Speech by John M. Reich, Director
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Good morning and thank you for this opportunity to return to my adopted home state where I spent 22 years as a community banker, in Fort Myers and Sarasota.

I appreciate the opportunity to speak to the Community Bankers Association of New York State to talk about a few issues that are on my mind, but first I want to say just how happy I am to be at the Office of Thrift Supervision. Never in my years as a community banker in Florida did I ever imagine myself in any kind of regulatory capacity in Washington, DC. I am delighted to say that, as I have visited the Regional Offices of OTS in Jersey City, Atlanta, Dallas, and San Francisco, I have found our people to be professional, committed to our mission of maintaining the safety and soundness of the thrift industry, and committed to wanting to see your institutions do well.

The issues I thought I would touch on include (1) an update on the EGRPRA effort to reduce regulatory burden; (2) some discussion and a status report on Basel II and Basel I-A, as it is being called; (3) some thoughts and concerns about the use of non-traditional mortgage products; (4) some comments about the Federal Home Loan Bank system; and finally, (5) some comments about CRA and where I think we're headed with it at OTS, and particularly as a result of the hurricane damage suffered in Louisiana and Mississippi a few weeks ago.

Regulatory Burden Reduction

As many of you know, in 2003, FDIC Chairman Powell asked me to lead an interagency effort, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), to eliminate regulatory requirements that are outdated, unnecessary or unduly burdensome. I am continuing to oversee this effort as Director of OTS.

During the past two years, I have conducted 16 outreach meetings with banks and thrifts, and consumer and community groups, including several meetings with both industry and consumer/community groups in attendance. Representatives of all of the federal banking agencies, the Conference of State Bank Supervisors, various industry trade associations, and community organizations have joined me in these meetings. In each of these meetings, I have asked participants to identify regulatory requirements that they believe are outdated, unnecessary or unduly burdensome.

As a result of these efforts, a growing number of legislative items and issues have gained support, and we hope to continue to add more as the participating agencies identify consensus provisions.

Just yesterday, the House Financial Services Committee unanimously approved its regulatory relief bill, H.R. 3505. I have worked closely with the House bill's sponsor, Jeb Hensarling and others, on a number of the provisions included in H.R. 3505.

There are many good things in H.R. 3505, including relief from filing currency transaction reports for institution's regular customers. This has been a relief provision in the works for some time and, hopefully, it will soon be enacted into law.

H.R. 3505 would also raise the small bank threshold for the 18-month exam cycle from $250 million to $1 billion. There are many similar provisions that individually do not appear to be particularly compelling regulatory burden relief items. But, HR. 3505 does in fact accomplish an across-the-board reduction in the burdens that you face today. I believe, in the aggregate, the bill contains some real regulatory relief. If you agree, as always, I urge you to contact the members of your Congressional delegation to support it.

We're also doing what we can at the agency level to provide regulatory relief on our own. Last week, the FDIC Board, of which I am still a member, approved a Final Rule to amend the FDIC's Annual Independent Audit and Reporting rules, under the FDIC's Part 363, raising the asset exemption threshold from $500 million to $1 billion. This means that institutions of $1 billion or less will no longer have to:

- **Provide a management report concerning the effectiveness of the institution's internal controls over financial reporting and its compliance with safety and soundness laws;**

- **Obtain an independent public accountant's attestation on management's internal control attestation; and**

- **Establish an audit committee comprised of outside directors who are completely independent of management—the requirement is modified to require only a <u>majority</u> of the Audit Committee to be independent.**

I do hope you will find some measure of relief in these changes. We are continuing to work on identifying areas to provide regulatory burden relief on our own. And I encourage you to continue to contact me with any additional ideas or suggestions you may have.

Basel Update

Let me now turn to Basel. Having just returned Tuesday evening from speaking to an International Forum in Brussels, I have a heightened awareness of the zeal that European bank supervisors have for the speedy implementation of Basel II.

I've learned some things. For one thing I learned that all of the banks in the European Union—100 % of them, comprised of about 10,000 banks in all—plan to adopt and operate under Basel II. The difference is that the part of Basel II that most of them are adopting is called the Standardized approach to capital determination, and it is a significantly more simplified calculation of capital than the Internal Ratings Based approach our largest institutions are adopting.

Last week, along with other Federal regulators, I testified before the Senate Banking Committee on development of the new Basel capital rules. There has been some debate in the U.S. about the need for Basel II, the proposed revised capital framework for our largest U.S. financial institutions. Some hold the view 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.

For the largest and most sophisticated banks, and especially those that operate internationally, Basel II may be the most appropriate capital framework. For many of you, either the current Basel I rules or a modified Basel I framework, which has acquired the nickname Basel I-A, may be most appropriate.

On October 19, the four Federal Banking Agencies issued an Advanced Notice of Proposed Rulemaking seeking comment on a number of ideas regarding how we might modernize our existing Basel I-based capital rules. I urge you to read it and to provide us with your thoughts on how best to update our existing Basel I rules. I am also particularly interested in hearing from you on whether the status quo should be retained as an option for many institutions. I am aware of this sentiment from a number of community bankers who have indicated they are perfectly content to continue to operate under the existing framework. And a good case may well be made that causing you to move to a new set of capital rules from where you are today increases regulatory burden.

Alternative Mortgage Products

An area that has generated considerable attention recently that I want to discuss is the development and rapid growth of so-called non-traditional mortgages.

Two new products in particular, "interest-only" and "pay option" adjustable rate mortgages (ARMs), have garnered the most attention. With interest-only ARMS, the borrower pays a set interest payment and no principal for a set period of

years (typically 5, 7, or 10 years). With a pay option ARM, the borrower is only obligated to pay a minimum monthly payment, which is typically below the interest owed on the mortgage. If the borrower so chooses, the "deferred interest" accumulates, creating negative amortization from the outset, and the principal on the loan increases. Usually, the amount of the negative amortization allowed is capped, generally at a percentage of the original loan amount.

These products, in fact, have predecessors among products long offered by the thrift industry. Thrifts have offered adjustable rate mortgages (ARMs) for more than thirty years. And some thrifts have offered—and successfully managed—ARMs with negative amortization features for twenty years.

The features of interest-only and pay option ARMs can temporarily protect borrowers from payment increases resulting from rising interest rates. Similar types of mortgages have been used on the West Coast, in particular, for a number of years. 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% increase or more in the monthly payment.

These new products have the potential to take risk to a higher level than bank managers may be accustomed to. Given the relatively short period of time many of these newer instruments have been offered, the banking industry's overall experience with these two particular products is limited. Nonetheless, these products are now being offered in many markets across the country and it appears that a growing number of institutions with limited experience in managing the risks associated with these types of loans have begun to originate them in increasing volumes.

I believe most thrifts have approached innovative market products with caution and due diligence. It is our experience that thrifts specializing in mortgage lending are keenly aware of the need to manage carefully all of the risks involved, including sound underwriting standards, close attention to loan and portfolio performance, and effective oversight and controls. Typically, institutions add new mortgage products slowly and carefully as they learn about all the extra dimensions of risk they might be facing.

Last June, OTS issued a revised Examiner Handbook on residential mortgage lending in which we emphasized the need for addressing the additional risks in mortgage lending arising from interest-only and pay option ARMs. As you might know, we are also collaborating on drafting interagency guidance due out in a few weeks that addresses the additional risks these products present.

In a nutshell, what we have said and continue to say about these products is that they can be effective financial management tools for some borrowers, but are not appropriate for every borrower. They are clearly not appropriate for borrowers with high debt levels that are using the product to purchase real estate they could not otherwise afford. All other things equal these products harbor greater risk than traditional mortgages. That additional risk needs to be managed and ameliorated by the application of sound underwriting practices and strong risk management systems together with complete disclosure of not only the benefits of these products but also the risks they pose for the borrower.

Banks should also pay particularly close attention to "risk layering", which involves relaxing other underwriting standards, such as loan-to-value ratios, or credit scores. Risk layering tends to multiply the risks involved, not just add to them.

Rapid growth of any product, and for these products in particular, can challenge existing management information systems and risk management systems. This is particularly true for new entrants to the market that may not fully appreciate all the risks involved, especially given several years of benign business conditions. I urge any institutions that are currently offering, or are rolling out these new products to limit your concentrations by establishing prudent limits as a percentage of your capital until you gain more experience and are more comfortable with your assessment and management of the risks involved.

Of particular concern is that, in the wake of the refi boom, the market competition from overcapacity in the industry may be promoting a weakening of underwriting standards that may prove imprudent in the long term. As I stated before, we expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence, and, as a result, manage them successfully. As regulator, that is our recommendation as well as our expectation.

Federal Home Loan Bank System

We are also paying close attention to the Federal Home Loan Bank System these days. We are the lead agency on an interagency working group monitoring the FHLBanks. With more than 8,000 institutions owning stock at the twelve FHLBanks, the impact of this system is far reaching, both on your balance sheet and on the way that many of you have come to rely on the system for your periodic funding needs.

The benefits of FHLBank membership include, principally, the ability to borrow funds at a rate generally lower than the open market; secondly, access to community reinvestment funds; and finally, the receipt of cash or stock dividends when declared by the FHLBanks. The trade-off, of course, is that FHLBank stock is restricted by a notice of redemption (either 6-months or 5-years). While the

FHLBanks have always redeemed stock within a very short period of time—usually less than 30-days—we cannot assume that this will always be the case.

As you know, the Federal Housing Finance Board required the 12 FHLBanks to register their stock with the SEC by August 29, 2005. Only three of the FHLBanks completed that process by the due date, including the FHLBank of New York. The remaining nine FHLBanks are reviewing their financials back to 2001 to address some accounting issues related to the method of accounting for derivative instruments and hedging activities, as set forth in FAS 133.

In August 2005, the Finance Board issued an advisory prohibiting the payment of dividends by the FHLBanks that had not filed an effective SEC registration statement unless prior regulatory approval is received. Two of the FHLBanks are subject to certain restrictions based on agreements they entered into with the Finance Board in 2004.

Current accounting guidance provides that when evaluating FHLBank stock, its value should be determined based on the ultimate recoverability of its par value. As individual FHLBanks register with the SEC, we'll have more complete and better information regarding valuation. In the interim we are in active and frequent discussions with the Finance Board to monitor and better understand these events. The Finance Board is working with us cooperatively and understands and respects our need to have full understanding of the risks these situations may present from a supervisory perspective, as well as how critically important it is for our industry to have a healthy and vibrant FHLBank system. In its totality, I do believe the system is in sound condition.

Federal Deposit Insurance Reform

Federal deposit insurance reform has been discussed by Washington policymakers for quite some time. The initial debate was triggered by the FIRREA legislation in 1989, and started in earnest shortly after enactment of FDICIA in 1991. Finally, it seems we are getting close.

The House Financial Services Committee passed deposit reform legislation in October, and the bill is now attached to the House Omnibus Budget Reconciliation bill pending before the full House. The bill would merge the Bank Insurance Fund and the Savings Association Insurance Fund and provide the FDIC more flexibility in setting deposit premiums. The House bill also provides for increased insurance coverage for individual retirement accounts, as well as a periodic inflation index for bumping up the overall individual account coverage level.

The Senate Banking Committee has also approved its version of deposit insurance reform legislation, also as part of the Senate's larger budget reconciliation process.

The two bills are similar in structure, but are not identical in provisions relating to the level of coverage and the amount of premiums the Federal Deposit Insurance Corporation could charge well-managed institutions. Inconsistencies between the bills will have to be resolved in conference, and at this point it looks as if there is every reason to expect a compromise to enact legislation.

Hurricane Katrina Relief Efforts

Before concluding today, I want to touch briefly on some of the things that we are doing—on our own and in conjunction with the other banking agencies—to assist in the disaster recovery efforts in the Gulf Coast Region. In general terms, our response can be described as a series of short-term and longer-term commitments to work with institutions affected by hurricanes in the Gulf Coast. We are also working closely with any institutions located outside of the hurricane-affected areas that are willing to participate in the hurricane recovery efforts.

In many ways, these efforts mirror the response to 9/11, but in a much broader geographical context. And we are drawing on much broader resources—again, both within and outside the Gulf Coast Region—to assist in the recovery. To the extent that you and your institutions have things to offer, I urge you to get involved. In this instance, it is not a trite cliché to observe that every little bit does help.

Regarding the short-term responses of OTS, we are working with the other banking agencies to assist affected institutions, identify problems and facilitate remedies on an ongoing basis. We are continually assessing each institution's needs, and coordinating with other regulators, trade associations, Treasury, DHS, and other state and federal agencies to address these needs. These efforts include:

- **Working with DHS to get institution personnel access to locked down areas;**
- **Assisting institutions in obtaining Telephone Priority Status (TPS) in several cases to reestablish data phone lines to provide systems access;**
- **Assisting institutions with limited resources and/or branch infrastructure to partner with other institutions to share branch facilities;**
- **Helping to arrange mobile temporary branch facilities for institutions unable to access their own facility;**
- **Encouraging institutions to use non-documentary verification methods for customers not able to provide standard identification documents; and**
- **Accelerating procedures to approve temporary facilities for thrifts with destroyed or severely damaged facilities.**

There are also a number of particular regulatory actions that we have taken, including permitting institutions to waive ATM fees; easing check cashing

restrictions; allowing customers to defer or skip loan payments; waiving credit card and other late fees, and easing credit terms for new loans. We encourage institutions to consider all reasonable and prudent actions that could help meet the critical financial needs of their customers, non-customers, and their communities.

Some of our longer-term relief initiatives include:

- **Taking into account an institution's disaster relief efforts when evaluating its CRA performance;**
- **Easing regulatory requirements on issues such as appraisal standards;**
- **Delaying examination cycles for institutions in affected area;**
- **Giving due consideration to modifications on loans in affected areas;**
- **Encouraging institutions to work with customers in the affected areas to:**
  - **Waive late payment charges and early withdrawal penalties;**
  - **Offer prudent loans to help rebuild damaged property;**
  - **Expedite lending decisions, consistent with safety and soundness; and**
  - **Restructure borrowers' debt obligations;**
- **Encouraging institutions to explore available FHLBank programs, as well as state and federal guarantees and other means to help mitigate excessive credit risks; and**
- **Granting extensions of time for submissions of regulatory filing requirements.**

It is our hope that these efforts will assist in revitalizing affected communities and preserving the stability of institutions affected by and/or involved in the Gulf Coast recovery efforts.

Conclusion

Thank you for inviting me to speak with you today. I had no idea my appearance was going to coincide with the announcement of a merger of the Community Bankers Association of New York State with the New York State Bankers Association. I want to take this opportunity to commend Mariel Donath and the fine staff at CBANYS for your accomplishments over the years in representing the savings associations of New York State. And I look forward to working with Mike White and the newly reconstituted New York Bankers Association on issues of importance to our industry in the future. Thank you.