

**REMARKS OF JOHN M. REICH, DIRECTOR  
OFFICE OF THRIFT SUPERVISION  
TO WOMEN IN HOUSING FINANCE  
WASHINGTON, DC  
MARCH 22, 2006**

Good afternoon. This marks my first appearance before Women in Housing Finance, and I am pleased to be here. I understand that your organization has been around since 1979 and not only has a focus on policy and professional development, networking and education, but also has an outstanding record of good works through the WHF Foundation. You have an outstanding model of service and commitment combined with your primary mission as a professional organization focused on housing and financial services issues. I applaud your accomplishments and efforts in all of these areas.

I want to spend a few moments with you today talking about two areas that are on my mind as Director of the Office of Thrift Supervision (OTS) — housing issues and my favorite topic, regulatory burden reduction. But first, let me tell you a little about myself so you can perhaps understand a little better my focus on the issues I will address today.

I came to OTS with significant experience as a regulator, policymaker, and community banker. My five years at the Federal Deposit Insurance Corporation (FDIC), including three and half years as the FDIC Vice Chairman, taught me much about the kinds of things that are important from a supervisory and regulatory perspective. And my 12 years on Capitol Hill working alongside Senator Connie Mack were tremendously beneficial in understanding how Washington works, how policy is developed, and how things get done inside the beltway. It was informative and enlightening to say the least, particularly for someone coming to Washington with a background as a community banker.

I was a community banker for 23 years in Illinois and Florida, including ten years as President and CEO of the National Bank of Sarasota, in Sarasota, Florida. And I continue to identify most closely with that part of my professional experience. It is a frame of reference that I still call upon in making and evaluating policy decisions that affect the institutions we regulate. And it provides a foundation for my professional experiences since coming to Washington.

During my brief tenure at OTS, I have learned much about the agency and its staff, and I have also learned a lot about the industry we regulate. OTS and the charter we administer have unique and inherent strengths, including a specialized role in housing finance and the mortgage markets, as well as a unique supervisory structure that provides for a unified regulator for both the institutions we regulate and their holding companies. However, these multiple disciplines require a uniquely qualified and effective staff.

While OTS operates with a minimum of overhead, we have a skilled staff with tremendous experience in nearly every sector of modern banking. And we are continually striving to improve our staff. This year, we will hire 60 new examiners, bolstering our

exam staff by 11.5 percent. We are also boosting training and hiring in certain critical areas, including capital markets, economic analysis, and compliance management.

We oversee an industry and charter that is primarily engaged in retail banking or, more precisely, retail community banking. This is a rapidly growing segment of the financial services world. A few weeks ago, we reported that for 2005 assets for the segment of the industry we regulate were up 12.0 percent from the prior year to a record \$1.46 trillion. And in the past five years, industry assets grew 57.7 percent, representing a robust average annual five-year growth rate of 9.5 percent. By any measure, these are excellent numbers.

Earnings, too, were strong last year, and have been strong and steady for the last five years. For 2005, earnings were up 17.6 percent from 2004, and more than doubled the last five years, climbing from \$8.0 billion in 2000 to a record \$16.4 billion in 2005.

While mortgage lending activities account for a significant portion of these numbers, other areas of retail banking are emerging as significant growth areas for the charter. This is a natural progression that we want to encourage for the continued health and vitality of the charter, as well as its diversification. As the retail community banking sector grows, I believe our charter is well positioned to provide a structural and regulatory alternative both to established financial services businesses and to new entrants that are working to grow market share in this area. 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. And OTS's seamless supervision at all levels of an organization — at the bank level as well as at savings and loan holding companies — ensures a comprehensive supervisory regime with minimal regulatory overlap.

The charter has adapted remarkably well to today's financial services marketplace, but what about the core housing mission of the industry? How are savings institutions faring in the mortgage markets? And what about recent concerns with the mortgage markets, including the proliferation of alternative mortgage products, concentrations in commercial real estate lending, concerns with a "housing bubble," and the current interest rate environment under a flat yield curve?

OTS-regulated institutions account for a sizeable portion of aggregate mortgage originations nationwide. Although the industry we regulate is less than one-sixth the size of the commercial banking industry, last year OTS-regulated thrifts accounted for 26 percent of total one-to-four family mortgage originations nationwide. And that does not include taking into account the size of the mortgage banking industry that operates outside the context of a depository institution charter. Thus, more than one quarter of all one-to-four family mortgage loans last year was originated by an industry substantially smaller than the aggregate size of its market competitors.

So what are some of the housing-related issues the industry is facing? Let's start with the proliferation of alternative or non-traditional mortgage lending products. The

popularity of two products in particular, “interest-only” and “pay option” adjustable rate mortgages (ARMs) has garnered significant attention in recent months.

Interest-only and pay option ARMs can temporarily protect borrowers from payment increases resulting from rising interest rates. While the experience so far with these instruments has been favorable, these 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 interest rate assumptions, as much as a 100 percent increase or more in the monthly payment. While interest rate risk is traditionally the main risk with most mortgage products, these products include an additional element of credit risk not present with traditional mortgage products. Credit risk in mortgage lending is typically managed by the application of sound underwriting criteria, but this process becomes significantly more complex with non-traditional lending products such as interest-only and pay option ARMs.

Products much like these have long been offered by the industry we regulate. 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, particularly the inherent credit risks, associated with these types of loans.

Do we want to halt the use of these products or impose limits on the amount or usage by particular institutions that have a proven and sustained track record in managing the risks associated with these products? The answer, of course, is no. There is clearly a market for this product in situations where the loan is properly structured, appropriately marketed, well underwritten, safely managed, and the terms are fully disclosed. 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.

Appropriately structured negative amortization products may offer qualified borrowers who are capable of understanding and managing the possible risks attendant to this product greater financial flexibility than traditional products. 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. Nor would I want to limit the use of these products by institutions that understand and are managing the risks.

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them to know the characteristics, strengths and weaknesses of the products they offer and to let experience and sound management practices guide them in knowing their markets and customers, determining appropriate concentration limits, and successfully managing their risks. As a regulator, that is our recommendation as well as our expectation.

In December, the federal banking agencies issued guidance on non-traditional mortgage loan products. For anyone interested in commenting on the proposed guidance, the comment period will close one week from today, on March 29th.

Another issue prompting interagency guidance is the concentration in commercial real estate (CRE) lending by some 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 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. The guidance sets forth concentration ratios based on loan type. While the concept of capital allocation based on concentration ratios is not novel, the proposed guidance establishes new thresholds.

While CRE lending exposure is generally limited in the institutions we regulate, I 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 located particularly in high growth regions of the country remain a concern.

Legitimate concerns are being expressed about the proposed guidance. It is, in my view, not cast in concrete, and I encourage interested parties to comment. The comment period has been extended until April 13th.

Next, I want to focus briefly on the current interest rate environment under a flat yield curve. What does this mean for the institutions we regulate? The immediate impact for depository institutions generally is higher funding costs, which can mean a narrowing of the spread between what institutions pay for money and what they lend it out at, also known as their net interest margin. A narrowing of net interest margin will squeeze profits, which is obviously a concern, but I want to focus on a different phenomenon. That is the impact of a flat yield curve on mortgage lending and, specifically, a potential migration from shorter term ARMs to fixed rate mortgage products.

As short term borrowing costs increase for institutions so do the rates that they charge for shorter-term loan products, specifically ARMs. At the same time, longer term fixed rate products do not move up as quickly simply because longer term mortgage rates are not as sensitive to increases in short term funding costs. The effect is a narrowing of rates offered for ARM and fixed rate loans, with more borrowers willing to pay slightly higher interest rates to lock in a fixed rate for the life of a mortgage loan.

What this means for the institutions we regulate is potentially greater interest rate risk associated with increased fixed rate mortgage lending. However, this is an area where we believe our interest rate risk model will benefit the institutions we regulate by providing information on their interest rate risk sensitivity in their market and within their peer group. We will continue to monitor interest rate risk closely in the months ahead.

Similar to the concerns of a flat yield curve are continuing commentaries about a housing bubble in certain markets across the country. While I believe much of the hype about a housing bubble has subsided with recognition that housing costs have generally stabilized and/or slowed down significantly, this is an area we continue to monitor closely. While a multitude of economic pressures can influence housing costs, it is important to bear in mind that mortgage lenders, particularly many of the institutions we regulate, have significant experience in dealing with a housing slow down. In California, for example, several of our largest lenders were able to weather a significant housing slump in the late 1980s and early 1990s. Sound risk management and aggressive, but prudent lending strategies enabled these institutions to come out of that difficult period stronger and more able to compete in California's unique and volatile mortgage market.

For now, we are continuing to monitor the interest rate risk exposure of our institutions, and we are paying close attention to markets and regions that have experienced inordinate increases in housing costs. And, again, our interest rate risk model is a tool that will assist us in keeping a close eye on any areas of concern.

The final housing issue that I want to discuss with you is actually much more than a housing issue — it is a social issue. It is something that I struggle with and, I fear, we will all have to deal with it for a long time to come. The situation in the Gulf Coast is an ongoing crisis of monumental proportions. I have visited the hurricane-devastated areas of New Orleans three times in the past five months. During my first visit I was unprepared for the devastation I witnessed there, and little has changed in the intervening months. 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 displaced hurricane victims are daunting and unprecedented; they strike at the bare essentials of food, clothing and shelter. While there is a high labor demand related in part to recovery efforts, there is little available housing to support the existing workforce. Everyday starting early in the afternoon, traffic backs up for miles on Interstate 10 as commuters head back to their temporary and for many, perhaps permanent, homes in Baton Rouge, Lafayette, and surrounding communities. For these Katrina commuters a typical one and a half hour drive is now a nightmare marathon of bumper-to-bumper traffic that seems never to end. It is not uncommon for many of these people to spend three hours in traffic every afternoon, and that is for just half of their daily commute back and forth between their new homes and their jobs in New Orleans.

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. Individuals, businesses and financial institutions are facing issues ranging from uncertainty regarding levee reconstruction standards and timing to poor communications and mail delivery service. More than 100,000 homes require electrical rewiring, and there is a shortage of qualified electricians in the region. Modestly damaged homes are deteriorating rapidly due to mold problems, cleanup and rebuilding costs are escalating, and there are too few qualified contractors and subcontractors. There are also a multitude of unresolved

insurance issues, and insurance companies are reluctant to write new policies in the area. And the list goes on and on.

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, no available affordable housing, and no assurance your neighborhood will ever re-emerge.

The short-term prospects for 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. Again, affordable housing is at the core of a viable recovery for New Orleans. How these issues are addressed will define the future of New Orleans and the Gulf Coast — and we must continue to find creative ways to assist in the recovery.

My final topic for today is a subject near and dear to my heart. Regulatory burden reduction is an issue that imposes tremendous burden on community banks and, as such, raises legitimate oversight concerns for community bank regulators. 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.

Several weeks ago, I testified before the Senate Banking Committee that accumulated regulatory burden is suffocating the banking industry despite the fact the industry seems to be doing so well. While regulatory burden impacts all institutions, I believe it has a significantly greater competitive impact on smaller community-based institutions. There is considerable anecdotal evidence supporting the notion that regulatory burden has risen to the top of the list of reasons why these institutions sell out.

To those who say let market forces determine the future of community banking, my response is that our industry is not a free market. It is a highly regulated market and this is having great influence on the bottom line and market behavior of many community banks. Regulatory forces that unduly impact industry competitiveness are not good for institutions of any size when they skew market forces; and that is what we are faced with today.

I am deeply concerned that community banks will continue to disappear from our landscape, with local communities and consumers across the country being the ultimate losers. When community banks are absorbed by larger non-local competitors, I've seen firsthand what usually results. The absorbed banks lose their personal touch and their communities lose the leadership previously provided by senior bank officers and their directors who are business owners with vested interests in their communities.

The loss of these community human resources not only impacts local banking relationships with small businesses and individuals, it reduces human resources available for leadership of community service organizations on which senior bank officers and their directors serve. There is an unquantified social cost to industry consolidation that is

attributable to the weight of accumulated regulatory burden. This is a growing problem in communities across the country, with implications largely ignored by policymakers.

Ten years ago, Congress enacted EGRPRA, which required the federal regulators to review all of their regulations in an effort to reduce regulatory burden on the industry. We have taken this mandate seriously and are approaching the conclusion of our effort in the next few months. I fear all of this work may be for naught if a regulatory relief bill is not enacted this year. And there has been a lot of work done!

When this project began in June of 2003, we began to increase awareness of the burden issues facing both large and small banks. In addition, we have worked to reduce burden where we can; that is, where we already have the authority to act. And at every opportunity with my colleagues on the FFIEC, I raise the issue of regulatory burden with almost every new regulation, process, or procedure and how to accomplish the objectives while minimizing the regulatory burden on the industry.

The EGRPRA process has generated an extensive list of recommendations before Congress that is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. Now we must ensure that these recommendations lead to fruition with the passage of a significant bill in the Congress. There are skeptics. But the House recently passed H.R. 3505, a comprehensive regulatory relief bill, by an overwhelming vote of 415 to 2. And the Senate Banking Committee is poised to take up a similar bill very soon. Thus, regulatory burden relief is very much in play.

This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. I believe we have a limited window of opportunity this year to move forward on regulatory relief legislation. There is much greater visibility and recognition of the problem now than in the past. It is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

Thank you for the opportunity to speak to you, today. Again, I am honored to be here and I look forward to visiting with you again some time in the future. I will be happy to answer your questions.

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