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Statement of

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Acting Director, Office of Thrift Supervision

regarding the

Strengthening and Streamlining Prudential Bank Supervision

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

August 4, 2009

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I. Introduction

Good morning, Chairman Dodd, Ranking Member Shelby and members of the Committee. Thank you for the opportunity to testify today on the Administration's Proposal for Financial Regulatory Reform. It is my pleasure to address the Committee for the first time in my role as Acting Director of the Office of Thrift Supervision (OTS).

We appreciate this Committee's efforts to improve supervision of financial institutions in the United States. We share the Committee's commitment to reforms to prevent any recurrence of our nation's current financial problems.

We have studied the Administration's Proposal for Financial Regulatory Reform and are pleased to address the questions you have asked us about specific aspects of that Proposal. Specifically, you asked for our opinion of the merits of the Administration's Proposal for a National Bank Supervisor and the elimination of the federal thrift charter. You also requested our opinion on the elimination of the exceptions in the Bank Holding

Company Act for thrifts and certain special purpose banks and about the Federal Reserve System's prudential supervision of holding companies.

II. Goals of Regulatory Restructuring

The recent turmoil in the financial services industry has exposed major regulatory gaps and other significant weaknesses that must be addressed. Our evaluation of the specifics of the Administration's Proposal is predicated on whether or not those elements address the core principles OTS believes are essential to accomplishing true and lasting reform:

1. **Ensure Changes to Financial Regulatory System Address Real Problems** — Proposed changes to financial regulatory agencies should be evaluated based on whether they would address the causes of the economic crisis or other true problems.
2. **Establish Uniform Regulation** — All entities that offer financial products to consumers must be subject to the same consumer protection rules and regulations, so under-regulated entities cannot gain a competitive advantage over their more regulated counterparts. Also, complex derivative products, such as credit default swaps, should be regulated.
3. **Create Ability to Supervise and Resolve Systemically Important Firms** — No provider of financial products should be too big to fail, achieving through size and complexity an implicit federal government backing to prevent its collapse — and thereby gaining an unfair advantage over its more vulnerable competitors.

4. **Protect Consumers** — One federal agency should have as its central mission the regulation of financial products and that agency should establish the rules and standards for all consumer financial products rather than the current, multiple number of agencies with fragmented authority and a lack of singular accountability.

As a general matter the OTS supports all of the fundamental objectives that are at the heart of the Administration's Proposal. By performing an analysis based on these principles, we offer OTS' views on specific provisions of the Administration's Proposal.

III. Administration Proposal to Establish a National Bank Supervisor

We do not support the Administration's Proposal to establish a new agency, the National Bank Supervisor (NBS), by eliminating the Office of the Comptroller of the Currency, which charters and regulates national banks, and the OTS, which charters federal thrifts and regulates thrifts and their holding companies.

There is little dispute that the ad hoc framework of financial services regulation cobbled together over the last century-and-a-half is not ideal. The financial services landscape has changed and the economic crisis has revealed gaps in the system that must be addressed to ensure a sustainable recovery and appropriate oversight in the years ahead. We believe other provisions within the Administration's proposal would assist in accomplishing that goal.

While different parts of the system were created to respond to the needs of the time, the current system has generally served the nation well over time, despite economic downturns such as the current one. We must ensure that in the rush to address what went

wrong, we do not try to "fix" non-existent problems nor attempt to fix real problems with flawed solutions.

I would like to dispel the two rationales that have been alleged to support the proposal to eliminate the OTS: 1) The OTS was the regulator of the purportedly largest insured depository institutions that failed during the current economic turmoil, and, 2) Financial institutions "shopping" for the most lenient regulator allegedly flocked to OTS supervision and the thrift charter. Both of those allegations are false.

There are four reasons why the first allegation is untrue:

First, failures by insured depository institutions have been no more severe among OTS-regulated thrifts than among institutions supervised by other federal banking regulators. OTS-regulated Washington Mutual, which failed in September 2008 at no cost to the deposit insurance fund, was the largest bank failure in U.S. history because anything larger has been deemed "too big to fail." By law, the federal government can provide "open-bank assistance" only to prevent a failure. Institutions much larger than Washington Mutual, for example, Citigroup and Bank of America, had collapsed, but the federal government prevented their failure by authorizing open bank assistance. The "too big to fail" institutions are not regulated by the OTS. The OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were *allowed to fail.*

Second, in terms of numbers of bank failures during the crisis, most banks that have failed have been state-chartered institutions, whose primary federal regulator is not the OTS.

Third, the OTS regulates financial institutions that historically make mortgages for Americans to buy homes. By law, thrift institutions must keep most of their assets in home mortgages or other retail lending activities. The economic crisis grew out of a sharp downturn in the residential real estate market, including significant and sustained home price depreciation, a protracted decline in home sales and a plunge in rates of real estate investment. To date, this segment of the market has been hardest hit by the crisis and OTS-regulated institutions were particularly affected because their business models focus on this segment.

Fourth, the largest failures among OTS-regulated institutions during this crisis concentrated their mortgage lending in California and Florida, two of the states most damaged by the real estate decline. These states have had significant retraction in the real estate market, including double-digit declines in home prices and record rates of foreclosure.[1] Although today's hindsight is 20/20, no one predicted during the peak of the boom in 2006 that nationwide home prices would plummet by more than 30 percent.

The argument about regulator shopping, or arbitrage, seems to stem from the conversion of Countrywide, which left the supervision of the OCC and the Board of Governors of the Federal Reserve System (FRB) in March 2007 — after the height of the housing and mortgage boom — and came under OTS regulation. Countrywide made most of its high-risk loans through its holding company affiliates before it received a thrift charter.

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[1] See Office of Thrift Supervision Quarterly Market Monitor, May 7, 2009 (http://files.ots.treas.gov/131020.pdf).

An often-overlooked fact is that a few months earlier, in October 2006, Citibank converted two thrift charters from OTS supervision to the OCC. Those two Citibank charters totaled more than $232 billion—more than twice the asset size of Countrywide ($93 billion). We strongly believe that Citibank and Countrywide applied to change their charters based on their respective business models and operating strategies. Any suggestion that either company sought to find a more lenient regulatory structure is without merit.

In the last 10 years (1999-2008), there were 45 more institutions that converted away from the thrift charter (164) than converted to the thrift charter (119). Of those that converted to the OTS, more than half were state-chartered thrifts (64). In dollar amounts during the same 10-year period, $223 billion in assets converted to the thrift charter from other charter types and $419 billion in assets converted from the thrift charter to other charter types.

We disagree with any suggestion that banks converted to the thrift charter because OTS was a more lenient regulator. Institutions chose the charter type that best fits their business model.

If regulatory arbitrage is indeed a major issue, it is an issue between a federal charter and the charters of the 50 states, as well as among the states. Under the Administration's Proposal, the possibility of such arbitrage would continue.

The OTS is also concerned that the NBS may tend, particularly in times of stress, to focus most of its attention on the largest institutions, leaving mid-size and small institutions in the back seat. It is critical that all regulatory agencies be structured and operated in a manner that ensures the appropriate supervision and regulation of all depository institutions, regardless of size.

IV. Administration Proposal to Eliminate the Thrift Charter

The OTS does not support the provision in the Administration's Proposal to eliminate the federal thrift charter and require all federal thrift institutions to change their charter to the National Bank Charter or state bank. We believe the business models of federal banks and thrift institutions are fundamentally different enough to warrant two distinct federal banking charters.

It is important to note that elimination of the thrift charter would not have prevented the current mortgage meltdown, nor would it help solve current problems or prevent future crises. Savings associations generally are smaller institutions that have strong ties to their communities. Many thrifts never made subprime or Alt-A mortgages; rather they adhered to traditional, solid underwriting standards. Most thrifts did not participate in the private originate-to-sell model; they prudently underwrote mortgages intending to hold the loans in their own portfolios until the loans matured.

Forcing thrifts to convert from thrifts to banks or state chartered savings associations would not only be costly, disruptive and punitive for thrifts, but could also

deprive credit-worthy U.S. consumers of the credit they need to become homeowners and the extension of credit this country needs to stimulate the economy.

We also strongly support retaining the mutual form of organization for insured institutions. Generally, mutual institutions are weathering the current financial crisis better than their stock competitors. The distress in the housing markets has had a much greater impact on the earnings of stock thrifts than on mutual thrifts over the past year. For the first quarter 2009, mutual thrifts reported a return on average assets (ROA) on 0.42 percent, while stock thrifts reported an ROA of 0.04 percent. We see every reason to preserve the mutual institution charter and no compelling rationale to eliminate it.

OTS also supports retention of the dual banking system with both federal and state charters for banks and thrifts. This system has served the financial markets in the United States well. The states have provided a charter option for banks and thrifts that have not wanted to have a federal charter. Banks and thrifts should be able to choose whether to operate with a federal charter or a state charter.

V. Administration Proposal to Eliminate the Exceptions in the Bank Holding Company Act for Thrifts and Special Purpose Banks

A. Elimination of the Exception in the Bank Holding Company Act for Thrifts

Because a thrift is not considered a "bank" under the Bank Holding Company Act of 1956 (BHCA),[2] the FRB does not regulate entities that own or control only savings

[2] 12 U.S.C. 1841(c)(2)(B) and (j).

associations. However, the OTS supervises and regulates such entities pursuant to the Home Owners Loan Act (HOLA).

As part of the recommendation to eliminate the Federal thrift charter, the Administration Proposal would also eliminate the savings and loan holding company (SLHC). The Administration's draft legislation repeals section 10 of the HOLA concerning the regulation of SLHCs and also eliminates the thrift exemption from the definition of "bank" under the BHCA. A SLHC would become a bank holding company (BHC) by operation of law and would be required to register with the FRB as a BHC within 90 days of enactment of the act.

Notably, these provisions also apply to the unitary SLHCs that were explicitly permitted to continue engaging in commercial activities under the Gramm-Leach-Bliley Act of 1999.[3] Such an entity would either have to divest itself of the thrift or divest itself of other subsidiaries or affiliates to ensure that its activities are "financial in nature."[4]

The Administration justifies the elimination of SLHCs, by arguing that the separate regulation and supervision of bank and savings and loan holding companies has created "arbitrage opportunities." The Administration contends that the intensity of supervision has been greater for BHCs than SLHCs.

[3] 12 U.S.C. 1467a(c)(9)(C).
[4] 12 U.S.C. 1843(k).

Our view on this matter is guided by our key principles, one of which is to ensure that changes to the financial regulatory system address real problems. We oppose this provision because it does not address a real problem. As is the case with the regulation of thrift institutions, OTS does not believe that entities became SLHCs because OTS was perceived to be a more lenient regulator. Instead, these choices were guided by the business model of the entity.

The suggestion that the OTS does not impose capital requirements on SLHCs is not correct. Although the capital requirements for SLHCs are not contained in OTS regulations, savings and loan holding company capital adequacy is determined on a case-by-case basis for each holding company based on the overall risk profile of the organization. In its review of a SLHCs capital adequacy, the OTS considers the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

On average SLHCs hold more capital than BHCs. The OTS conducted an internal study comparing SLHC capital levels to BHC capital levels. In this study, OTS staff developed a Tier 1 leverage proxy and conducted an extensive review of industry capital levels to assess the overall condition of holding companies in the thrift industry. We measured capital by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio. Based on peer group averages, capital levels (as measured by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio) at SLHCs were higher than BHCs, prior to the infusion of

Troubled Assets Relief Program funds, in every peer group category. The consistency in results between both ratios lends credence to the overall conclusion, despite any differences that might result from use of a proxy formula.

As this study shows, the facts do not support the claim that the OTS does not impose adequate capital requirements on SLHCs. The proposal to eliminate the SLHC exception from the BHCA is based on this and other misperceptions. Moreover, in our view the measure penalizes the SLHCs and thrifts that maintained solid underwriting standards and were not responsible for the current financial crisis. The measure is especially punitive to the unitary SLHCs that will be forced to divest themselves of their thrift or other subsidiaries.

We believe SLHCs should be maintained and that the OTS should continue to regulate SLHCs, except in the case of a SLHC that would be deemed to be a Tier 1 Financial Holding Company. These entities should be regulated by the systemic risk regulator.

B. Elimination of the Exception in the Bank Holding Company Act for Special Purpose Banks

The Administration Proposal would also eliminate the BHCA exceptions for a number of special purpose banks, such as industrial loan companies, credit card banks, trust companies, and the so-called "nonbank banks" grandfathered under the Competitive Equality Banking Act of 1987. Neither the FRB nor OTS regulates the entities that own

or control these special purpose banks, unless they also own or control a bank or thrift. As is the case with unitary SLHCs, the Administration Proposal would force these entities to divest themselves of either their special purpose bank or other entities. The Administration's rationale for the provision is to close all the so-called loopholes under the BHCA and to treat all entities that own or control any type of a bank equally.

Once again our opinion on this aspect of the Administration Proposal is guided by the key principle of ensuring that changes to the financial regulatory system address real problems that caused the crisis. There are many causes of the financial crisis, but the inability of the FRB to regulate these entities is not one of them. Accordingly, we do not support this provision.

Forcing companies that own special purpose banks to divest one or more of their subsidiaries is unnecessary and punitive. Moreover, it does not address a problem that caused the crisis or weakens the financial system.

VI. Prudential Supervision of Holding Companies

A. In General

The Administration's Proposal would provide for the consolidated supervision and regulation of any systemically important financial firm (Tier 1 FHC) regardless of whether the firm owns an insured depository institution. The authority to supervise and regulate Tier 1 FHCs would be vested in the FRB. The FRB would be authorized to designate Tier 1 FHCs if it determines that material financial distress at the company

could pose a threat, globally or in the United States, to financial stability or the economy during times of economic stress.[5] The FRB, in consultation with Treasury, would issue rules to guide the identification of Tier 1 FHCs. Tier 1 FHCs would be subjected to stricter and more conservative prudential standards than those that apply to other BHCs, including higher standards on capital, liquidity and risk management. Tier 1 FHCs would also be subject to Prompt Corrective Action.

The Proposal also calls for the creation of a Financial Services Oversight Council (Council) made up of the Secretary of the Treasury and all of the Federal financial regulators. Among other responsibilities, the Council would make recommendations to the FRB concerning institutions that should be designated as Tier 1 FHCs. Also, the FRB would consult the Council in setting material prudential standards for Tier 1 FHCs and in setting risk management standards for systemically important systems and activities regarding payment, clearing and settlement.

The Administration's Proposal provides a regime to resolve Tier 1 FHCs when the stability of the financial system is threatened. The resolution authority would

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[5] The FRB would be required to base its determination on the following criteria:

"(i) the amount and nature of the company's financial assets;
"(ii) the amount and types of the company's liabilities, including the degree of reliance on short-term funding;
"(iii) the extent of the company's off-balance sheet exposures;
"(iv) the extent of the company's transactions and relationships with other major financial companies;
"(v) the company's importance as a source of credit for households, businesses and State and local governments and as a source of liquidity for the financial system;
"(vi) the recommendation, if any, of the Financial Services Oversight Council; and
"(vii) any other factors that the Board deems appropriate.

TitleII, Section 204. Administration Draft Legislation.
http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf

supplement and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act. The Secretary of the Treasury could invoke the resolution authority only after consulting with the President and upon the written recommendation of two-thirds of the members of the FRB, and the FDIC or SEC as appropriate. The Secretary would have the ability to appoint a receiver or conservator for the failing firm. In general, that role would be filled by the FDIC, though the SEC could be appointed in certain cases. In order to fund this resolution regime, the FDIC would be authorized to impose risk-based assessments on Tier 1 FHCs.

OTS's views on these aspects of the Administration Proposal is guided by our key principle that any financial reform package should create the ability to supervise and resolve <u>all</u> systemically important financial firms. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well–managed and efficient succeed and prosper. Those that fall short of the mark struggle or fail and other, stronger enterprises take their places. Enterprises that become "too big to fail" subvert the system when the government is forced to prop up failing, systemically important companies — in essence, supporting poor performance and creating a "moral hazard."

The OTS supports this aspect of the Proposal and agrees that there is a pressing need for a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose unacceptable risk to financial stability. The systemic risk regulator should have the ability and the

responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities and insurance.

We also support the establishment of a strong and effective Council. Each of the financial regulators would provide valuable insight and experience to the systemic risk regulator.

We also strongly support the provision providing a resolution regime for all Tier 1 FHCs. Given the events of recent years, it is essential that the federal government have the authority and the resources to act as a conservator or receiver and to provide an orderly resolution of systemically important institutions, whether banks, thrifts, bank holding companies or other financial companies. The authority to resolve a distressed Tier 1 FHC in an orderly manner would ensure that no bank or financial firm is "too big to fail." A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

The continued ability of banks, thrifts and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator should be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and other factors, should be as comparable as possible for entities that have multinational businesses.

B. *Role of the Prudential Supervisor in Relation to the Systemic Risk Regulator*

You have asked for our views on what we consider to be the appropriate role of the prudential supervisor in relation to the systemic risk regulator. In other words, what is the proper delineation of responsibilities between the agencies?

Generally, we believe that for systemically important institutions, the systemic risk regulator should supplement, not supplant, the primary federal bank supervisor. In most cases the work of the systemic regulator and the prudential regulator will complement one another, with the prudential regulator focused on the safety and soundness of the depository institution and the systemic regulator focused more broadly on financial stability globally or in the United States.

One provision in the Proposal provides the systemic risk regulator with authority to establish, examine and enforce more stringent standards for subsidiaries of Tier 1 FHCs – including depository institution subsidiaries – to mitigate systemic risk posed by those subsidiaries. If the systemic risk regulator issues a regulation, it must consult with the prudential regulator. In the case of an order, the systemic regulator must: (1) have reasonable cause to believe that the functionally regulated subsidiary is engaged in conduct, activities, transactions, or arrangements that could pose a threat to financial stability or the economy globally or in the United States; (2) notify the prudential regulator of its belief, in writing, with supporting documentation included and with a recommendation that the prudential regulator take supervisory action against the subsidiary; and (3) not been notified in writing by the prudential regulator of the

commencement of a supervisory action, as recommended, within 30 days of the notification by the systemic regulator.

We have some concerns with this provision in that it supplants the prudential regulator's authority over depository institution subsidiaries of systemically significant companies. On balance, however, we believe such a provision is necessary to ensure financial stability. We recommend that the provision include a requirement that before making any determination, the systemic regulator consider the effects of any contemplated action on the Deposit Insurance Fund and the United States taxpayers.

C. Regulation of Thrifts and Holding Companies on a Consolidated Basis

You have asked for OTS's views on whether a holding company regulator should be distinct from the prudential regulator or whether a consolidated prudential bank supervisor could also regulate holding companies.[6]

The OTS supervises both thrifts and their holding companies on a consolidated basis. Indeed, SLHC supervision is an integral part of OTS oversight of the thrift industry. OTS conducts holding company examinations concurrently with the examination of the thrift subsidiary, supplemented by offsite monitoring. For the most complex holding companies, OTS utilizes a continuous supervision approach. We believe the regulation of the thrift and holding company has enabled us to effectively assess the risks of the consolidated entity, while retaining a strong focus on protecting the

[6] With respect to this question we express our opinion only concerning thrifts and their holding companies. We express no opinion as to banks and BHCs.

Deposit Insurance Fund.

The OTS has a wealth of expertise regulating thrifts and holding companies. We have a keen understanding of small, medium-sized and mutual thrifts and their holding companies. We are concerned that if the FRB became the regulator of these holding companies, it would focus most of its attention on the largest holding companies to the detriment of small and mutual SLHCs.

With regard to holding company regulation, OTS believes thrifts that have non-systemic holding companies should have strong, consistent supervision by a single regulator. Conversely, a SLHC that would be deemed to be a Tier 1 FHC should be regulated by the systemic regulator. This is consistent with our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms.

VII. Consumer Protection

The Committee did not specifically request input regarding consumer protection issues and the Administration's Proposal to create a Consumer Financial Protection Agency (CFPA); however, we would like to express our views because adequate protection of consumers is one of the key principles that must be addressed by effective reform. Consumer protection performed consistently and judiciously fosters a thriving banking system to meet the financial services needs of the nation.

The OTS supports the creation of a CFPA that would consolidate rulemaking authority over all consumer protection regulations in one regulator. The CFPA should be responsible for promulgating all consumer protection regulations that would apply uniformly to all entities that offer financial products, whether a federally insured depository institution, a state bank, or a state-licensed mortgage broker or mortgage company. Making all entities subject to the same rules and regulations for consumer protection could go a long way towards accomplishing OTS's often stated goal of plugging the gaps in regulatory oversight that led to a shadow banking system that was a significant cause of the current crisis.

Although we support the concept of a single agency to write all consumer rules, we strongly believe that consumer protection-related examinations, supervision authority and enforcement powers for insured depository institutions should be retained by the FBAs and the National Credit Union Administration (NCUA). In addition to rulemaking authority, the CFPA should have regulation, examination and enforcement power over entities engaged in consumer lending that are not insured depository institutions. Regardless of whether a new consumer protection agency is created, it is critical that, for all federally-insured depository institutions, the primary federal safety and soundness regulator retain authority for regulation, examination and enforcement of consumer protection regulations.

VIII. Conclusion

In conclusion, we support the goals of the Administration and this Committee to create a reformed system of financial regulation that fills regulatory gaps and prevents the type of financial crisis that we have just endured.

Thank you again, Mr. Chairman, Ranking Member Shelby and Members of the Committee for the opportunity to testify on behalf of the OTS.

We look forward to working with the Members of this Committee and others to create a system of financial services regulation that promotes greater economic stability for providers of financial services and the nation.