

*Remarks of John M. Reich, Director
Office of Thrift Supervision
to the Italian Bankers, Washington, DC
October 20, 2008*

Buongiorno and welcome to Washington, DC! I'm pleased to have the opportunity to talk to you today. Let me begin by acknowledging the wonderful contribution Italians have made to the United States.

Our country has gained much from our citizens who trace their ancestry to Italy, both in cultural and economic matters. We are highly aware of the Italian influence in America each day, whether it is Vivaldi, Verdi or Puccini we hear, Raphael, Michelangelo, or da Vinci we see, or, in an even more everyday sense, the food we enjoy. I only wish I could say I've experienced Italy firsthand. I can't say that yet; but I hope to do so soon.

I'd like to talk to you today about community banks in the United States against the backdrop of today's tremendously challenging financial environment. I was a community banker for many years before I became a regulator. I believe community banks are the backbone of the U.S. financial system., and that being a community bank CEO is one of the best jobs in the world.

The U.S. financial markets today are radically changed from when I was a community banker. Even a year ago, I would never have predicted the extent of today's U.S. credit crisis; that the crisis today would be much greater than the thrift and banking crisis of the late 1980s and early 1990s. I believe no one could have predicted the blows to the U.S. financial industry, including the government seizing Fannie Mae and Freddie

Mac; Lehman Brothers' filing for bankruptcy; the Federal Reserve, our central bank in the U.S., taking an 80 percent stake of American International Group Inc.; Merrill Lynch & Co. Inc. rushing to sell itself to Bank of America Corp.; the failures of Washington Mutual and IndyMac, our largest thrift institutions; and the conversions of our two largest investment banking organizations – Goldman Sachs and Morgan Stanley – to bank holding companies.

I certainly never anticipated a situation necessitating European central banks to commit the equivalent of \$2.3 trillion dollars and the U.S. central bank to commit \$700 billion to restore confidence and credit.

ACTIONS TO AID RECOVERY

I recognize and appreciate the continuing efforts by European bankers, by our own U.S. Federal Government, and by others around the world to address the problems of financial institutions in a systematic manner to combat the strains and stresses in financial markets around the world. On October 3rd, our Congress passed, and the president signed the Emergency Economic Stability Act (EESA), which established the Troubled Asset Relief Program (TARP) allowing the Treasury Department to use up to \$700 billion to inject or purchase capital in financial institutions, to purchase or insure mortgage assets, and to purchase any other assets deemed necessary to promote financial market stability.

Subsequently, the Treasury announced a new capital purchase program whereby a broad array of financial institutions may sell preferred shares of their stock to the U.S.

government, much like European governments are doing. Other moves to help stabilize financial markets were announced by the Treasury Department and the Federal Deposit Insurance Corp. (FDIC) recently, including a plan to enable the FDIC to temporarily guarantee senior unsecured debt, such as commercial paper, interbank lending, and transfers between banks to let the institutions convert maturing senior debt into new issues fully backed by the FDIC. The FDIC also will provide full deposit insurance coverage through 2009 for non-interest bearing transaction accounts, which are mainly used by businesses.

The OTS supports these initiatives to help stabilize financial markets and promote and encourage the availability of credit. We also believe the previous move to temporarily increase the FDIC deposit insurance from \$100,000 to \$250,000 for retail deposit accounts is an important step to restoring consumer confidence in the safety of their deposits and avoid future runs on banks, which although unfounded, have contributed to recent bank failures.

We will weather this storm. Indeed, the United States Government and our friends in Europe and around the world will continue to undertake a series of broad, coordinated actions to minimize the impact of the current instability on the overall global economy.

I am confident we will continue to work in a coordinated way with the international community, because isolationism and lack of coordination will not help resolve the global financial stress. The world economy is more interconnected than ever and it has never been clearer that we here in the United States must coordinate with our

European colleagues and with the other economies around the world to overcome the present financial turmoil.

FOCUS ON COMMUNITY BANKS

Turning for a minute specifically to community bankers in the United States, there is no question in my mind that they are not responsible for the current financial and mortgage markets debacle. The causes are many, and much has already been written and said about these causes, and no doubt many books will be written about these causes which, to mention a few, include:

1. A sustained period of low interest rates, combined with rapidly appreciating housing prices.
2. Failure to adhere to fundamental principles of credit extension (character, capital, collateral, capacity, and conditions).
3. The creation of new mortgage financing programs and instruments that were inappropriate for some borrowers.
4. Gaps in the regulation and oversight of state licensed mortgage entities compared with federally regulated depository institutions, and
5. An abundance of global liquidity providing funding for mortgage backed securitizations that were incorrectly rated by the credit rating agencies.

To some extent community banks may be gaining market share of deposits today because consumers have lost some faith in large institutions and are turning to neighborhood banks in which their trust remains. In America, many so-called experts have long predicted that community banks here are on borrowed time and will eventually disappear. Certainly, industry consolidation in the United States has taken place over the last 20 years resulting in a reduction in the number of community banks. Some have failed because of fundamental weaknesses in their business models and their lack of

needed expertise. But a number of viable community banks were acquired by their larger competitors. OTS today supervises 829 savings institutions across the country, and approximately 470 savings holding companies, most of which are well capitalized and well positioned to face the uncertain future ahead.

That is not to say the road in front of us will be easy. Community banks are under extraordinary pressure today.. Margins are compressed, competition for loans and capital is intense, unprecedented stock price volatility continues, delinquencies are rising, charge-offs are increasing, and regulators are focusing more than ever on credit quality

In spite of these challenges, I continue to be optimistic about the role and long term future of community banks in the U.S. The community bank model, based on personal service and community involvement, is proven and sound; and the skill and adaptability community bankers have shown in serving the credit needs of local markets have proven over decades to be able to compete successfully against larger regional and nationwide institutions.

Let me say a word about mutual savings banks and their value to the U.S. banking system. Mutual savings associations are among the oldest types of financial institutions in the United States. European voluntary organizations and “friendly societies” provided the inspiration for their mutual savings bank counterparts in the U.S. Currently 38 percent of thrift institutions in the U.S. are mutuals. They serve all segments of their communities by offering products and services tailored to the community. Because they are not publicly held stock companies, they are independent and management and the board are able to focus attention on the long term needs of the community and its citizens

rather than short term quarterly results of interest to analysts and investors in stock companies..

RISK MANAGEMENT

Now let me tell you a little bit about how we monitor risk at our institutions. We are mandated by law to perform an onsite examination each 12 to 18 months, depending on the size and strength of an institution. When we conduct an examination, we rate every institution according to a CAMELS rating - an acronym, which stands for Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to interest rate changes. It is a basic rating framework adopted by all of the federal banking agencies in the U.S. There is much that can be said about this, and I believe you will hear more tomorrow morning when you visit OTS. I will just highlight three aspects here which you may find of interest:

First, I am very proud of the work that OTS has done in regard to interest rate risk modeling. Because of the heavy concentration of thrift institution assets in mortgage lending, asset and liability maturity mismatch has always been a significant risk. To address this, OTS has developed and refined over the years a model for measuring the impact of interest rate changes on the net value of an institution's portfolio. This tool is an "early warning" device that enables us to detect industry outliers and trends, and also allows us to assess the quality of interest rate risk management practices at individual thrifts.

Second, we put an emphasis on risk management systems. We require thrift management to set parameters around each type of risk – whether it is market risk,

interest rate risk, credit risk, or operational risk. This has been helpful during the recent crisis, but the crisis has made clear that the risk modeling we have all been using can be improved. We are requiring managers to improve modeling and to conduct stress test scenarios that combine several related events, not simply a series of isolated events, to ensure that our institutions have vigorous contingency plans for liquidity. The events of the past year and a half have certainly provided ample data for use in our risk-based models. We are working to ensure that institutions incorporate these lessons in their risk management systems.

Third, we have in the U.S. a regulatory regime called Prompt Corrective Action (PCA, which mandates regulatory action if capital levels drop below certain levels. PCA requires US bank regulators to apply progressively more significant restrictions on an institution's operations as its capital ratios fall. The PCA framework has five capital levels, and once a firm's capital falls below the top tier – “well capitalized” – certain actions are required. The definition of well capitalized includes risk-based capital ratios, but also includes a basic leverage ratio. The latter acts as a counterbalance and supplement to the risk-based capital measures. A well-capitalized firm must maintain Tier 1 capital at 5% of total assets. I know that in the current crisis, this idea, which has not been too popular in Europe in the past, may be getting a second look among some foreign regulators.

Finally, just a word about Basel II. I know that many in Europe are aware that the US implementation of the Basel II regime is on a later timetable than it is in Europe. Obviously, the financial crisis has diverted attention from implementation and the topic

has virtually dropped out of our headlines. We never intended in the US to apply the Basel II advanced models-based approach to smaller institutions, and only a dozen or so large institutions will be required to adopt the advanced approach. Smaller institutions will have an option. They will be able to choose to adopt a form of the Basel II standardized approach currently being finalized, or remain on the current Basel I capital regime.

Clearly, every aspect of regulation will be subject to review in light of the extraordinary changes that have occurred in the financial markets, but my view has been that the Basel I regime is adequate to address the risks faced by smaller institutions, and that the complexity required of the Basel II approaches carry costs for smaller institutions that exceed the potential benefits.

THE FUTURE OF FINANCIAL INSTITUTION REGULATION

Finally - a few comments about the financial regulatory structure in the U.S. This is a subject that has been considered many times by Congress over the past 60 years. But given the recent financial crisis, the atmosphere in Washington, D.C. today is more favorable to considering restructuring financial regulation than it has ever been. Congressional Hearings on financial regulation have already begun and will continue into next year. Their scope will no doubt cover more than insured depository institutions. Recent events have pointed to weaknesses and gaps in areas of regulation and supervision in many areas of financial activity, including banking, securities, insurance, and the state licensed mortgage brokerage industry.

Although I think the current banking regulatory structure has served us well for many years, there is definitely room for improvement in our system. It is entirely likely we will see significant changes to our present regulatory structure.

In conclusion, let me say that I've enjoyed speaking with you this morning, and we look forward to hosting you at our offices at OTS tomorrow morning.

Grazie!