

*Remarks of John M. Reich, Director
Office of Thrift Supervision
to the New York Bankers Association
Palm Beach, Florida
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Good morning, and thank you for inviting me to be with you today here in my adopted home state of Florida. I am a transplanted Midwesterner who spent over 20 years in this state as a community banker, 10 of which as a community bank CEO in Sarasota, 175 miles across the state. It is nice to be here, if only for a short period of time.

It is a pleasure to see the New York bankers again and to share with you some of the things that have occurred since I was with you last November in Phoenix. As you know, it has been an eventful year. First, let me congratulate your own Brad Rock for his election as chairman of the American Bankers Association.

In the past year at the OTS, we've continued to hire new examiners and enhance our consumer affairs program. These initiatives are just one part of the effort I mentioned to you last year to revitalize OTS. Today, our workforce stands at nearly 1,100—an increase of almost 15 percent since I became Director. We also reestablished our Central Region office in Chicago to better serve the states of Indiana, Illinois, Michigan, Ohio and Wisconsin. And we've continued to solidify our financial position. Assets under OTS supervision total \$1.5 trillion and have grown more than 55 percent in the last five years—an indication, I believe, of the continued vibrancy of the industry and value of the thrift charter for operating in today's competitive financial services environment.

Many of you knew Bob Albanese, who was OTS Regional Director for our Northeast Region for many years until his retirement a few months ago. We were fortunate that Michael Finn, a 22-year experienced OTS regulator from Hoboken, New Jersey, who most recently was our West Regional Director in San Francisco, wanted to return to the East, and we were delighted to have Mike assume his responsibilities as our Northeast Regional Director in September. Mike is here this week and I hope you have the opportunity to meet him.

State of the Industry

Last year, I spoke about the state of mortgage lending and noted that the leading indicators, which signaled the way the industry might be heading, were “particularly troubling.” I cited slowing housing markets, declining home values and credit risks with nontraditional mortgage products. I also noted concerns about inadequate loan documentation, slippage in underwriting and liberalized terms to maintain loan volume. We've been working closely with our regulated institutions the past year to address these issues. While the vast majority of institutions remains well positioned to deal with the current mortgage market, there has been some deterioration.

Institutions continue to be stressed by the struggling performance of certain mortgage product lines. Nearly 17 percent of subprime adjustable-rate mortgage loans were delinquent in the second quarter of this year, an increase of almost 8 percent from a year ago. We are currently in the peak period of ARM resets with the likelihood of late payment rates over the next few quarters remaining quite high.

Problems in the subprime market have taken a toll on the asset-backed commercial paper market. Several weeks ago, rating agency downgrades and news of failing mortgage lenders caused the demand for this paper to disappear virtually overnight. Many lenders had funding difficulties due to inability to roll over maturing commercial paper. The result has been a 24 percent decline in the amount of asset-backed commercial paper outstanding—to roughly \$899 billion. While overnight commercial paper is still trading, it is at rates approximately 32 basis points higher than the average rate in the past year. And longer-term funding remains difficult to secure and is usually done on a case-by-case basis.

The announcement of a fund by Citigroup Inc., Bank of America Capital Corp., and JPMorgan Chase & Co., to buy assets from structured investment vehicles, or SIVs, should provide some relief to the market for asset-backed commercial paper. SIVs that are unable to roll over maturing commercial paper have been forced to sell assets, such as subprime loans, at deep discounts to pay off debt holders. The new fund—the Master Liquidity Enhancement Conduit or M-LEC—will purchase or fund assets of the SIVs until they mature. While the final terms have not been released, this plan will be monitored closely given the nearly \$400 billion in assets currently held by SIVs.

One of the major issues the past several months has been investors' difficulty in getting reliable information to evaluate mortgage-backed securities. This has caused investor confidence in credit ratings to deteriorate, making credit analysis difficult to say the least. As a result of this lack of transparency, mortgage loan originations have declined sharply. Although the capital markets have calmed, they remain a concern for large financial institutions facing volatile interest rates and risk aversion by investors.

Although thrifts are feeling effects from the liquidity squeeze, housing slowdown, and increase in home mortgage delinquencies, the industry as a whole remains sound due to its capital, earnings and profitability, and provisions for loan losses. These three pillars provide a firm foundation for withstanding adverse conditions in the future. Though it is still too early to predict the duration and impact of the current market turmoil, I will tell you that through the examination process, we are seeing some ratings deterioration among institutions we supervise.

Lessons Learned

It's important to take from our experience the past several months lessons that will help us strengthen our industry for the future. One dominant theme seems to be going back to basics. A business model that relies on solid underwriting, limited exposure to the risky ends of the market, and diversified funding sources remains a sound

long-term business strategy. While this may seem simplistic, it works. Let's explore it a little more.

First, diversification is important—both on the asset and the liability sides of the balance sheet. Mono-line businesses have greater exposure, especially at the riskier ends of the credit spectrum. In fact, a case can be made for additional flexibility in the thrift charter to ensure adequate diversification in times of stress. We have proposed legislation to do just that—on a case-by-case basis—for thrifts to be able to diversify beyond existing statutory limits on small business loans and secured consumer lending.

The second lesson is that underwriting is fundamental. Bankers should never outsource their credit decisions to Wall Street or the investor community. What has become of Character, Collateral, Capacity, Capital and Conditions?

Third, transparency is paramount to the proper functioning of markets. A lack of reliable information can cause investors to leave, or pull back, during a credit crunch.

And fourth, a level playing field is important in the extension of credit. While running large volumes of loans through a largely unregulated mortgage pipeline may have worked for a while, we need to consider bringing that business into the regulated fold to ensure oversight, accountability and consumer protection.

Conditions for Consumers

We don't need to view the latest headlines to know that current conditions continue to create difficulties for consumers. And it is not just subprime borrowers who are being affected but anyone trying to sell or buy a home. Again, a lack of *transparency* has been a significant issue—transparency for mortgage lenders about the true creditworthiness of many borrowers and transparency for consumers about the terms of their mortgages. This lack of transparency has helped to feed the problems in the capital markets, fueling investors' fears about mortgage investments.

In addition, predatory lending and outright fraud have been significant problems. According to Mortgage Asset Research Institute, the number of reported cases of mortgage fraud rose from about 3,500 in 2000, to 28,000 in 2006—a staggering increase. Also, the fact is that subprime borrowers are often the unsuspecting targets of fraudulent mortgage lending schemes. But how do we get to these scams without affecting credit?

It is important that as we focus on preventing unnecessary foreclosures, we avoid blurring the line between subprime lending and predatory lending. Although we want to prevent predatory lending and fraud, we do not want to restrict legitimate subprime lending. Problems with subprime lending arise when mortgage loans are granted to borrowers who cannot afford them, either because they lack financial resources or because loan terms make a particular loan unaffordable. Poor underwriting, predatory lending and fraud are problems, but subprime lending, by itself, is not the problem.

Although not everyone should own their own home, homeownership remains the bedrock of strong communities. Homeownership increased by more than half from the end of World War II to the height of the housing boom in 2005, when it peaked at nearly 70 percent of families. That peak is likely not sustainable. But it is also important to note that the overwhelming majority—83 percent—of subprime mortgages in this country are being repaid on schedule. As a regulator, I want to be sure that in attempting to avoid foreclosures, stop abuses and reassure the capital markets, we do not cut off credit to worthy borrowers. And I also want to make certain that whatever legislation and rulemakings emanate from the current situation, that community banks that played no role in the creation of this mess do not wind up being penalized for its creation.

What the OTS and the other FBAs are Doing

Now that I have discussed market problems, financial institution challenges and consumer issues—a few comments about current and possible solutions for the future.

The banking agencies have already issued important guidance to the industry and our examiners on nontraditional ARMs, subprime lending, working with troubled borrowers to avoid foreclosure and other important subjects.

In August, the OTS also issued an Advance Notice of Proposed Rulemaking, or ANPR, seeking comment on expanding our regulatory authority to address unfair or deceptive acts or practices in the thrift industry. Recognizing that consumers and institutions benefit most with consistent rules and guidance, we plan to share the comments we receive on the ANPR with the other federal banking agencies. Our intent is to move toward a goal of interagency consistency in this area.

If you are interested, please note that the comment period for the ANPR ends November 5. I encourage you to share your views on this important subject.

What More Can Be Done?

When I talk to bankers at these events, I often hear that a *level playing field* does not exist in the home mortgage sector as well as on a number of other fronts. I have always agreed. In the mortgage arena, mortgage lending abuses have come from players outside the reach of federal regulators, and in many cases also outside the reach of the states. The lack of accountability generates a continuing force for tipping the competitive balance in the home mortgage marketplace in favor of entities that play by a less stringent set of rules.

We have suggested to Capitol Hill that the time has come for a more structured regulatory regime to apply to all segments of the home mortgage market and lawmakers are proposing a wide array of solutions, including some minimum national underwriting standards, to which the states could add their own possibly more rigid requirements. As I indicated, the goal should be creation of a *level playing field* in order that regulated financial institutions that abide by the rules do not suffer a competitive disadvantage.

The ideal solution, in my view, has two components: licensing and registration of mortgage brokers, and joint state and federal oversight of mortgage banking activities. National licensing and registration standards, such as those proposed by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators for mortgage brokers and originators, would ensure that bad actors cannot move from one state to another, free to prey on a new set of unsuspecting victims and without any accountability for their previous activities.

Equally important is federal oversight of the entities that fund the mortgage process. It is critical to ensure that mortgage banks be forced to compete by the same set of standards as insured depository institutions. Establishing a partnership between the states and a federal overseer—similar to that which exists between the FDIC and state banking commissioners in the oversight of state-chartered banks—to set and enforce minimum mortgage funding standards would ensure accountability and consistency throughout the mortgage lending process. Such a partnership need not involve establishing a federally mortgage banking charter, but rather a federal-state partnership to regulate these entities and ensure nationwide uniformity.

The OTS has extensive expertise in the oversight and supervision of mortgage banking operations that I believe would benefit the currently unregulated mortgage banking market. If Congress determined that the OTS could provide the best solution to oversee a state-federal national mortgage banking program, we would certainly rise to the challenge.

American consumers deserve basic protections when they make the largest investment of their lives and we, as public servants, have a responsibility to do our best to provide those protections. *Transparency* and accountability in the mortgage origination and funding processes—as well as a *level playing field* for all entities in the home mortgage sector—will provide these protections.

Conclusion

Before concluding, I want to mention that the OTS will once again be sponsoring a National Housing Forum this December. As we did last year, we plan to bring together some of the nation's foremost experts to discuss critical housing finance issues. This year's Forum will be on Monday, December 3, at the National Press Club in Washington, D.C. I hope to see many of you there.

I would also like to take this opportunity to congratulate your own Brad Rock for his recent election as Chairman of the American Bankers Association.

Thank you again for the opportunity to speak to you today.