REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE EXCHEQUER CLUB
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Good afternoon. It is indeed an honor to be with you again. My previous opportunity to be here was in November 2004, when I was Vice Chairman of the FDIC and spoke to you regarding my concerns about accumulated regulatory burden and its impact on industry consolidation.

Presently, I am concluding my first six months at the Office of Thrift Supervision (OTS), and I appreciate this timely opportunity to spend a few minutes updating you on my impressions of the agency and the institutions we supervise. I will also discuss the regulatory burden relief project, which I am managing for the FFIEC, as it enters a particularly critical phase on Capitol Hill. Finally, I will update you on three supervisory issues. Before concluding, I will make a few comments on the situation in the Gulf Coast and our efforts there.

I must begin by telling you that I came to this job with the perspective of a 23-year national banker – and wasn't sure quite what to expect. Any new Director of the OTS has to deal with threshold questions about the future of the agency and its charter – and my experience has been no different. But after six months on the job, learning about the agency and meeting its capable staff, I come to you with the impression that OTS and the charter we administer have inherent strengths that will ensure its continued viability and relevance well into the future.

I will tell you what these are.

First, our charter is primarily a retail charter and I see no evidence that this part of the financial services world is in decline. Rather, the opposite is true. Today, OTS is reporting that for 2005 industry assets are up 12.0 percent from the prior year to a record $1.46 trillion. In the past five years, industry assets have grown 57.7 percent, representing a robust average annual five-year growth rate of 9.5 percent. Similarly, earnings for 2005 are up 17.6 percent from 2004, and industry earnings have more than doubled in the past five years, climbing from $8.0 billion in 2000 to a record $16.4 billion in 2005.

As this sector grows, I believe our charter is well positioned to provide a structural and regulatory alternative to both established financial services businesses and to new entrants that are working to grow market share in this area.

Second, the statutory framework and regulatory structure around savings banks allow for a degree of regulatory consistency not found elsewhere. Our charter's well-established and well-recognized powers of branching and preemption ensure savings institutions are able to follow their customer base and the growth of their business from one end of the country to the other – all with minimal regulatory burden. Further, the seamless supervision of at all levels of the organization – both savings banks and savings and loan holding companies are supervised by the OTS – ensures both a comprehensive supervisory regime and minimal regulatory overlap.

Finally, the record shows that our charter is remarkably flexible in adapting to the many products and structures present in today's financial services marketplace. We operate with a minimum of overhead, and with a skilled staff with tremendous experience in nearly every sector of modern banking, and both our charter and our agency are remarkably able to adapt to market demands.

The savings bank charter is deployed in neighborhood community banks all across America. It is used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerates involved in a wide array of diverse businesses – to name just a few. These organizations have all come to the savings bank charter at different times and for reasons as diverse as their underlying businesses and the markets they serve. And the facts seem to show that it has been a profitable decision.

That is not to say we don't have our challenges. We do. A significant challenge involves human capital. Like all the banking agencies, we are competing with Wall Street and the industry for similar talent. A growing portion of our workforce will be retiring in the next few years and we must replace these seasoned regulators with new hires. Just this year, we will hire 60 new examiners. We are boosting our resources on training and hiring the critical areas of modern banking – capital markets, economic analysis, and compliance management. We are re-establishing here in Washington, DC a centralized direction for compliance, CRA, community affairs, and consumer protection – all functions that were delegated to the regions in recent years.

A key staffing decision I made recently is the hiring of Scott Polakoff as the agency's new Chief Operating Officer and Deputy Director. Scott is an exceptional individual, a terrific career regulator with outstanding credentials and leadership skills. Scott will truly be an invaluable asset for OTS, and we are very fortunate to have him.

In addition to resolving our human resources needs, we have also requested four statutory changes from Capitol Hill. These are part of the interagency regulatory burden legislation, and will help us build on the flexibility inherent in our charter and ensure long-term competitiveness and vitality.

First, we need parity for savings banks under the federal securities laws. This fix will ensure that savings associations and banks are on an even footing with respect to investment advisor and broker-dealer activities.

Second, we should permit unlimited small business lending for federal savings associations and raise the cap on commercial lending from 10 percent to 20 percent of assets.

Third, we should amend the Home Owners' Loan Act (HOLA) to eliminate the artificial 35 percent limitation on secured consumer lending. This will align that authority with the fact that there is no corresponding limitation on unsecured credit card lending.

Finally, we should provide parity for federal savings associations on federal court jurisdiction by clarifying that the savings association is a citizen of only the state in which its main office is located for purposes of determining federal court jurisdiction.

These are all common sense changes in our statute that will help us continue to provide a flexible and streamlined alternative for established financial services businesses and new entrants into the market.

The challenges I have outlined are not unique to OTS, and our plan for meeting them will, in my view, put our agency on solid footing for the long term – and allow us to meet the growing and increasingly diverse demands of a complex financial marketplace.

I also think there is a good chance to get our priorities, and those of the other agencies and the industry, enacted as part of our broader regulatory relief effort – the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) project. As you may recall from my last visit here, this is a subject near and dear to my heart. Both as a regulator and as a former community banker, I am concerned that the accumulated weight of regulatory burden threatens the competitiveness of the banking industry and falls particularly hard on community banks. This is not idle speculation – it is a fact.

We have tried over the last 2 ½ years to increase awareness of the burden issues facing both large and small banks. My counterparts in the other banking agencies and I have put hundreds of agency regulations out for comment – receiving more than 1,000 suggestions in the process. We have held 16 banker and consumer outreach sessions around the country, given numerous speeches, and have offered Congressional testimony on the subject to both houses of Congress. We appear again before a Senate Banking Committee Hearing tentatively set for March 1st.

In addition to building awareness in the marketplace and in Congress, we have worked to reduce burden where we can – and where we already have the authority to act. Along with the other federal banking agencies, we have increased the small bank threshold under the Community Reinvestment Act (CRA) from $250 million to $1 billion, simplified some of our application and reporting requirements, streamlined examination processes, and made other changes to our regulations and internal procedures to reduce burden. I have noticed, also, that almost every new regulation, process, or procedure now includes a discussion about burden and how to accomplish the objectives while minimizing the regulatory burden on the industry.

Now we must ensure that our recommendations pass Congress. I know there are skeptics here. Unfortunately there are skeptics even among some of the industry associations that a regulatory relief bill will ever get enacted. But the House Financial Services Committee recently acted on a 67-0 vote to send a comprehensive regulatory relief bill to the House floor. The Senate Banking Committee is poised to take up a similar bill this spring. Make no mistake about it, this is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of recommendations before Congress is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. I hope I can count on many of you here to encourage Congress to make it happen.

In addition to our Congressional agenda on regulatory burden, we have been working on the policy around three supervisory issues that have evoked both interest and controversy. All three are particularly important and relevant to the universe of OTS-supervised institutions and holding companies.

The first of these involves interagency guidance, issued in December, on non-traditional mortgage products. Not unexpectedly, the guidance generated considerable attention due to the popularity of two products in particular, "interest-only" and "pay option" adjustable rate mortgages, or "ARMs".

The features of interest-only and pay option ARMs can temporarily protect borrowers from payment increases resulting from rising interest rates. The experience with these instruments has, so far, been favorable. However, these new products share a common, potentially substantial additional risk element—a payment shock when the loan terms are eventually recast. For pay option ARMs, in particular, this shock can be quite dramatic—under reasonable assumptions about interest rates, as much as a 100 percent increase or more in the monthly payment.

Products much like these have long been offered by the thrift industry. Savings institutions have offered ARMs for more than thirty years. Some institutions have offered and successfully managed ARMs with negative amortization features for more than twenty years. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks associated with these types of loans.

I do believe there is a market for this product in situations where the loan product is properly structured, fully disclosed, appropriately marketed, well underwritten, and safely managed. That said, given the structural complexities and possible payment increases when the loan terms are reset, this product is not appropriate for unsophisticated borrowers or those with weaker credit capacities. I believe that some negative amortization products may offer qualified borrowers with greater financial flexibility than traditional products, which is beneficial to borrowers capable of understanding and managing the possible risks attendant to this product. While it is not a product that should be offered to all borrowers, I would not want to deprive qualified candidates from a homeownership opportunity by declaring this product off limits.

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them to set concentration limits as a percentage of capital and, as a result, manage them successfully. As a regulator, that is our recommendation as well as our expectation.

For anyone interested in commenting on the proposed guidance, the comment period will likely be extended 30 days and close on March 29.

Another initiative receiving some attention lately is the proposed guidance we issued last month on commercial real estate (CRE) lending by insured institutions.

The proposed guidance sets out thresholds for assessing whether an institution has a CRE concentration requiring heightened risk management practices. It focuses particularly on concentrations in those types of CRE loans that are vulnerable to cyclical commercial real estate markets. Institutions with these types of concentrations are expected to hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios.

While savings banks' CRE lending exposure is generally limited, we support the principle of robust risk management and commensurate capital in the presence of higher risk loan concentrations. In the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system. While underwriting standards are generally stronger now than in the past, higher concentrations in CRE loans at some institutions remain a concern.

If you have an interest in commenting on the proposed CRE lending guidance, the comment period closes March 14.

Finally, I will spend a minute or two on the perennial topic of the proposed Basel II capital standards. There has been considerable debate in the U.S. about the need for Basel II, the proposed revised capital framework for our largest and internationally active financial institutions. Some believe that we simply need to update our existing capital rules to accommodate advances and changes in the banking system since the original Basel I Accord was adopted and implemented in 1988. Others argue that implementation of Basel II is imperative to ensure the continued international competitiveness of our largest institutions.

While a Basel II-type approach may be best for our largest internationally active banks – about 24 in number, for most institutions, either the current Basel I rules or a modified Basel I framework is likely more appropriate. The challenge is how to proceed on these parallel tracks.

This past October, the federal banking agencies issued an Advanced Notice of Proposed Rulemaking, or ANPR, seeking comment on modernizing Basel I. The comment period on the so-called Basel IA ANPR closed a few weeks ago. We are currently reviewing comments and will soon be developing a formal rulemaking on the subject. We anticipate the Basel II rulemaking will be available to the public at the end of March and published in the Federal Register in May for an extended comment period. Our goal is to issue the Basel IA rulemaking some time this summer, providing a meaningful overlap between the Basel IA and Basel II comment periods.

I am aware of significant sentiment from a number of community bankers that they are perfectly content to continue operating under the existing Basel I framework. In my view, a good case can be made that requiring institutions to move to a new set of capital rules will increase regulatory burden. At the same time, many believe that we need to modernize our risk-based capital system to make it truly more risk-based. The challenge is to do this without creating undue burden and complexity for our community institutions - certainly nothing approaching the complexity of Basel II.

Before concluding, I want to say a few words about the crisis in the Gulf Coast following the hurricanes last year. In late November, I decided to visit the hurricane-devastated areas of New Orleans. I am traveling there again this afternoon after this meeting, and again at the end of the month for an interagency forum with the industry.

To put it mildly, during my first visit I was unprepared for the devastation I witnessed there, and my impression is that little has changed in the intervening weeks. The scene defies description. It is truly unnerving – even for a former resident of Florida familiar with the damage that a hurricane can inflict – to witness block after block, mile after mile of standing empty structures and no signs of human activity.

The challenges facing the hurricane victims are daunting and unprecedented. While most local financial institutions are back on line, they still must deal with many of the issues directly affecting their customers. These challenges are overwhelming. I will give you a few examples of what individuals, businesses and financial institutions are facing:

- FEMA flood maps may not be redrafted until later this year, and until that task is completed, government decisions on building codes and locations are on hold;
- Levee reconstruction standards and timing are uncertain, yet are critical to those people who evacuated the city and are uncertain whether they will ever return;
- Insurance companies are reluctant to write new policies;
- Over 100,000 homes are estimated to need electrical rewiring, but there is a shortage of qualified electricians in the region;
- Homes modestly damaged are deteriorating rapidly due to mold problems;
- Costs to rebuild have increased dramatically due to tightness in the supply of labor and materials;
- There are an inadequate number of contractors and subcontractors;
- Soil contamination will require multi-government review and timing is uncertain;
- Many properties have yet to be reviewed by an insurance adjuster;
- Debate continues among insurance companies over flood versus wind damage; and
- Communication remains poor and postal service is sporadic.

It is one thing to face the huge task of rebuilding a storm-damaged dwelling, it is quite another to face that challenge when there is no public infrastructure in place and no assurance your neighborhood will ever re-emerge.

The banking regulators are doing everything we can to assist institutions and victims. The Federal Financial Institutions Examination Council (FFIEC) website contains questions and answers for institutions attempting to deal with issues such as extensions of loan payments and related accounting and disclosure issues. We have an "800" number to receive and address inquiries from victims. The banking agencies have clarified that favorable CRA consideration will be given to activities by financial institutions nationwide that provide lending, investment, or service activities in the devastated area.

In December, OTS sponsored a forum, jointly with Operation HOPE, to solicit support and assistance from the business community to identify, address and resolve the financial challenges faced by hurricane victims. Tomorrow, I will again be visiting with our institutions in the hurricane-affected areas. In addition, on March 2nd and 3rd, the banking agencies are sponsoring a banking forum in New Orleans to focus attention on the short- and long-term challenges facing institutions operating in the areas affected by the hurricanes.

The short-term prospects for the OTS-supervised institutions in the Gulf Coast region seem favorable; however, I am concerned about the long-term effect of the hurricanes. A favorable economic outlook and a recovering job-creation picture are critical to the area's recovery, but there first must be a stable and viable foundation on which businesses and communities can rebuild. How these issues are addressed will define the future of New Orleans and the Gulf Coast – and we must continue our efforts to assist them in this effort.

Let me conclude today by reiterating that our core mission is maintaining the safety and soundness of savings institutions, and ensuring their compliance with the laws and regulations we administer, including consumer protection laws. In addition to hiring new examiners, we will improve our training for existing examiners and enhance our supervisory, policy, and legal staff – both in Washington and throughout our regional structure. My goal is to provide our staff every opportunity to succeed in improving our oversight of, and responsiveness to, the industry we regulate.

We will continue our efforts to pass a significant regulatory relief bill. Congress needs to address this important problem this year and I believe, with your help, it will happen.

A final and critically important priority is capitalizing on the vibrancy of our charter to ensure we remain a viable alternative for both established retail banking businesses and new entrants into the financial marketplace. We will continue our efforts to ensure that OTS and the institutions we regulate are safe, sound, and well positioned to meet the challenges and seize the opportunities ahead.

Thank you. I will be happy to answer your questions.