. In Question 10, you asked whether our examiners were trained effectively to evaluate new activities and emerging products and financial instruments. As an example of how we are addressing that issue, I cite our issuance of new compliance examination procedures concerning mutual fund sales and the series of guidance we have issued to our examiners, consumers, and the industry. In the fall of 1993, we issued guidance for consumers about the differences between mutual funds and insured accounts. We followed up on that effort by issuing an interagency statement offering uniform guidance on the sales of mutual funds. In 1994, the OCC tested compliance with the guidance by undertaking a review of bank mutual fund advertisements and marketing materials. Over 700 national banks engaged in the retail sale of mutual funds voluntarily submitted materials for this effort. I initiated meetings based on the results of our findings with bank trade associations to address our concerns and establish disclosure standards.

Coordination with the SEC. You asked in Question 9 how we coordinate our examination activities with the Securities and Exchange Commission (SEC). The OCC and the SEC share supervisory responsibility for the oversight of mutual fund sales by national banks and operating subsidiaries. In 1995, the OCC and SEC agreed to coordinate efforts related to oversight of investment advisory activities. As a result, the OCC and SEC have conducted several joint examinations of banks and operating subsidiaries involved in investment advisory activities. Also, we share a variety of supervisory and examination information with the SEC, and the SEC with us.

In 1995, the economics staffs of the OCC and the SEC jointly conducted a survey of 2,000 investors to assess their understanding of the risks and expenses associated with mutual funds. The survey found that there was virtually no difference in the understanding of the risks and expenses involved in mutual funds between investors who purchased mutual funds from banks and those who purchased from nonbanks.

NASD Agreement. The bank regulatory agencies and the National Association of Securities Dealers (NASD) share a common interest in the supervision of broker/dealers selling nondeposit investment products on depository institution premises and, in particular, the supervision of broker/dealers affiliated with a banking organization or thrift institution. To promote regulatory consistency and reduce unnecessary burdens, the four federal financial institutions regulators and the NASD signed an agreement in January 1995 to share information from examinations. The agreement also states that the OCC and the NASD may request that an examiner be present during the other's examination of a banking organization. The OCC will refer apparent violations of securities laws to the NASD, and the NASD will refer apparent violations of banking laws to the OCC. Our District offices continue to work with the NASD according to the terms of this agreement.

International Cooperation. The effectiveness of our examination program is further enhanced by our ongoing coordination with international bank regulators. In this era of increased globalization, it is imperative that U.S. banking regulators work with their counterparts abroad. The OCC's primary mechanism of cooperation is through the Basle Committee on Banking Supervision (Basle Committee), which pursues its goal to improve supervisory coordination and the quality of supervision by exchanging information and expertise, developing and sharing improved supervisory approaches, guidance and technology, and setting minimum standards where needed. Currently, in addition to participating in all subgroups and task forces, including the Working Group on Electronic Money, the OCC chairs the Basle Committee's Information Subgroup, whose purpose is to identify and analyze the information needed by supervisors to supervise effectively, and by market participants to improve market transparency and promote market discipline.

In June 1996, the G-7 Heads of State called for a cooperative study to investigate the implications of recent technological advances that make possible the creation of sophisticated methods for making retail electronic payments. A Working Party, of which the OCC was a member, produced a report in April 1997 that identified the policy issues facing G-10 governments as a result of electronic money and highlighted issues that could benefit from additional international cooperation.

Recently, the Basle Committee has furthered the development of international capital adequacy standards, completing standards for market risk. In adopting "sound practices" guidelines for the supervision of derivatives, the Basle Committee also adopted in large part the derivatives guidance issued by the OCC. The Basle Committee released its Core Principles for Effective Banking Supervision--25 basic principles for ensuring the effectiveness of a banking supervisory system--in September 1997. They were developed over the last fifteen months to respond to the Lyon G-7 Summit communique of June 1996 calling for actions to improve the strength of financial systems caused by weaknesses in the banking system.

We are also extending our international coordination efforts to include foreign securities and insurance supervisors. The OCC is a member of the Joint Forum on Financial Conglomerates (Joint Forum). The Joint Forum is a high-level panel consisting of members of the Basle Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. Its objectives are to promote cooperation between bank, securities, and insurance supervisors and to develop "sound practice" standards for the prudential supervision of financial conglomerates. This past year, a major initiative of the Joint Forum has been a careful review of several global financial conglomerates to determine how they manage risks and how those risks are supervised.

Organizational Changes. As indicated by the summary of activities above, the OCC has demonstrated significant supervisory and examination flexibility to meet the current needs of supervising the banking industry. Since I became Comptroller, the OCC has also made a number of internal organizational changes to improve our ability to monitor and effectively supervise emerging risks. We added expertise and restructured the organization to respond to changes in the banking industry, particularly consolidation and the decreased relevance of geographic location in supervising large banks. These banking industry changes also increased our need for specialists.

Creating New Units to Address Emerging Risks. Soon after I became Comptroller, I recruited an individual with substantial expertise in the derivatives activities of major Wall Street securities firms and commercial banking organizations to lead the OCC's Derivatives Task Force. That task force issued guidance to bank management on managing the risks of financial derivatives. The unit has been formalized as the OCC's Treasury and Market Risk Division.

In 1995, I formed the National Credit Committee because of growing concerns about erosion in credit underwriting standards. The Committee continues to help the OCC identify and respond to changes in credit risk that could affect the safety and soundness of the National Banking System. In each of the past three years, the Committee surveyed loan standards at the 40 largest national banks, identified areas that needed improvement, and communicated its findings to bank management.

I recently discussed with members of our National Credit Committee the group's assessment of credit underwriting standards at the largest national banks. There is every indication these standards have slipped further. Our examiners tell me that, over the past year, underwriting standards have continued to loosen in most lending categories. The trend is particularly pronounced in commercial lending, but there has also been some loosening in segments of the retail market. Accordingly, in a speech to the American Bankers Association last Sunday, I announced a series of steps involving the banks, our examiners, and the FFIEC that are designed to help banks identify and address any weaknesses in their loan portfolios, so they can safely weather the inevitable vicissitudes of the national economy. If we take measured steps now, we can avoid serious problems later. The National Credit Committee's recent findings and the initiatives we are taking to address these findings are a good example of how our new organizational structures are working together with supervision by risk to enhance our safety and soundness efforts.

Another organizational innovation is the National Risk Committee, formed in 1996 to identify and analyze potential significant risks to the banking system, and make recommendations to senior management as to appropriate supervisory responses. Composed of an interdisciplinary group of deputy comptrollers, the committee views potential risks from a range of perspectives. Recommendations from the National Risk Committee have led to various OCC actions, such as the recent credit scoring bulletin and advisory letter on the allowance for loan and lease losses. This committee will continue to help the OCC prioritize its supervisory resources and alert national banks to new potential risks as they are identified.

In our Economics Department we created the Risk Analysis Division, which is devoted to the delivery of expertise in quantitative modeling of financial risks. Economists from that division have provided top-quality assistance to our examiners in evaluating large banks' use of quantitative models to measure, monitor, and control market risk, interest-rate risk, and credit risk. The economists, who work on-site as part of the examination team, offer assessments of whether the risk models are logically and empirically well-founded and whether they are applied appropriately by the bank.

Early this year, we established a Bank Technology Unit to focus on the impact of changing technology on national bank activities. This group is responsible for determining how the use of technology by national banks can be best supervised, and providing training and support to OCC examiners who specialize in banks' use of technology to ensure national banks are managing this risk appropriately. They have been particularly focused on the Year 2000 issue.

Restructuring Supervision Policy and Operations. To make certain that the OCC could respond to continuing changes in the banking industry quickly, we began a fundamental restructuring of our supervision policy and operations units in January of this year. This restructuring, which is nearing completion, has involved the entire supervision work force. We believe these changes will create a more flexible and efficient organizational structure that will allow the OCC to provide higher quality supervision to an industry that has and will continue to change dramatically. At the same time, we believe these changes will provide more career opportunities than would otherwise have been the case for our employees.

On the policy side, we have created risk specialty units for asset management, core policy, credit risk, capital markets, and community and consumer policy. These units are charged with ensuring that we keep abreast of emerging risks and that we have appropriate supervisory policies and examination expertise in these key areas.

On the operations side, we have restructured our supervision units to better reflect the differing risks and supervisory challenges posed by large and community banks. Today, for example, we have examiner specialists for different types of risk, including bank information systems, CRA/compliance, fiduciary activities, fraud, capital markets, and credit. As part of this restructuring, we have reassessed our staffing requirements. Our banks are now supervised by far more experienced examiners than in 1985, possessing an average of 13.9 years of experience today versus 8.1 years in 1985.

Our restructuring also reflects the changes that have taken place in the banking industry's organizational structure. When I took office in April 1993, there were 3,593 national banks. Today there are 2,656 national banks. Major cities, such as Los Angeles, Denver, Dallas, and Houston, are no longer the headquarters of major banks. With fewer banks to supervise, we need fewer employees, and with fewer major banking centers, it has been necessary for many employees to relocate. In 1993, we had 3,873 employees, while today we have 2,820. The number of OCC offices has declined from 89 in 1993 to 84 today, and the distribution of employees among these offices has changed significantly. Our staff levels allowed us to perform 2,318 full scope safety and soundness examinations on 2,726 national banks in 1996, a coverage ratio of nearly 85 percent. This compares with a coverage ratio of only about 40 percent in 1985.

We realize that we will have to adjust our staffing in the future given the changing industry structure. To facilitate this adjustment, in addition to OCC's traditional hiring programs, the agency has also established a mechanism that would allow us to tap an experienced "reserve pool" of examiners so that we can quickly and easily do contract hires to respond to crises or other sudden increases in workload. This approach is preferable to, and far more cost-effective than, maintaining too large a staff in good times so that we are not caught short-handed in down-times, or continually trying to catch up with the current economic and banking environment through permanent hiring. This procedure also eliminates the need for a prolonged hiring and training period for new examiners.

Fair Lending Compliance. As I noted earlier, over the past four years, the OCC has also undertaken a number of measures to enhance access to financial services for all Americans, including improvement of our enforcement of fair lending laws. We issued new fair lending examination procedures in 1993, and the OCC has conducted over 3,000 examinations using these new procedures. We recently further revised our fair lending examination procedures to cover all credit products and stages of the lending process. These revised procedures make greater use of statistical analysis and mandate the use of modeling when activity is sufficient to produce reliable results. These procedures also include information about examining banks that use credit scoring and self-evaluation techniques, and how the OCC will evaluate disparate impact. Along with new examination procedures, we have used mystery shoppers to test for the presence of discriminatory lending behavior, and we have encouraged banks to self-test to ensure the integrity of their processes and procedures. As I mentioned earlier, since April 1993, the OCC has held numerous informal discussions and formally referred 24 cases to Justice and HUD identifying national banks that we believed were in violation of fair lending laws.

Economists from the Economics and Evaluation Division participate in fair lending examinations, employing statistical models to supplement judgmental evaluations in checking for the presence of discriminatory behavior. The use of statistical analysis, including models, helps the OCC focus and thus increase the efficiency of its examination effort by pre-screening banks to find possible discriminatory behavior and by guiding us in completing our actual examinations in a highly productive, objective manner.

Along with the Secretary of HUD and the Attorney General, in 1993, I initiated an Interagency Task Force on Fair Lending to deter lending discrimination.[7] This Task Force undertook a comprehensive review of fair lending enforcement and issued a joint policy statement on lending discrimination. In addition, starting this past January, a separate interagency group of economists and statisticians has commenced meeting to exchange ideas regarding the approaches and statistical techniques they employ in fair lending exams.[8] Most important, these task forces have provided the agencies that are responsible for fair lending enforcement with a means to exchange information and enhanced their ability to work together toward a common goal. Currently, the OCC and other FFIEC-member agencies are working to develop interagency fair lending examination procedures that will ensure a consistent interagency approach to fair lending supervision.

During this time period, we have seen a corresponding increase in lending to minorities. Conventional mortgage loans by all mortgage lenders to all minorities increased 46 percent from 1993 to 1996, twice the increase in overall mortgage lending.[9] While recent data show impressive gains in lending to minorities, I am troubled that loans to African-Americans rose more slowly in 1996. Accordingly, I have directed my staff to begin an immediate in-depth effort to get to the bottom of the weaknesses in last year's numbers. I also asked all the relevant agencies and departments to join us in this effort, and have requested that a report be delivered this month so that we can immediately take whatever corrective action may be necessary.

CRA. Congress reaffirmed the important responsibility that banks have to serve their local communities when it passed the CRA in 1977. However, as I noted earlier, the regulations to implement CRA that were in place when I became Comptroller were not as effective as they could have been, primarily because they focused on a bank's compliance process rather than its actual lending performance. To revise the CRA regulations so they would focus on performance and therefore be more effective and accepted, we held seven public hearings with the other bank and thrift regulatory agencies in 1993 across the country, and we put our proposed solution out twice for public comment. We issued revised regulations in 1995, and all national banks are subject to the revised regulations as of July

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[7]In addition to the OCC, this group includes the FRB, the FDIC, the OTS, the NCUA, the Office of Federal Housing Enterprise Oversight, the Federal Housing Finance Board, the Departments of Justice, Treasury, and HUD, and the Federal Trade Commission.

[8]This interagency group includes representatives of the OCC, the FRB, the FDIC, the OTS, and the Federal Trade Commission.

[9]Source: HMDA data.

1997, when the OCC unveiled its revised CRA examination procedures for large banks. I remain committed to our efforts to ensure consistent application of the CRA regulations across the bank and thrift regulatory agencies.

Our efforts are being rewarded by the creation of effective partnerships between banks and community development groups--partnerships that are, today, growing in strength and helping to rebuild communities. The increased attention given to this area has had concrete results: home mortgage loans in low- to moderate-income census tracts increased 30 percent from 1993 to 1996, compared with an increase of 23 percent across all census tracts.[10] Also, as I mentioned earlier, in the past three years, banks' CRA loan commitments have totaled $175 billion, representing over 80 percent of all reinvestment commitments since enactment of the CRA.

Planning for Future Supervisory Needs

You expressed an interest in Question 10 about the measures we are taking to train our examiners to evaluate new activities and emerging products. I discussed this briefly earlier in this statement, but I would like to elaborate here. Because of continuous changes in bank activities, the demands placed on our employees to develop expertise in new and rapidly evolving financial products and services is greater than ever before. The importance of training and selective hiring to address these dynamic changes cannot be overstated. There are a number of initiatives being undertaken by the OCC to ensure that our staff has the skills necessary to supervise the banking industry of the 21st century.

Training. The OCC's comprehensive Continuing Education Program consists of numerous formal training programs in a wide variety of technical, administrative, and managerial areas. A number of our staff also take courses offered through the FFIEC. Through these programs, examiners are kept up-to-date on the state of the industry and prepared for higher-level responsibilities. For example, in recent years, we have developed significant training programs in a number of technical product areas, such as capital markets and derivatives, and are currently training bank information systems examiners on topics such as Internet security. We will continue to build upon the OCC's extensive experience with training examiners in new and familiar areas. At times we will work independently, and at other times we will work with other bank regulatory agencies, using recognized experts with well-documented experience to lead the training.

We are also in the process of developing an enhanced approach to training, creating a continuous learning environment. This summer, we created a new, higher-level position in the organization, a Deputy Comptroller for Continuing Education, in recognition of the critical importance of the training function, to lead our efforts to prepare our staff for emerging

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[10]Source: HMDA data.

supervisory challenges. Already, we are offering new courses for the coming year in such areas as cyberbanking and syndicated loans.

While today we offer a large number of training classes throughout the year, the training program of the future will not be based solely on classroom experience. We are exploring alternative methods of training delivery, such as interactive software and video conferencing technology. Such alternatives will facilitate the OCC's ability to address individual training needs, as well as decrease scheduling conflicts and lower travel costs. We have streamlined the process in order to get our staff access to expert training more quickly and easily. In addition, as the banking industry continues to change and we continue to draw on the full range of expertise of OCC employees, including economists and lawyers, we will develop a training environment that suits a wider variety of OCC specialists.

Skills and Resources. To formalize the OCC's commitment to maintain the quality of our supervision, we have made one of our primary objectives for 1997 the continued enhancement of the OCC's workforce knowledge, skills, abilities and resources. To meet our objective, we are determining what types of skills and knowledge are necessary to meet our supervisory needs at present and in the future and taking action to ensure that we have access to the necessary skills and knowledge, either through developing training opportunities or hiring individuals with specific expertise. For example, earlier this year we contracted with a security expert to assist us with electronic money issues and supervising remote banking activities. This assessment will be an ongoing process.

Another of our primary objectives for 1997 and 1998 is to install new technology to support the workforce so that OCC employees have timely and reliable access to the OCC's information technology systems and automated data sources. The OCC recognizes the importance of using technology to improve the efficiency and quality of bank supervision. Appropriate use of technology can produce several important benefits. Technology can help improve intra-agency communications, enable us to use more sophisticated analytical methods where appropriate, and focus our resources on the most significant risk areas once examiners enter a bank. The result can be less burden on banks and improvement in the quality of our examinations.

Already we have switched from using only a mainframe environment into connecting all employees with a local area network (LAN). This change enables improved agency-wide communications, because documents can be more readily shared. Our plan also calls for agency-wide distribution of examination support systems such as the Integrated Bank Information System (IBIS) and the Industry Sector Information Service (ISIS). IBIS uses technology to give examiners and analysts on-line access to data, analytical tools, and models of the banks and their competitive and economic environment. ISIS delivers information on industries and individual companies for the primary purpose of supporting credit quality analysis. These systems are designed to improve our examiner's abilities to analyze data. Full implementation of these new systems will help make the examination process more efficient and effective.

Summary and Conclusions

Supervision is the principal means the OCC employs to ensure that national banks remain safe, sound, and competitive and that the industry continues to support the citizens, communities and economy of the United States. As the industry has changed, the OCC's supervisory philosophy and practices have adapted. Throughout our history, the OCC has updated and modified its supervisory techniques and acquired new expertise. Our experience has taught us repeatedly that on-site, hands-on examination of a bank is critical. It has also taught us that supervision must be forward-looking, and that many traditional banking activities, like lending, can be as risky as non-traditional ones.

When I became Comptroller four and one-half years ago, I set as a priority the strengthening of supervision at the OCC. In doing this, I wanted us to understand fully the lessons of the past and to use what we have learned to improve our supervision. With the help of the OCC's many dedicated professionals, we have made a number of important changes to our supervision that enhance safety and soundness and increase the effectiveness of our supervision by better focusing our resources on those activities and products presenting the greatest risks. The OCC's current, risk-based supervision program integrates what we have learned from the lessons of the past with the fundamental elements of on-site, hands-on examination of banks. At the same time, we are dedicating additional resources to the training of our examiners and planning to ensure that we have the necessary expertise on-hand to supervise the National Banking System of the future. We believe the changes we have made improve the safety and soundness of the national banking system as it evolves.

My goal for the remainder of my term is to assure that the National Banking System remains healthy, stable, and able to serve the diverse needs of American consumers and communities. To do so, we must ensure that the National Banking System is prepared to enter the new century. At the same time, I am committed to making certain that our supervision and our policies can meet new challenges that the future will bring.