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INTRODUCTION

I appreciate the opportunity to address America's Community Bankers again. The thrift industry is healthy and strengthening. The number of problem thrifts and the level of problem assets continue to fall. During the past year, OTS has worked closely with ACB and the thrift industry in an effort to streamline OTS regulations, reduce reporting burden, and ensure that federal policy does not disadvantage the mutual form of organization.

It is particularly appropriate that this meeting is being held in Boston. Boston is an historical city that has demonstrated its ability to respond to change. A city once built around manufacturing, fishing, and shipping, Boston has transformed itself as these activities became less important. The local economy has shifted toward electronics, biotechnology, and services such as education and health delivery. The result is a restructured but nonetheless vibrant and healthy city.

The thrift industry in this country also has a long history. It traces its origins to the early nineteenth century when groups of neighbors pooled their savings so that each member could in turn borrow money to buy a house.

Mutual savings institutions date back to 1816. The first, The Provident Institution for Savings, was located in Boston, Massachusetts. The first building and loan was founded 15 years later.

The world of residential mortgage lending has changed significantly since that first loan. What undoubtedly was a simple loan transaction 179 years ago has become a much more complicated and costly transaction. In fact, some are now asking whether portfolio lenders specializing in residential mortgage lending are viable. Do the descendants of the Provident Institution for Savings have a role in today's financial system?

In my remarks today, I will briefly review the long-running debate about whether the thrift industry can and should continue to exist. Then I will explain why I oppose forcing federal thrifts to give up their charters. I will conclude by suggesting an alternative approach-- an approach that equalizes deposit insurance premiums, removes the tax barriers to charter conversions, and allows the market to answer the age-old question of whether we need a thrift industry.

THE VIABILITY OF THE THRIFT CHARTER

A. Should We Eliminate the Thrift Charter?

Concerns related to the viability of the thrift charter are not new. The issue seems to arise every few years.

When I first joined the Treasury Department in 1971, I received a copy of the Hunt Commission Report. One finding of the Commission was that requiring financial institutions to solve the problems of society typically did not work. Forcing institutions to invest part of their portfolio in particular types of investments, the Commission found, is the equivalent of a special tax.

The Commission report went on to say that while the initial effect of such forced investments might be beneficial, eventually other institutions with broader powers would offer customers better terms than the "taxed" institutions could afford. Put simply, the Commission predicted that placing restrictions and unique costs on thrift institutions, but not on their competition, would result in a declining thrift industry. A comparison over time of the market share of thrifts compared with their competitors bears out this prediction.

Arguably, in the past, a number of regulatory benefits offset the disadvantages of forced specialization in home lending by thrifts. These benefits included more liberal branching authority than commercial banks, deposit rate ceilings (the old Regulation Q), low cost advances from the Federal Home Loan Bank System, favorable access to the Federal Home Loan Mortgage Corporation, and favorable federal tax treatment. In the last fifteen years, the Congress has either eliminated or shared most of these benefits with thrift competitors.

At the same time, the federal government's support of the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, through Treasury lines of credit and exemptions from many of the regulatory costs imposed on private corporations, has resulted in the mortgage banking industry capturing a growing portion of the residential mortgage market.

This raises the question of whether depository institutions choosing to be specialized housing lenders can survive and prosper in today's market. The need to find alternative funding sources for the debt obligations of the Financing Corporation (FICO)[1] has focused attention on this issue.

As you know, the initial plan for funding the FICO obligation and simultaneously capitalizing the Savings Association Insurance Fund (SAIF) was predicated on a combination of annual Treasury contributions to the SAIF and a rapidly growing thrift industry. No Treasury contributions, however, were ever made and the thrift industry has contracted. What we are left with is an undercapitalized SAIF, a growing FICO burden for thrifts that are SAIF members, and SAIF insurance premiums that are on average six times higher than those charged by the Bank Insurance Fund (BIF).

A solution recommended by the Administration, FDIC, and OTS is to spread the FICO obligation to include all FDIC-insured banks, capitalize the SAIF, and then merge the two insurance funds. Not surprisingly, commercial banks have objected to sharing responsibility for FICO. Commercial banks have also objected to merging the fully capitalized thrift and bank insurance funds. These banks argue that if the thrift industry cannot meet its FICO obligation on its own, and maintain a separate insurance fund, then the thrift charter should be abolished.

B. Solution Proposed by the House Bill -- Elimination of the Federal Thrift Charter

In fact, the House Banking Committee has voted out a bill that would eliminate the federal thrift charter. The House bill would force every federal thrift to convert to a national bank, state bank, or state savings association by January 1, 1998. I have three fundamental problems with this approach.

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1 FICO was established by Congress in 1987 to issue bonds to help fund the now-defunct Federal Savings and Loan Insurance Corporation. FICO issued $8.2 billion in non-callable bonds that mature in or around the year 2019. Annual interest payments on the bonds total $793 million. Under current law, interest on the bonds is paid out of assessments levied against savings associations insured by the Savings Association Insurance Fund (SAIF). The FICO draw on SAIF assessments reduces income to the SAIF and keeps SAIF assessments high.

First -- I do not accept the premise that a depository institution that specialized in mortgage lending is unsafe.

Today's thrift industry has fully recovered from the 1980s debacle. I congratulate you for surviving a tough decade. Capital is at the highest level in more than 50 years. The industry is profitable and growing stronger each quarter. Facts do not support the suggestion that mortgage lending specialists are inherently unprofitable and present undue risk to the federal deposit insurance funds.

The balance sheet of the typical thrift does indeed look very different from the balance sheet of the typical commercial bank. Residential mortgage assets accounted for more than 70% of thrift assets at the end of last year. By contrast, less than a quarter of the typical community bank portfolio[2] consists of residential mortgage assets.

It is also true that the average return on assets (ROA) for the thrift industry in recent years has remained substantially below that of the average ROA for commercial banks. This has caused some to conclude that specializing in home lending is not viable; that mortgage lending specialists are more failure prone and pose a greater risk to the deposit insurance funds than other types of lenders.

In reality, however, the picture is far more complicated. OTS staff looked at the portfolio composition of thrift institutions with ROAs in excess of 1%. They found that high-performing thrift institutions with less than $1 billion in assets typically hold a greater percentage of their portfolios in residential mortgage assets than the thrift industry as a whole.

Interestingly, the reverse is true for the high performing thrifts with assets of more than $1 billion. This difference may be due to large institutions having the resources to successfully pursue several lines of business simultaneously. It may also be because larger thrift institutions often operate in urban areas and are apt to face highly competitive mortgage markets.

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2 "Community bank" is defined as commercial banks with assets under $1 billion.

No matter how you slice it, the hard data undercut broad claims that mortgage specialization is typically an unprofitable or unsafe business strategy. Data from the thrift crisis of the 1980s reinforces this conclusion.

OTS staff studied the performance of thrifts from 1985 to 1994. They found that traditional thrifts with asset portfolios consistent with the tougher QTL test imposed by FIRREA were much less likely to fail than thrifts with a lower level of residential mortgage assets. Moreover, the cost of resolving thrifts that did fail was much lower if the failed thrift had concentrated on residential mortgage lending.

Thus, the data show that specialization in mortgage lending per se does not place the insurance funds at risk. Undoubtedly, thrift institutions in some markets have suffered reduced earnings because of the forced concentration in residential mortgage lending. These thrifts might benefit from converting to banks. On the other hand, many of the most profitable thrifts in the country are mortgage lending specialists.

Second -- I oppose eliminating powers that are unique to federal thrifts.

Cutting back on the authority of thrift institutions to affiliate with non-banks and to engage in insurance and other activities may be a step backward on the road to financial modernization. The House Banking Committee has produced a financial modernization bill that would enable commercial banks to begin affiliating with holding companies engaged in a broader range of financial enterprises. Chairman Leach has noted that banks are losing market share "to the point [that they] could, in short order, become anachronistic unless they are more comprehensively empowered." I agree with Mr. Leach.

Why then "level the regulatory playing field" by eliminating the federal thrift charter? The argument appears to be that if banks pay part of the FICO obligation, and if the BIF and SAIF are merged, any of the so-called "regulatory advantages" of thrifts should be stripped away. The hit list includes the broader powers of thrift holding companies and service corporations, and the broader branching powers of thrifts.

But is this approach consistent with the long-term health of your institutions? The thrift powers on the hit list do not present safety and soundness concerns. Moreover, under current law, banks can convert to thrift charters to take advantage of the thrift powers. The whole concept underlying our dual banking system is that charter choices are good.

The idea that in our large and diverse economy, one federal charter should fit all does not strike me as valid. So long as institutions can freely convert to take advantage of whatever form of charter best fits their business strategy, why limit their business options?

There is growing support in this country for integrated, full-service financial holding company structures. Why then force thrifts to terminate their affiliation with holding companies engaged in activities broader than those currently permissible for bank holding companies? The practical effect would be to prevent thrifts from responding to customer demands for the very type of integrated financial services that are so critical to the future of depository institutions.

In an age of financial modernization and regulatory burden reduction, does it make sense for the federal government to decree that all federal thrifts must adopt a form of charter that has been deemed anachronistic?

Third -- forcing all federal thrifts to convert to commercial bank charters will be costly.

Charter conversions are not free. A thrift converting to a commercial bank must become familiar with a new set of statutory and regulatory requirements. Internal systems and software must be modified to conform to the financial reporting format of its new regulator.

Beyond these expenses are all the other costs associated with restructuring an institution's business to conform to the rules governing its new charter. Conversions will be particularly costly, if bank examiners view the legislation forcing the conversion of thrifts to banks as a Congressional mandate for thrifts to reduce their residential mortgage concentration.

Under the House bill, thrifts would be required to dispose of nonconforming subsidiaries and investments by a specified date. Loans not conforming to the bank lending limits would also have to be sold. Branching strategies would have to be cut back to meet bank rules. No further branching would be permitted in some states where thrifts already have branches. Thrifts would have to disaffiliate with holding companies engaged in activities impermissible for bank holding companies absent compliance with restrictive grandfathering conditions.

It is one thing for an institution to conduct its own cost/benefit analysis and determine that the benefits of conversion outweigh the costs. It is quite another for the federal government to force institutions to incur the costs of conversion, when the mandatory conversions do not serve an apparent public policy objectives.

Thus, to recap, I oppose forcing federal thrifts to give up their charters for three reasons: (1) the financial performance and safety and soundness of most thrifts will not be enhanced by forced charter conversion; (2) the federal thrift charter is in many ways more modern than available commercial bank charters; and (3) mandatory conversion could impose unnecessary costs on thrifts. I recommend an alternative approach.

C. Let the Market Determine the Charter Mix

I believe it should be the marketplace and not the federal government that determines the make up of our financial systems. The best regulatory environment is one that frees the markets to operate. We need to eliminate regulatory factors that currently skew the market -- such as artificially high deposit insurance premiums for SAIF members and tax barriers that prevent thrift-to-bank conversions. To be specific, I recommend a four-part legislative program.

1. Resolve the Problems of SAIF and FICO Promptly

First, the SAIF/BIF insurance premium disparity and the potential funding problems of the FICO must be resolved without delay. At a minimum, this means that the FICO obligation must be spread pro rata among all FDIC-insured institutions and the SAIF must be promptly capitalized. I also strongly support merger of the deposit insurance funds.

These changes must be enacted as soon as possible -- before the premium disparity drives SAIF-insured institutions to engage in unproductive and costly avoidance activities to minimize their SAIF deposits. If the federal government fails to act now, it may miss its best chance to resolve the FICO and SAIF problems with minimal risk to the taxpayer. Legislation resolving the problems of FICO and SAIF should be enacted this year.

2. Remove the Tax Barriers to Conversions

The second step I recommend is elimination, or at least substantial reduction, of the tax barrier to thrift-to-bank conversions similar to the bill recently introduced by Chairman Archer and Chairman Leach. Reducing the tax penalties triggered when a thrift institution converts to a bank charter allows thrift managers to freely choose their charter.

This approach would allow thrift institutions that wish to become a bank to do so, without forcing conversions on institutions that wish to continue as mortgage lending specialists and want to retain the operating flexibility inherent in the federal thrift charter. With this approach, the market -- not the federal government -- would decide whether there is a continued need for specialized mortgage lenders.

3. Ensure Maintenance of a Strong Supervisory Function

As the thrift industry restructures itself, it is important that we maintain a strong supervisory function. We cannot afford a repeat of the 1980s. As we create a system where thrifts can freely become banks and vice versa, it is important that we mitigate the regulatory dislocation that could occur if a significant number of thrifts decide to convert to commercial banks.

I am proud of the work performed by the staff of the OTS. I am concerned, however, that the continuing uncertainty over the agency's future may adversely affect our ability to attract and retain a high quality staff. It is critical that OTS, either on a stand alone basis, or in combination with one of the other banking agencies, be able to retain a core of experienced staff to supervise those institutions choosing to remain specialized housing lenders. Stabilizing the thrift supervisory function would ensure that thrift institutions continue to be supervised by staff familiar with residential mortgage lending.

Merging OTS into one of the other banking agencies would allow the new agency to reallocate supervisory personnel as needed to adapt to charter changes. It would also provide a vehicle for the new agency to design transition procedures to reduce the cost to thrift institutions of converting to commercial banks.

4. Modernize the Financial Institutions Charter

The fourth step is to provide more operating flexibility to insured depository institutions. The first three steps:

- the SAIF/FICO fix,
- elimination of tax barriers to charter conversions, and
- regulatory restructuring

are relatively straightforward. But they do not address the need to review and update the bank and thrift charters.

The Federal Government must continue its efforts to craft legislative initiatives, consistent with safety and soundness, that will ensure that depository institutions can continue to serve the changing needs of their customers. In many ways, some features of the thrift charter may provide the flexibility that many analysts believe the commercial banks need to remain competitive. It is also important that before the decision is made to eliminate a charter devoted to housing finance, the government should analyze the effects on the country's housing finance system. We should be comfortable that alternative vehicles exist that would fill any gap created by the wholesale conversion of thrift institutions to bank charters. I support a disciplined and prompt analysis of the viability of the thrift charter as suggested by Senator D'Amato.

CONCLUSION

In closing, I recognize the challenges you all face as you attempt to design business strategies in an uncertain environment. We will do all that we can at OTS in the coming months to assist you as together we work through any legislative initiatives.

Thank you.