REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE NEW YORK BANKERS ASSOCIATION
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Good morning and thank you for inviting me to join you today for the New York Bankers Association annual Convention. It is a pleasure to be here at the Arizona Biltmore in Phoenix. I want to thank Michael Smith for the honor to speak to you again. This is my third opportunity as OTS Director to speak to a group of New York bankers, but I have had numerous occasions the last year to speak with some of you individually. Each time I learn something new – about your concerns and business challenges. It is my view that my presence here is a far greater benefit for me to listen and learn than to talk. I listened last night at a dinner attended by some of you and, as always, it was very enlightening.

But now, it is my turn to talk. I will try to keep my remarks brief and I hope useful to you. I want to give you insight into some of the issues that I grapple with daily, and to provide the perspective of a regulator who is a former community banker. As I mentioned the last time we met, I continue to define myself first and foremost as a community banker. But I also have a job to do in Washington that impacts the community bankers in this room, which I suggest is all of you, so let me talk about that for the next several minutes.

The last time we met was on April 6 of this year in New York City. At that time, I spent a considerable portion of my remarks on the issue of credit quality. I also discussed two proposals for joint guidance by the federal banking agencies on nontraditional mortgage lending products and commercial real estate lending. And I highlighted OTS's Complex and International Organizations program and concluded my remarks with an update on the ongoing interagency Basel process.

I want to update you on these issues today, including a further update on where the banking agencies are on Basel. But first I want to speak to you about the challenges we are facing in managing the OTS for the long term, including issues related to the growing strength and vitality of the thrift industry.

Managing for the Long Term

When you visit the exhibit area you will notice that for the first time the OTS has an exhibitor presence at a New York Bankers Association sponsored event. In my view, this is long overdue. A month ago I spoke to the America's Community Bankers about the new face of OTS, and we unveiled an OTS booth presence at both the ACB and American Bankers Association annual conferences. This is the first time that I am aware of that the OTS has had an exhibitor presence at any national or state banking trade association conference. While this has been standard operating procedure for several of the other banking agencies, it is a new initiative for the OTS. And I think we have done a good job in conveying a vision for the OTS and the thrift industry going forward.

So, what is that vision? And what are we doing to manage for the long-term success of the OTS? Our vision statement says, "To perform and be recognized as the premier regulator of financial institutions and holding companies." While it seems aggressive, I suggest to you that no organization is going to achieve meaningful success in its mission absent a challenging vision statement. In other words, you have to think big, both for yourself and for those who use and rely on your products and services – in our case, that includes the institutions we regulate and their customers.

When I came to the OTS last year, my initial impressions were favorable. In particular, I was impressed with the thrift charter and the overall health and capitalization of the industry. And I discovered an agency with the ability to impact and influence public policy to assist you in operating safe, sound and profitable institutions that continue to serve local communities. Finally, I was particularly pleased with the competence and expertise of the OTS staff. I am more confident of all of these things today. My confidence is bolstered by my experiences and a number of initiatives that we have pursued the past year that I believe better position the OTS for the future. We are moving quickly to address areas that require immediate attention and to formulate a longer-term strategy to address issues requiring that type of approach.

Perhaps most importantly, we significantly improved and expanded our examiner corps by hiring more than 80 new examiners this year and upgrading our training program for new and existing examiners.

I also identified areas to enhance our leadership and vision, and in some areas add staff to effectively implement and support important policy objectives. One area was our consumer affairs program. In my view, our consumer affairs strategy is integral to our overall success and effectiveness as a regulator. Thus, I have strengthened this program and recruited the talent to lead and staff it. We have also improved our leadership, staffing and focus in other areas, including supervision policy and our complex and international organizations program, a key growth area for the OTS and the industry. I will talk a little more about that program in a few minutes.

Another area we are reviewing is our applications process. I have heard concerns about the length of time and complexity of various OTS applications. It is imperative that this program is sensitive and responsive to the business needs of the institutions we regulate. I have already received a number of recommendations for improving our applications process. I am currently reviewing these recommendations, and I intend to move quickly to make the changes necessary to ensure our applications process is efficient, effective and responsive to our needs and those of the institutions that utilize it.

In addition to focusing on our internal operations and improving our overall regulatory and supervisory approach, another initiative is improving our communications framework. We are in the process of developing a multi-pronged external outreach strategy that provides the industry better and timelier information on what we are doing and on developments that affect and enhance the thrift charter.

In connection with our outreach strategy, the OTS is sponsoring a National Housing Forum on Monday, December 11 at the National Press Club in Washington, DC. It includes well-known experts on some of the most critical housing finance issues in our current environment. If you are interested in attending the conference, which will include speaking appearances by Treasury Secretary Henry Paulson, House Financial Services Committee Chairman Mike Oxley and Ranking Member Barney Frank, you may register for it on the OTS website (at www.OTS.treas.gov). I am happy to report that Mike Smith has already registered.

By all measures, I believe the past year at OTS was an unqualified success. In addition to adopting a vision for the agency, we initiated the strategy and goal planning required to achieve that vision. And we paid particular attention to renewing our commitment to effectively examining and supervising, with minimum regulatory burden, our evolving industry. Finally, we are working with the industry to expand our domestic footprint to better serve the needs of local community banking while also raising the profile of our international organizations program.

Regarding our international program, it is worth noting that the OTS is unique in the U.S. regulatory structure because, in addition to the institutions we regulate, we supervise on a consolidated basis the companies that control these thrifts. While most thrifts concentrate their lending in the U.S. market, a number of our holding company enterprises are truly global in scope and geography. In fact, OTS-regulated thrift holding companies provide financial services to customers in more than 100 countries around the world, and have combined assets of more than $7.6 trillion.

With the global reach of our holding company population we have found it in our interest to grow our understanding of the retail and consumer finance marketplace outside the United States. Because many OTS-supervised companies offer these products through regulated subsidiaries in local jurisdictions, we have worked hard in recent years to build strong relationships with our supervisory counterparts in key jurisdictions around the world. Gaining insight from these supervisors – and sharing back our consolidated view of the entire enterprise – has helped strengthen our understanding of the companies' overall operations and helped us gain an appreciation for the challenges faced by supervisors as more and more markets open up to these types of lending products.

The strong retail lending trend evident in the U.S. and other established economies over the past two decades is rapidly expanding to emerging markets around the world. And many firms supervised by the OTS are making important inroads to serve these markets. This is a critical long-term growth area for the OTS and the thrift industry and I intend to ensure that we are prepared to meet the challenges presented in these new markets.

State of the Industry

When I spoke to you this past April, I noted that the trends we review include both lagging and leading indicators of what we are seeing in the industry. Lagging indicators tell us where the industry has been, and include things such as loan classifications and past due ratios. Leading indicators suggest where the industry may be heading, and include factors such as loan documentation, loan pricing, and underwriting standards.

Since April, both lagging and leading indicators have been troubling. Profits have been declining at many institutions as a result of declining margins due to slower mortgage originations. This has been a particular concern for smaller institutions. For the first six months of 2006, the average return on assets (ROA) for all institutions was 1.34; however, the average ROA was only 1.07 for institutions with assets less than $100 million.

Particularly troubling are the leading indicators – responses that we are seeing from institutions to the phenomenon of declining margins and profitability. Among the concerns we have identified are institutions purchasing loan participations without adequate documentation. And, as predicted, there has been an overall slippage in underwriting due to increased competition in certain markets segments and areas. In particular, loan pricing continues to misalign with credit risk, and there continues to be an increased liberalization of terms by some institutions in order to maintain loan volume. Finally, there continues to be excessive dependence on wholesale funding by a number of institutions.

The banking agencies have increased their vigilance of these issues, both from a supervisory perspective and a policy perspective. Examiners are digging deeper into loan portfolios to understand the risks institutions are assuming, and they are paying close attention to loan documentation, pricing, loan-to-value ratios, and underwriting standards. And we continue to monitor funding issues and operational costs. In addition to interest rate risk, the agencies continue to grapple with policy responses to credit risks, particularly for nontraditional mortgage lending products and commercial real estate (CRE) lending.

Guidance on nontraditional mortgage lending products was issued by the banking agencies one month ago, on October 12. It is safe to say that it was much debated before its final release. The proposed guidance on CRE lending also remains a topic of serious discussion and debate among the banking agency principals. It is each of our desire to release it soon, but I can assure you that, as with the nontraditional mortgage lending guidance, none of us is willing to do so until we are absolutely convinced that it is the best possible product and guidance for the industry.

So how about the lagging indicators; what do they tell us? Based on preliminary numbers that my staff has compiled, the numbers are still relatively strong, including solid profitability, capital and asset growth. The one area of concern is an up-tick in troubled assets, but this is relative to the historic record lows of the past two years.

Notwithstanding these strong numbers, two areas continue to concern me.

First, as I alluded to above, there continues to be a significant earnings disparity between larger institutions and smaller community banks. This is profoundly affecting the direction of community banking in our country. Pressures created by our regulatory structure make it difficult for smaller community banks to compete profitably. We have overburdened all institutions, but particularly community banks with increased compliance costs that produce little tangible benefit to our banking system. The result is charter consolidation created by pressures imposed on community banks that are forced to sell out.

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. 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.

The other area of concern I have is the state of the housing industry – which directly affects the industry we regulate. Slowing housing markets and declining home values continue to make the headlines, with sales of new and existing homes in September down 12.2 and 14.2 percent, respectively, from one year ago. Also headed in the wrong direction were U.S. productivity growth, initial jobless claims, factory orders, retail sales, and the consumer price index. And margin compression due to interest rate increases pressured third quarter thrift and bank earnings, especially those of community-based institutions.

What does this all mean? At a minimum, it must be put into perspective. The recent data are discouraging, but only in comparison to the extraordinary results from the last several years. Near term comparisons are always difficult because they often lack the context and perspective of a meaningful point of reference. For example, recent home price declines are coming off record levels. The average U.S. home price increased 56 percent for the five-years ending the second quarter of 2006. And the average increase was more than 100 percent in some markets. So it was reasonable to expect an adjustment.

Despite all the bad news, 2006 is still shaping up to be the third best year for housing on record – just behind 2004 and 2005.

Yes, that provides some perspective. Most importantly, it reminds us of the importance of monitoring the fundamentals, such as sound underwriting. Failing to adapt effectively to changing economic conditions is my greatest concern for institutions and the industry. We can and should expect institutions to react to an economic slowdown and to increasingly competitive lending markets in order to attempt to bolster revenue and profitability. But history has taught us to be especially cautious of industry reactions to economic uncertainty and declining profitability. Actions to improve revenue and profitability, if not properly implemented and managed, can lead to long-term problems.

We are proactively monitoring a number of areas to avoid potential problems, including movements into direct lending; increasing levels of higher-yielding and higher-risk loan products; excessive cost cutting; expanding revenue sources into riskier lines of business; and stock price initiatives that may not serve the best long-term interests of an institution.

Again, it is important to reiterate that our industries are currently in very sound condition and any economic slowdown will be met with strong capital, earnings, and asset quality. Equally important is the fact that the banking agencies are staffed with examiners and supervisors that have been through several economic slowdowns and have significant experience to draw upon.

Update on Policy Initiatives

Before concluding, I want to briefly update you on several policy issues – pending CRE guidance, Basel, and the FDIC's new risk-based premiums for the industry.

As I mentioned, CRE lending remains a topic of discussion among the banking agencies. While we hope to issue guidance soon, I cannot tell you with certainty what it will look like. We all agree that institutions should hold capital commensurate with the level of risk in their CRE lending portfolios, yet there is not agreement on the specificity of the guidance. It is my hope that the guidance addresses the comments raised during our comment process, clarifies the underlying theme of the agencies' risk management expectations for the industry, and more clearly articulates our intent.

On Basel, the one point I want to stress with you today is my continuing commitment to having a meaningful overlap of the Basel II and Basel IA review processes. The recently issued notice of proposed rulemaking, or NPR, on Basel II provides an opportunity for advancing the first part of the Basel dialogue, including ensuring that Basel II does not competitively disadvantage U.S. institutions that continue to operate under a Basel I-based approach. And we are currently working with the other banking agencies to issue an NPR to modernize the existing Basel I rules via the so-called Basel IA proposal. A Basel IA NPR should be released in the near future. As I have stated before, I will also continue to support the preference of many highly capitalized institutions to continue to operate under the existing Basel I rules.

A final issue that I want to mention is the FDIC's new risk-based premium assessment system. Under the new system, the FDIC will evaluate each institution's risk based on three criteria – the supervisory rating, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that are rated. The FDIC also set the assessment rates for 2007, which will vary between five to seven basis points for most of the industry. Finally, the FDIC implemented an assessment credit structure in which the majority of institutions will receive credits that offset their 2007 premiums.

Thank you again for the opportunity to speak to you, the New York Bankers Association, today. I will be happy to answer your questions as time permits.