REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE NEW YORK BANKERS ASSOCIATION
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Good morning. It is a pleasure to be here today and I thank you, Michael Smith, for the invitation. In a sense, this marks my second appearance before you as Director of the Office of Thrift Supervision (OTS). This past November 18, I spoke to the Community Bankers Association of New York State (CBANYS). As I recall, immediately prior to my speech, it was announced that CBANYS was merging with the New York Bankers Association. Given the clear impact that the announcement had on everybody in the room that morning, I considered whether I should simply give the same speech again today. But, for those who were able to pay attention the first time, I will spare you a repeat of my words that day. Instead, I will concentrate on a different topic for the majority of my remarks today — credit quality.

In addition to credit quality, I want to touch on two issues very much entwined in that topic — recent proposed guidance issued by the Federal Banking Agencies (FBAs) covering two areas, nontraditional mortgage lending products and commercial real estate lending. And I will also highlight a topic that has not received much domestic attention to date, but that has become a very significant and internationally recognized part of our operations — OTS's Complex and International Organizations program. Finally, I will briefly conclude with some observations on Basel II, and my favorite topic — regulatory burden relief.

During the last several years, the banking industry has demonstrated remarkable success and adaptability to relatively fluid economic conditions. I believe one of the mainstays to the success of our banking system is our supervisory structure. The United States bank regulatory system is considered to be among the most comprehensive and admired in the world. Our supervisory system is grounded in a regular program of on-site examinations complemented by comprehensive and frequent reporting and off-site monitoring — a level of supervisory review that, in the aggregate, provides tremendous insights into industry developments and trends, and that assists us in our overall supervisory strategy going forward.

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. To some analysts, it may appear that the banking industry has never been healthier and, to a certain extent, a good case can be made to support this notion. The industry continues to grow and has experienced record profitability the last several years. Loan originations have been high, but are stabilizing, and, despite somewhat thinning margins, loan classifications and past-due ratios are at all time lows. And industry capital has never been better. So why raise the issue now?

As every good banker knows, now is precisely the time to pay attention. My 23 years as a community banker, plus nearly a dozen years on Capitol Hill, supplemented by more than five years as a bank regulator, have taught me to pay particularly close attention to leading indicators of change. While lagging indicators provide a good snapshot of where we are now based on what we know from the immediate past, leading indicators help us to identify what is on the horizon based on information that is generally predictive of longer term trends. Leading indicators enliven the lagging indicators snapshot and sometimes produce a very different picture — and the perspective of experience helps us to see that picture for what it really is, not for what it appears to be at the moment.

What are the leading indicators that concern us? First, let us take a look at the obvious issues. Despite record profitability, we are beginning to see declining profits in a number of institutions, particularly at smaller community-based institutions. This results from declining margins due, in part, to a recent decline in mortgage originations, particularly in certain market areas. Given the tremendous growth in originations over the last several years, it is not particularly surprising originations are starting to decline to a more stable and sustainable level. Far more troubling are the responses we are seeing to this phenomenon.

For example, in an effort to continue feeding their current loan volume, some institutions are purchasing loan participations. The concern that I have, however, is that some of these purchases are occurring despite the fact that the packages lack complete documentation. Moreover, I am told that some sellers are telling buyers that if they insist on complete documentation then other buyers will take their place. This practice is unacceptable and will be scrutinized by our examiners. We expect any banker who purchases a loan participation to analyze it as if the bank originated the credit. Incomplete documentation that obstructs the ability to understand the credit risk of any loan product or participation is a practice that can lead to significant problems and should not be tolerated by bank management.

Similarly, I am concerned that there has been an overall slippage in underwriting due to increased competition in certain markets segments and areas. Specifically, my examiners have noted examples where loan pricing misaligns with credit risk solely due to competition and the desire for loan volume. We are also seeing an increased liberalization of terms by some institutions in order to maintain their loan volume. This is particularly troubling as institutions are effectively taking on greater risks with less vigilance regarding their overall program requirements.

A final, but very important concern is greater reliance on wholesale funding by a number of institutions. Excessive dependence on wholesale funding creates greater risks. The combination of greater dependence on a more volatile funding stream coupled with greater risk exposure in the underwriting and pricing of loan products will likely squeeze some institutions, if it has not done so already. And yield curve pressures continue to cause institutions to increase their risk profile and/or leverage their capital to maintain and/or increase their return on equity (ROE).

All of these factors give us good reason for concern. How are we responding? We are increasing our vigilance, both from a supervisory perspective and a policy perspective. On the supervisory side, we our asking our examiners to dig deeper into loan portfolios to understand the risks individual institutions are assuming. We are paying close attention to the fundamentals, including loan documentation, pricing, loan-to-value ratios, and overall underwriting standards.

We are also closely monitoring how institutions are funding their ongoing operations, particularly their mortgage originations. And we continue to monitor overall operational costs, again, with close attention paid to costs attributable to prior build-ups in mortgage lending operations. In addition to our ongoing monitoring of interest rate risk, we are looking at credit risks, particularly with respect to nontraditional mortgage lending products.

From a policy perspective, one of the risks we are closely monitoring involves the proliferation of alternative or nontraditional 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 nontraditional lending products such as interest-only and pay option ARMs. Aggressive pricing and increasingly lax underwriting standards heighten these credit risks.

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. And pricing is a particular concern.

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? 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.

In December, the FBAs issued proposed guidance on nontraditional mortgage loan products. The comment period on the proposed guidance closed last week. Among the comments we received, one experienced mortgage lender suggests significant regulatory attention should be directed at the practice of deep payment discounts, or promotional loan rates that get a borrower in the door. As that commenter noted, offering deep payment discounts to borrowers who do not otherwise qualify at the fully indexed rate is not only risky to the institution, but wrong for the borrower. At the same time, that commenter took exception to the notion that only a certain strata of borrowers are appropriate for nontraditional mortgage product offerings. We will work with the other FBAs over the next several months to review these and the other comments received on the proposed guidance to make certain that we get this right.

Regardless of the guidance, 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.

Another issue prompting interagency policy 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. 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.

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.

The other major topic I want to address today is OTS's Complex and International Organizations (CIO) program.

As you know, OTS has a well-established program for discharging its statutory responsibilities with respect to thrift holding companies. OTS's holding company examination program is designed to understand the structure of the parent and identify the effect, if any, that the holding company enterprise has on the subsidiary savings institutions.

The holding companies we regulate range from non-complex shell companies to very large, internationally active conglomerates. Conglomerates are, by definition, companies that operate in diverse fields through a number of legal entities — and they are typically managed along business or geographic lines rather than by legal entity.

Conglomerate supervision poses unique challenges for supervisors, and OTS has specialized procedures for this subset of our holding company population. These procedures are designed to assess the conglomerate on a consolidated basis and perform full-time, continuous reviews of the capital structure, corporate governance, and risk management functions — as well as other areas where there is a concentration of risk. We also review the work of other functional supervisors, both foreign and domestic, in order to identify trends and avoid duplicative and overlapping supervision.

Supervising these firms requires multi-industry and international expertise. It requires extensive interaction with foreign and domestic supervisors heightening the need for OTS to maintain consistency in its policies and communications. Our examiners must understand the governance and risk management practices of large and complex enterprises, as well as the economic and regulatory environment for many diverse lines of business. They must also be able to make sound judgments and conduct supervisory conversations with high-level company executives and supervisors around the world.

Our conglomerate supervisory structure is designed to guide our examiners and their efforts. Our supervisory procedures are intended to keep us focused on the activities, functions, and processes most critical to each conglomerate's consolidated operations and ongoing viability. We start with an understanding of a conglomerate's organizational structure, its capital underpinnings, and how it manages the various businesses under the corporate umbrella. We then develop customized supervisory plans for each conglomerate and these plans guide the examiners in their work. We augment the information we receive through regular holding company reporting with information from the marketplace, from the companies' own internal risk management and internal audit process, and from regular specialized reports we receive from conglomerates on risk concentrations and intra-group transactions. This information is used continually to adjust and refine our supervisory strategy and our onsite examination work stream. And we typically meet on a regular basis

with other interested supervisors in the United States and around the world who have an interest in our consolidated view of a given conglomerate's operations.

This cross-sector consolidated supervision discipline is relatively new. And supervisors around the world who face the challenge of understanding and supervising these complex companies are still refining it. We are also fine-tuning our own approach to discharging our responsibilities with respect to financial conglomerates, but are pleased with the progress we have made in this area over the past two years and look forward to more success.

I would like to move briefly now to the recent release of the Basel II notice of proposed rulemaking (NPR) by the Federal Reserve Board (FRB). Given the attention prior to its release, I think it is good that the NPR is out. This is the work product of the four FBAs. OTS and the OCC, as part of the Treasury Department, have submitted the draft NPR to the Office of Management and Budget (OMB) for its review. OMB clearance is required before the NPR can be published in the Federal Register. At that time, there will be a 120-day comment period. In effect, the FRB's release of the NPR provides extra time for review of the proposal, which, given the breadth and complexity of the document, can only help the process.

I want to reiterate what I have said about Basel II since joining OTS, namely that nothing in this initiative is etched in stone. It is a proposal, culminating a number of years of hard work and research. While I have testified before Congress in support of Basel II generally, I am cautious about whether we are doing this optimally. I do believe it is important that our largest and most sophisticated banking organizations employ the most current and appropriate methods of managing and measuring risk. Done correctly, this will increase their safe and sound operations and their competitiveness globally. But it is also important to ensure that appropriate levels of risk-based capital are maintained. While there appear to be sufficient mechanisms within the NPR to achieve this balance, this is something we must continue to study as we move into the structured phase-in implementation period. Basel II warrants close scrutiny by all interested parties. My hope is that the notice and comment process will further improve Basel II where needed.

Finally, I want to briefly mention regulatory burden relief. As some of you know, this is a subject near and dear to my heart. It 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.

A little over a month ago, I testified before the Senate Banking Committee that accumulated regulatory burden is suffocating the banking industry despite the fact that the industry seems to be doing so well. While regulatory burden impacts all institutions, I believe it has a significantly greater competitive impact on community banks and savings institutions. There is considerable anecdotal evidence supporting the notion that regulatory burden is at the top of the list of reasons why these institutions 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, with implications that are largely ignored by policymakers.

I believe this is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. I also believe we have a limited window of opportunity this year to move forward on regulatory relief legislation before Congressional elections this fall and the currently planned October adjournment. There exists today a much greater visibility and recognition of the problem than ever 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 again for the opportunity to speak to you, today. The "new" New York Bankers Association is an outstanding organization and I look forward to continuing an excellent working relationship with you.

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