Remarks of John M. Reich, Director
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To the Exchequer Club, Washington, DC
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Good afternoon. I am pleased to be here again today and I appreciate the opportunity to speak with you. The last time I visited here—in February of last year—I had been at the OTS only about six months. I have now been at the helm, so to speak, for more than two years and much has happened during that time, both at the OTS and in the industry we regulate.

Since my swearing in, I have set about to revitalize the OTS. We have expanded the agency's workforce, which now stands at nearly 1,100, and bolstered our supervisory expertise—particularly in the areas of compliance and consumer protection. We have reestablished our Central Region office in Chicago to better serve the needs of the five states in that region. And we have continued to solidify our financial position. Assets under OTS supervision total $1.5 trillion and continue to rise. In fact, industry assets have grown more than 55 percent in the last five years, an indication of the vibrancy of the thrift industry and the value of the thrift charter for operating in today's increasingly complicated and competitive environment.

The financial services industry, the markets, and the entire global economy are facing significant challenges, particularly in the last few months. Although federal savings banks are feeling—to a limited degree—the effects of the current market liquidity squeeze, housing slowdown, and increase in home mortgage delinquencies, the industry as a whole remains sound because of its strong capital, earnings and profitability, and provisions for loan losses. These three pillars provide a firm foundation for withstanding current adverse conditions. As I talk about these conditions today, two themes will emerge: first, the need for greater transparency and, second, the need for a level playing field for all entities in the mortgage marketplace.

Conditions in the Capital Markets

Current conditions, of course, include the significant disruptions we have seen in the capital markets, which pose serious challenges to the institutions we regulate. These challenges follow several years of record earnings and profitability for the thrift industry, accompanied by a precipitous rise in home prices. As prices peaked late last year, the housing market cooled—as the number of buyers decreased and interest rates rose. This led to an increasing supply of unsold new and existing homes, with home prices moving downward in many parts of the country.

At the same time, some institutions began experiencing problems due to struggling performance of certain mortgage product lines. Particularly hard hit have been adjustable-rate mortgages made to subprime borrowers. Recent problems have also affected Alt-A loans, as well as some prime loans, particularly jumbo loans not eligible to be purchased by Fannie Mae and Freddie Mac. Because only a limited number of jumbos can be sold to Fannie Mae and Freddie Mac, ongoing funding for jumbo loan programs must come from investor purchases of these loans in the secondary market. Surprisingly, finding investors for these high quality loans has been a challenge.

In the capital markets, volatility last month reached levels not experienced since the terrorist attacks on 9/11. Credit problems in the subprime markets quickly led to a liquidity crisis that hit all facets of the markets, including those considered among the most liquid. The speed at which liquidity deteriorated was unprecedented. Problems in the subprime market led to downgrades by rating agencies; and news of mortgage lenders shutting their doors caused demand for asset-backed commercial paper to disappear virtually overnight. Volatility breeds uncertainty during times of credit stress and, as a result, investors fled to the safety of Treasury securities and cash.

As their ability to roll over maturing commercial paper nearly ceased, many lenders began to experience funding difficulties. Active mortgage lenders felt the sharpest impact from these disruptions, particularly with their ability, or rather inability, to sell subprime and nonconforming jumbo loans for securitization in the secondary market. As a result, only bonds backed by the highest-quality mortgage loans have been trading—and even then at discounts.

Investors' difficulty in getting reliable information to evaluate mortgage-backed securities has also caused problems. Investor confidence in credit ratings has deteriorated, making credit analysis difficult and time consuming. An erosion in credit due diligence—carefully checking the value of the underlying assets—has also further reduced price *transparency*, which is often a contributing factor when markets "seize up."

So here is the first theme I mentioned: *transparency*. Investors did not have a firm enough grasp on what they were buying—and of the accompanying risks.

The net effect of these events has been that the number of mortgage loan originations has dropped considerably. However, as expected, the capital markets are adjusting. After a tumultuous period of illiquidity during the second and third week of August, the availability of funds in the financial system improved. On August 17, the Fed announced an unexpected reduction in the discount rate, including unusually favorable collateral and repayment terms. Also signaling its seriousness about temporarily easing credit conditions was an announcement stressing that borrowers at the discount window would be viewed as coming to the aid of the financial system, a stark contrast to the usual stigma attached to discount window borrowings. Although liquidity has not returned to normal, the situation has calmed somewhat. But the credit markets remain a concern for large financial institutions facing an environment of volatile interest rates and risk aversion by investors.

While we fully expect thrifts to withstand this period of stress because of their solid earnings, strong capital, and loan loss provisions, we cannot be certain precisely what events will transpire. Volatility in the capital markets can have far-reaching effects, and its impact and duration are always difficult to gauge.

Conditions for Consumers

Current conditions have also caused difficulties for consumers—not only for many subprime borrowers but also for anyone else trying to sell or buy a home. Again, a lack of *transparency* has been a significant issue—transparency for mortgage lenders about the true creditworthiness of many subprime borrowers and transparency for consumers about the true terms of their mortgages. This lack of transparency has helped to feed the problems in the capital markets, fueling investors' fears about investments related to real estate.

As a financial regulator, the OTS is charged with ensuring the safety and soundness of OTS-regulated thrift institutions, and also with ensuring consumers are treated fairly. We work to protect consumers from being short-changed as they attempt to achieve the American dream of homeownership and as they engage in other transactions with the institutions we regulate. Currently, a number of borrowers are struggling to meet their mortgage payments—some facing the imminent threat of losing their homes.

There are some difficult aspects to this part of our job. Some borrowers share blame for their current troubles. Some people bought homes they knew they could not afford. Other borrowers attested to inflated personal income and asset amounts. Meanwhile, speculators tried to "flip" properties they never intended to occupy. A healthy debate is under way about those borrowers and how we can ensure that, in trying to prevent foreclosures, we do not provide the wrong incentives. In short, we must take care not to reward certain types of behavior, but also avoid imposing undue costs on the mortgage markets.

At the same time, there are borrowers who—through no fault of their own—are facing delinquencies and potential foreclosures. Some have experienced personal setbacks, such as the death of a spouse, serious illness or injury, divorce, or the loss of a job. These setbacks are traditionally among the root causes of foreclosure. But others were put into loan products that were inappropriate for their financial circumstances. Many of these borrowers are fully employed, responsible, hard-working Americans who are locked into mortgages with monthly payments that are due to reset to amounts entirely outside the bounds of their income ranges and ability to pay. Often, prepayment penalties preclude the option of refinancing. Even for borrowers who do not face such penalties, disruptions in the credit markets make refinancing more expensive and less attainable.

Despite all of these challenges, we need to maintain an important perspective. As we focus on preventing foreclosures on creditworthy borrowers, we must avoid blurring the line of distinction between subprime lending and predatory lending. While we want to prevent predatory lending and the abuses that it represents, we do not want to restrict legitimate subprime lending. Problems with subprime lending arise when mortgage loans are granted to borrowers who cannot afford them, either because they do not have the financial resources to own a home or because loan terms make a particular loan unaffordable. Poor loan underwriting is a problem, as is predatory lending. But subprime lending, in and of itself, is not the problem.

Although we can all agree that not everyone should own their own homes, the increase in homeownership in this country has generally been viewed very favorably. Homeownership is the bedrock of strong communities. I have seen statistics showing that homeownership increased by more than half from the end of World War II to the height of the recent housing boom in 2005, when it peaked at nearly 70 percent of families. As we have seen, that peak is not sustainable. Having said that, it is also important to note that the overwhelming majority—84 percent—of subprime mortgages in this country are being repaid on schedule. As a regulator, I want to be sure that in attempting to avoid foreclosures, stop mortgage lending abuses and reassure the capital markets, we do not cut off credit to worthy borrowers.

What the OTS is Doing

So far during my comments today, I have discussed market disruptions, challenges for financial institutions and difficulties for consumers. Now I'd like to turn from problems—to solutions—not only solutions currently under way but also possible solutions for the future.

We have already issued important interagency guidance to our regulated institutions and for our examiners on adjustable-rate mortgages and subprime lending. We have also provided educational materials for consumers on these subjects. We issued interagency statements urging institutions to work with troubled borrowers to avoid foreclosure. And just a couple of weeks ago, the federal banking agencies, along with the Conference of State Bank Supervisors (CSBS), issued important guidance to the mortgage servicers we regulate. This guidance urges regulated institutions that service securitized residential mortgages to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and to pursue appropriate loss mitigation strategies to preserve homeownership.

I would like to emphasize that although guidance by a federal banking regulator does not carry the force of law, it carries a weight that is recognized by our examiners and by the institutions we regulate. Regulatory guidance sets supervisory expectations, providing direction for examiners and, yes, *transparency* for regulated institutions so institution executives understand where examiners will be focusing. Our examiners follow up with the institutions on how they are complying with such guidance and generally, the examiners find compliance. If institutions are not adequately following the guidance, we find out why, and we work with institutions to address particular issues and problems.

Last month, the OTS released an Advance Notice of Proposed Rulemaking seeking public comment on approaches we might consider in expanding our regulatory authority to address unfair or deceptive acts or practices in the thrift industry. One of the goals of this initiative is to provide greater *transparency* to our regulated institutions about our expectations regarding sound consumer protections and continued adequate oversight in this area.

The OTS also uses enforcement authority to address problems identified by our examiners. Our strategy in these cases is to try first to gain compliance by an institution voluntarily and through informal supervisory efforts. This strategy is typically effective. But in other cases, a formal enforcement action may become necessary. For example, in one recent case, the agency took action to protect the interests of homeowners in jeopardy of losing their homes due to an institution's harmful lending practices. Under a formal Supervisory Agreement, a multimillion-dollar reserve was established to cover costs associated with providing affordable loans to borrowers whose creditworthiness was inadequately evaluated when their loans were originated and to reimburse borrowers who paid excessive broker fees or lender fees at the time of the originations.

As I recount the actions that OTS is taking, I need to emphasize one area of action that does not generate headlines, but is nonetheless fundamental to what we do—and that is to pursue our core mission of ensuring the safety and soundness of our regulated institutions. Our closest contacts throughout these challenging times have been with our institutions. The vast majority of our employees are examiners who regularly visit the thrifts we regulate to ensure that they are operating in a safe and sound manner and in compliance with consumer protections. These examiners have a depth of experience invaluable during challenging times. They have seen the good times and the bad times, and the richness of their expertise is invaluable.

As I mentioned, our examiners are working with institutions to evaluate their lending programs for compliance with interagency guidance on nontraditional mortgages and subprime lending, and interagency statements urging institutions to work with troubled borrowers to avoid foreclosure. They are also looking closely at several other areas, including current levels of troubled assets, earnings pressure on the industry, liquidity concerns, and the impact of competition for deposits. I will briefly highlight each of these for you.

In evaluating *troubled assets*—loans 90 days or more past due and loans in nonaccrual status plus repossessed assets—we look at historical levels, trends and sudden changes. While troubled assets increased significantly the last year, the total percentage remains small—less than one percent of total assets. But the trend commands our attention. Of particular concern, the increase was primarily driven by higher delinquencies in single family mortgage and construction loans. A key issue for our examiners is ensuring that institutions with increased volumes of troubled assets have staff with the right skills to address these issues.

Another key area is *earnings pressure*, exacerbated by shape of the yield curve the past year, which has prompted institutions to look for ways to improve their yields. As they seek to add new product lines, bank managers must be vigilant about the risks. OTS examiners are monitoring institutions to make sure they have the expertise and controls to support new product offerings, and that growth of new lines is consistent with an institution's operating strategy and avoids excessive concentration risks.

For some of our lenders, the current concern is *liquidity*. Institutions selling loans to Fannie Mae and Freddie Mac are not greatly affected by current market conditions. However, as I mentioned earlier, the market for non-conforming loan products has weakened significantly, if not totally evaporated, the last several weeks. A number of institutions are re-evaluating their business strategies and OTS examiners are being vigilant to evaluate any changes.

The last area I want to mention is *competition for deposits*, which is strong in most large retail markets. Large organizations with effective marketing campaigns for deposits may cause other institutions to turn to more volatile—and potentially risky—funding sources. In this environment, contingency planning is essential. Thrifts must prepare for potential shifts in the markets. As a regulator, the OTS must ensure that the preparation is adequate. As recent events in the capital markets have illustrated, a solid foundation of deposits can provide stability during rocky times. Despite robust competition, the stability provided by deposits remains a positive force in the thrift industry, which has relied on customer deposits for liquidity since the first savings association was established in 1831.

What More Can Be Done?

So far, I have discussed only one of the two themes I mentioned at the beginning of my remarks: *transparency*. The second theme is ensuring a *level playing field* for all participants in the mortgage marketplace.

I have heard comments from executives at federally regulated financial institutions that a *level playing field* does not currently exist and I have to agree with them. Many of the abuses in home lending have come from a side of the mortgage market that is outside the reach of federal regulators, and in many cases also outside the reach of the states. Current supervisory structure provides minimal accountability—and represents a continuing force for tipping the competitive balance in the home mortgage marketplace in favor of entities that play by less stringent sets of rules.

The activities of mortgage brokers and nonbank lenders have filled stories in the press and caught the attention of lawmakers in recent months. As noted in a recent Time magazine article on the mortgage industry, "the farther away from the prying eyes of federal bank examiners a transaction occurs, the more likely it is to cause trouble."

We have suggested to Capitol Hill that the time has come for a more structured regulatory regime to apply to these corners of the home mortgage market. We must find a way to provide that *level playing field* and to eliminate or significantly reduce competitive pressures to engage in practices that are misleading and otherwise not consumer friendly. CSBS is a strong advocate of uniform licensing standards and national registration of mortgage brokers and loan originators. We support CSBS's efforts in conjunction with the American Association of Residential Mortgage Regulators to establish a national licensing system for mortgage brokers and originators.

The OTS and other federal regulators currently have tenuous authority to provide meaningful nationwide protection for mortgage originations conducted outside the entities that we regulate. Our ability to regulate activities of brokers and others in the mortgage origination process is constrained by the scope of our jurisdiction. However, Congress has the power to act to curtail abuses by requiring national registration and oversight of mortgage brokers and loan originators that operate outside of existing federal oversight and supervision

The other area of concern has been the funding of mortgages that were poorly underwritten and/or that had predatory pricing and lending terms. Again, Congress has the ability to address funding abuses by imposing much needed oversight and accountability for mortgage banks. The OTS has extensive expertise in the oversight and supervision of mortgage banking operations that I believe would benefit the currently unregulated mortgage banking market. As I have said in the past, the OTS is not asking for expanded regulatory authority, but if Congress determined that our agency could provide the best solution, we would rise to the challenge.

American consumers deserve basic protections when they make the largest investment of their lives and we, as public servants, have a responsibility to do our best to provide those protections. *Transparency* and accountability in the mortgage origination and funding processes would provide these much needed protections. And providing a *level playing field* would make sure that everybody plays by the same rules within the context of a healthy and competitive mortgage market.

Conclusion

Before concluding, I want to take this opportunity to mention that the OTS will once again be sponsoring a National Housing Forum this year. As we did last year, we plan to bring together some of the nation's foremost experts to discuss and debate many of the most critical housing finance issues. This year's National Housing Forum will be held on Monday December 3rd at the National Press Club in Washington, D.C. I hope to see many of you there.

Thank you for the opportunity to speak to you today. I am happy to answer your questions as time permits.