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Remarks
by
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to
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Thank you for asking me to join you here today. This is my fourth ACB convention, and I look forward to the new format.

I'd like to use my time with you today to bring you up to date on where the industry stands, tell you some of our concerns, respond to some of yours, and let you know what's on our plate. I also want to give you a preview of the truly innovative and exciting first-ever Thrift Industry Leadership Conference we're sponsoring for thrift CEOs and Directors next April in Atlanta.

But first, a brief review of the state of the industry. Since we won't publish third quarter numbers for another month, I can't tell you much about the most recent quarter, but preliminary indications are that there haven't been major changes in the generally solid situation. For the first six months of 2000, the OTS-regulated thrift industry earned about $4.25 billion, a little ahead of last year's record pace. ROA was down slightly to 93 basis points for the second quarter; equity capital stood at 7.7 percent, with 98 percent of the industry well-capitalized; and troubled assets fell to a record low. Interest rate sensitivity declined slightly as interest rates dipped, the yield curve took on a somewhat more normal shape and the industry responded to our concerns about excessive risk exposures. Other factors, such as earnings efficiency and delinquency rates, despite a modest increase in the rate for commercial loans, are all in good shape.

But as you all know, life as a thrift is certainly not a bowl of cherries. Many mortgage products have become commoditized, margins have declined on high-quality alternative products, excessively aggressive lenders have entered fields such as construction lending and are making it hard for those who underwrite and price responsibly, and competition for customers is intense. But every time I prepare for one of our Town Meetings with groups of thrift executives, almost every time I visit neighborhoods in my role as Chairman of the Board of the Neighborhood Reinvestment Corporation, and often as I simply talk with my staff, I hear of, read about and meet with institutions that have figured out how to serve their neighborhoods and achieve financial success. Some of this is undoubtedly being in the right place at the right time, but I've got to think that much more of it is careful attention to opportunities and risks, and focusing on long-term profitability.

OPPORTUNITIES

What are some of those opportunities? You've heard me talk about them before, but they've only gotten better. Take the immigrant community. The Joint Center for Housing Studies recently reported that between 1996 and 1999 the foreign-born were responsible for just over one-quarter of the net growth in households, and in central cities accounted for 22 percent of the increase in owner households and 62 percent of the increase in renters. Over the next decade over 27% of United States population growth will be due to immigration—and that does not, of course, count the native-born children of immigrants. This is a huge market. For example, Hispanics, both native-born and immigrants, paid over $30 billion in rent and owned homes valued at over $360 billion in 1997. And this was with a homeownership rate that still lags both Asians and blacks.

Other parts of the population also present real opportunities. Last month, the Census Bureau issued a report on Money Income in the United States. Not only did that report show that real median income of households had increased 2.7% between 1998 and 1999 to $40,816, but also that the 1999 median income was the highest ever recorded for black and Hispanic households and equaled the prior record for Asian and Pacific Islander households. Those increasing incomes mean more families are in need of financial services, many of them for the first time. The bad news, of course, is that many of them still don't seem to be getting those services from the community bankers who served their predecessors on the way up the economic ladder, and instead are falling prey to those who want no relationship, but rather a quick buck. Long-term relationships are your opportunity.

And then there are the elderly. The senior population is growing now and will begin to surge when we baby boomers start to hit 65 in 2011. Seniors and pre-seniors need help with retirement planning and managing their money so it lasts as long as they will. But they also have real credit needs. Almost 40 percent of seniors who are in their 70s today moved into their current residence after reaching 60, and that percentage will probably increase with increased quality of life and a wider range of housing choices. And those who stay put often need help with home improvements and perhaps medical expenses. It would be a shame for you to lose these folks, many of whom have checking account, deposit account or other relationships with you, to the predators. Go for it—they're your customers.

Finally, there are the small businesses, the soul of every community. This of course used to be the heart of the commercial banking business, but they're not paying as much attention any more. That's your opportunity. This is a different kind of lending, and one that takes knowledgeable staff, good systems and a will to structure and monitor a long-term program. Commercial loans as a percentage of thrift assets have increased nearly 56 percent over the last five years, but still account for only 2.8 percent of thrift assets, and much of that is concentrated in a few institutions. As the latest session of Congress is ending, it appears that thrifts will be able to invest directly in Small Business Investment Corporations—SBICs. This should provide additional opportunities to tap the small business market. Interestingly, while there seems to be trouble brewing in the large commercial loan market, so far the smaller end of the market looks pretty stable.

RISKS

So those are some of the opportunities. Where are the risks? We've been over this many times before, so I'll be brief:

- First, if you don't have a sound strategy, one that has been thought through by your board as well as senior management, and that comes complete with personnel, risk management, monitoring and systems, you've got a problem.
- Second, make certain that if you're taking more risk, you're adequately compensated. There is nothing more depressing than hearing of a thrift that has vastly increased its level of risk and has an ROA that's half the industry average. If you're not getting an adequate risk-adjusted return—and not just for a quarter or two—when you take greater risk, you need to figure out how to improve or unwind.
- Third, internal controls are critical. Whatever may once have been the case, you can't rely on either your outside auditor or your examiner to make certain the general ledger is balanced, that there are proper checks and balances and that people with substantial authority take regular vacations. That's your job, and that of your board. And if you're contracting out major functions, flyspeck the internal controls of your contractors even more closely than you would those of your own institution.
- Fourth, you need both reserves and capital commensurate with the risk you're taking. Don't let all the excitement generated in the trade press about agency disagreements over ALLL distract you. The rules haven't changed, although both we and—where applicable—the SEC, will be looking for better documentation, particularly of general allowances, than we frequently see.
- Fifth, pay attention to interest rate risk. You have the tools. We need to be careful not to send you from the frying pan of increased sensitivity to the fire of bad credit, and I hope we haven't been doing that. But this is one kind of risk that is easy to spot and relatively easy to deal with, so it's silly to ignore it.
- Sixth, technology risk is real, and on many dimensions. If you ignore technological change, you risk serious competitive damage. Don't simply follow along without fully understanding what is going on. Technology must be a critical element of any institution's strategy, with particular attention to making certain customer accounts are thoroughly insulated and that your institution's overall security is as tight as it can be.
- Seventh, watch out for reputation risk. Too many of you—and your predecessors—have worked too long and hard at building quality reputations to lose them reaching for profits, especially by teaming up with folks, like those who are now approaching federal thrifts with auto title loan or payday lending programs, who want you for nothing more than your federal preemption or your access to deposits or Home Loan Bank advances. And there are more subtle variations on this theme, including making certain that whatever your privacy policy is, you follow it.
- And finally, don't forget the old admonition that "if it's too good to be true, it probably isn't," or my preferred version, "miracles don't happen to me." Earlier this month, we issued a letter on investment products with split ratings. We've been talking to many of you about paying very close attention to Home Loan

Bank structured notes and callable advances, making certain you are using them to reduce, not increase risk and that you fully understand that the Home Loan Banks are no longer your lender of last resort but nevertheless continue to have access to your exam reports. And any number of you have discussed "great deals" with us that just weren't. Please call before you jump—your Regional Director or one of his senior staff really is there to help.

WHAT OTS IS DOING

OK, so this is all stuff you should be doing. What is your regulator doing? Lots. First, let me say that getting past Y2K successfully—with all of your help—has enabled us to increase the amount of time we spend with you on your core business activities. Some of this is in the form of increased field visits, where we see increased risks, or simply by having more time to spend with you and respond to your questions and concerns. We are also trying to do a better job of integrating information technology considerations into both safety and soundness and compliance exams, building on the collaboration started during Y2K. We have made major improvements, in personnel, policy and allocation of resources, in our trust operation.

Our compliance examiners—who are fewer in number than safety and soundness examiners—are, however, being stretched more than ever by the new privacy regulations as well as new Fair Credit Reporting Act examination authority. In addition, we are putting enhanced emphasis on situations in which we are concerned that institutions may be at risk for having originated or purchased predatory loans, with all their fair lending, RESPA, TILA and other risks.

We are putting renewed emphasis on the professional development of all our staff, and on the continued hiring of both entry-level and experienced examiners in all disciplines. We have successfully piloted a state-of-the-art Professional Development program in our Northeast Region and in two Washington offices, and are now rolling it out to the entire agency. This program goes beyond classic training to use methods such as mentoring, details, task force assignments, writing for publication and teaching to enhance both technical skills and professional competencies—and to increase the effectiveness of our recruitment and retention efforts to boot. And speaking of retention, we have also instituted a telecommuting policy across the agency, which should enable examiners to do more of their work away from your bank, although we will never give up on-site examinations, which we believe to be the key to effective supervision.

We have also revised our accreditation standards and instituted two new specialty examiner career tracks, in retail lending and commercial lending. Examiners in these specialty tracks will expand the agency's expertise, leading teams on complex examinations wherever in the country they may occur, and teaching and coaching other examiners. To those of you who wonder about our existing expertise in commercial lending, let me tell you a little story. The Shared National Credit program is run by the Fed, the OCC and the FDIC, and consists of teams of examiners who annually evaluate large commercial credits in which many banks are participating. About a year ago, realizing that a number of OTS-regulated institutions either were the lead bank or had participations in such loans, we joined the program on a pilot basis—amid some skepticism from the other agencies, I must admit. Well, on our first assignment, it turned out that the other agencies trusted our judgment completely, and accepted our examiner's review without question. It's a single incident, but one that I think is telling.

If any of you ever have any questions about the quality of the examination you are receiving, in any area, I urge you to let us know. Examiners themselves are trained to listen to your concerns. Their managers, up to and including the Regional Director, are also available. And if there's a problem that simply cannot be resolved that way, our Ombudsman, Lee Lassiter, is also available, and usually extremely effective in resolving your concerns. Like all individuals and organizations, we learn from constructive criticism, and even from the less constructive kind. But low grade moaning that we don't hear doesn't do anyone any good.

We're making a variety of other changes. We've established more efficient, more consistent monitoring systems and better ways for everyone around the country to access documents. We're in the continuous process of updating the handbooks, forms and other guidance, and getting more and more information out on our web site. And we are making both interim and more long-run improvements in the net portfolio value, or NPV, model, by which we model interest rate risk.

And finally, on the functional regulation front, OTS is building on what we've done for years—cooperate with our fellow regulators, whether they be federal or state banking regulators, insurance commissioners or securities regulators at the federal or state level. Under the direction of Managing Director for Supervision Scott Albinson, we have been working for the past two-and-a-half years to cement a close working relationship with state insurance commissioners. Last spring, the National Association of Insurance Commissioners approved a model information sharing agreement that will enable us to share with state insurance commissioners—on a confidential basis—information not only about consumer complaints but also about enforcement actions and other supervisory concerns. We now have written agreements with twenty-seven states. In addition, our Regional Directors have stepped up their interaction with insurance and securities commissioners in states where thrifts or thrift holding companies have such affiliations. We are also working more closely with state banking regulators on a variety of matters.

REGULATIONS

On the regulatory front, there's a lot of activity. Before we get to any of it, I want to thank you sincerely for the work you have done, individually and collectively, to comment on proposals we have put forth on an individual and interagency basis. The reason we put regulations out for comment is to receive them and we truly appreciate it when you take the time to tell us both when we've gotten it wrong—and suggest improvements—and particularly, when we get it right.

Interagency activity

First, interagency activity. This has primarily focused on capital issues. As you know, the comment period for the latest incarnation of recourse and direct credit substitutes has ended, and the agencies are reviewing the comments. This has been an incredibly difficult regulation to bring to closure, but I think we're closer than we've ever been. For community institutions, this is an important competitive regulation, in that it attempts to level the field between institutions with access to lots of ways to arbitrage regulatory capital and those whose business is more straight-forward. By bringing managed assets into the capital calculation, it would also level the playing field between credit card banks and other providers of credit.

A closely related rule is the proposal concerning residuals. I'd be less than honest if I didn't admit that the interagency support for this regulation was generated in large part by the several recent bank failures involving excess concentrations in residuals. But OTS staff fought hard to have earlier rulemakings better address the amount of capital needed for these riskier residual instruments. What we need to hear from you about this proposal is the extent to which we may have inadvertently impacted activities in the traditional mortgage market or responsible sub-prime lending. We did not mean to do this, and we need your comments to ensure that, when the regulation—which will, of course, be made consistent with the recourse rule—becomes final, it does not have that negative impact.

The final major interagency capital proposal outstanding is the Advanced Notice of Proposed Rulemaking we have recently published concerning a bifurcated capital system. As I said during the FDIC Board meeting when the FDIC voted on the proposal, it is critically important to focus on this proposal from two perspectives. First, how small, non-complex institutions should be regulated as to capital in an environment—which appears to be developing at the international capital discussions in Basle—in which large, internationally active institutions can rely largely on internal models. Second, how these small institutions can avoid being put at a regulatory capital disadvantage in such an environment. Internal models, based on specific portfolios, and quite refined at measuring risks, are likely to demand less regulatory capital for a given portfolio than a more broad-based regulatory capital framework with less precise risk measurement. If this ANPR is viewed simply as asking whether the existing risk-based capital system should be changed for small institutions, I fear we will lose an important opportunity for what may turn out to be a critically important dialogue. It is essential that we think ahead.

We are also nearing completion on further guidance on the issue of sub-prime lending, building on our March 1999 interagency guidance but including additional guidance with respect to capital. This has been long in the making, but I believe we are coming up with sensible guidance that will mitigate the risks inherent in this type of lending while still enabling it to go forward to serve its very important purpose of extending needed credit to those with less-than-stellar credit histories.

The banking agencies, with respect to the Call Report, and OTS, with respect to the Thrift Financial Report, have proposed a series of changes that are designed to enable us to more effectively meet a changing and ever more challenging set of supervisory responsibilities, and to do as much as possible through off-site monitoring rather than by lengthening on-site examinations or shortening the period between them. I know many of you commented on these proposals, and raised burden and feasibility questions. We will take those comments very much into account as we move forward, and will—consistent with the continuing differences in the two industries and the fact that the TFR (other than the CMR) has already been far more streamlined than the Call Report—coordinate with the bank regulators in our revisions.

The other major interagency regulatory projects are on the compliance side of the house: privacy, standards for safeguarding customer information, Fair Credit Reporting, disclosures with respect to sales of non-insured insurance products and CRA sunshine. These are all required in one way or another by the Gramm-Leach-Bliley Act. In other words, this is not just your hyperactive regulators in action.

With respect to privacy, of course, the final regulations are out. We recently published a privacy preparedness checkup to help both our examiners and you get a leg up on making certain that you are in compliance with this fairly complex and very public rule prior to July 1, 2001. It is critical that every institution understand its obligations under this law and regulation; in particular, even if you are a small institution that does not share information and has no intention of doing so, you have obligations to have a privacy policy and to provide notices to your customers that describe that policy and your information sharing practices. Moreover, your definition of not sharing and the statute's may be quite different. There are many courses available to you, including some sponsored by ACB and some over the internet, to help you put your privacy program together, and our examiners are also available to help. Within the next few months, the more detailed interagency examination policies will be published, along with a small entity compliance guide. These will provide even more guidance than our checkup. What is critical is that you successfully navigate this set of rapids, and on time, for there is little question that forces who would demand even more of you are waiting on the banks should you falter.

The safeguarding customer security guidance's comment period ended late last summer, and I think it is likely that the final guidelines will be very similar to those originally proposed. Although these arose out of the privacy context, they are valid for all security issues; you need to follow the four steps to success: inventory, evaluation, development and implementation.

The Gramm-Leach-Bliley Act restored the banking agencies' examination authority with respect to the Fair Credit Reporting Act, and strongly suggested we should write regulations. The agencies have jointly gone out with a proposal to implement, in particular, the portions of that statute that deal with sharing information with affiliates. The basic purpose of the regulation is to clarify existing law and to provide guidance on how to integrate Fair Credit Reporting notices to consumers with those required under the privacy regulations. Similarly, the proposed regulation concerning sale of insurance products basically implements, with little embellishment, provisions in Gramm-Leach-Bliley that extended disclosure requirements concerning securities products sold by or on behalf of depository institutions to insurance products. A major issue is the breadth of the regulation's coverage, and I gather we have received any number of comments on that subject.

Finally, CRA sunshine. I want to thank all of you who took the time and put forth the energy to write us, and the other bank regulators, the thoughtful and forceful comment letters we received on this proposal. I am hopeful we can reach, on an interagency basis, a reasonable conclusion that is true to the spirit of the statute but that, as the statute directs us, minimizes burden, and that we can do it reasonably soon. We at OTS are also working on the systems issues to make filing and disclosure, as well as access to documents filed, as painless as possible for all of us.

Before I close the interagency portion of this discussion, I want to mention a project that while not officially an interagency regulatory initiative is critical to us all—deposit insurance. I hope you were all able to hear Chairman Tanoue's speech on this subject yesterday. I want to tell you that I strongly support her call for open and serious discussion on all issues raised by the current deposit insurance system. The pro-cyclical nature of the system, which is contrary to any insurance logic, is a serious concern for us all. Both Chairman Tanoue and I strongly support merger of the funds, but this is merely one piece in a much more complex puzzle; I hope her thoughtful speech enhanced your knowledge of the issues and your interest in becoming a constructive participant in the discussions.

OTS Regulatory Activities

We have also moved ahead with a number of OTS-specific regulatory activities, many of which have been in the making for quite a long time so that we could get them as close to right as possible before publishing even a proposed regulation.

First are the two rules, one proposed and one interim final, on mutuals. I'd imagine, with the possible exception of those who are completely passionate about this issue, that you're a little tired of hearing either me or OTS Deputy Rick Riccobono talk about this subject, our respect for mutuals, and our intention to do what we can to help those who want to stay mutual do so. But let me just thank you right now for all the time you've spent with us—on Rick's listening tour, in town meetings, in ACB-sponsored forums and elsewhere—and for the thoughtful comments we have already received on this proposal. I want to thank the ACB and Charlotte Bahin in particular for your support for our efforts and your assistance in helping us get it right. I know you're going to spend more time at this meeting on your comments, and we truly appreciate that. Meanwhile, we are working hard at what we promised—enhanced examiner guidance better tailored to the special circumstances of many mutuals. I should tell you that the work we're doing in that area is leading us to rethink some of our guidance for small institutions in general, including minority-owned institutions.

We have also been spending a lot of time improving our supervision of holding companies, particularly diversified holding companies where the thrift is highly integrated into the general corporate family and non-diversifieds who are highly leveraged and thinly capitalized at the holding company level. This is an extremely difficult issue, and a hard balance to get right, but it is critically important to the health of both the thrift industry and, increasingly, the economy more generally. And it is an area where OTS has far more experience, over a far more diversified range of companies, than any other regulator.

Last month, at the invitation of NIKKIN, the leading Japanese financial newspaper, I gave a major speech on this subject at their Eleventh Annual Special Session on International Finance. The speech—which also includes my thoughts on internet-only banking—is on our web site, and I urge any of you interested in how OTS will be supervising holding companies going forward to read it. It is detailed and informative. Following up on the speech, last week we issued a notice of proposed rulemaking to reinstate—on a far more limited basis than previously—the requirement that we receive advance notice of certain holding company transactions that could have a material impact on the thrift. The NPR also provides guidance on our approach to holding company capital, which, unlike that of the Federal Reserve, is neither rigid nor one-size-fits-all. But the myth that OTS finds holding company capital an irrelevant concept is just that—a myth. I hope you give this regulation the same level of thoughtful consideration we saw in the mutual area, recognizing that the old way of doing things simply is insufficient in our changing environment.

I am also very pleased to announce that today we are issuing for comment a proposed new regulation on applications processing. Like the regulation on mutual-to-stock conversions, this is largely an effort to modernize and put our regulations into plain English, making them more understandable for thrifts and their counsel. However, like the mutual-to-stock regulation, for certain major transactions such as de novo chartering and many conversions, it also has an enhanced business plan and pre-filing meeting requirement. We're also making more explicit our concept of "materially deficient" and the actions we will take when applications languish for reasons within the applicant's control. We have also almost completed our application forms revisions, which will also be put out for comment. The applications processing rule will not go final until the forms also complete the comment process.

Today we are also proposing for comment a new rule that would establish the concept of optional model bylaw provisions for federal savings associations. These would be pre-approved bylaw provisions that supplement the pre-approved model bylaws that a federal thrift could—but need not—adopt without prior approval by OTS. We are also proposing the first such optional bylaw, which, if adopted by a thrift, would preclude from service as a director persons who, for example, are under indictment or have been convicted of certain crimes, or are subject to a cease and desist order entered by any of the banking agencies.

We are also working on the response to your comments, and those of many others, including state banking commissioners and attorneys general, on our Advanced Notice of Proposed Rulemaking Concerning Responsible Alternative Mortgage Lending. I believe we will make some recommendations to Congress concerning the Alternative Mortgage Transactions Parity Act, or AMPTA, and will also make some modest changes in our regulations that are designated as applicable to state-licensed housing lenders under AMPTA. I am, however, most gratified that in the period between when we started work on the ANPR at the beginning of this year and now, the Federal Reserve has held hearings on revisions to the Home Ownership and Equity Protection Act (HOEPA) regulations. I fully expect that the Fed will, in the near future, propose changes in those regulations to respond to the proliferation of predatory lending practices that exist just outside the existing regulations.

In the mean time, let me say that, while I believe the vast majority of loans made by thrifts, as well as the vast majority of loans bought by them, represent responsible credit practices, this industry—on the basis of recent examinations—is by no means immune from participating in predatory lending. The sooner we get ourselves out of denial and start taking action, individually and collectively, the better off our neighborhoods, the industry and the country will be. Please don't let this be another privacy situation, where the entire financial services industry denied a problem existed until it got solved for them by legislation. Because of the focus on mortgages, any legislation but the most finely crafted will impact thrifts more than other types of institutions.

IMPORTANCE OF HAVING A STRATEGY

I would like to close with a discussion of something many of us at OTS have talked about often this year in a variety of contexts—Directors' forums, town meetings, speeches on community reinvestment and on predatory lending, and discussions following examinations. That is the importance of strategic planning, of having a strategy.

Santayana said that those who cannot remember the past are condemned to repeat it. I think we need to extend that to recognize that those who do not plan for the future will never get there. Or on a more local and positive note, listen to Steve Swiontek of Gate City Bank in Fargo, North Dakota: "Strategic planning is the fundamental element that guides our business, shapes our vision, and unifies our team. It is an ongoing process. It enables Gate City to maximize the benefits of its mutual thrift charter and to properly meet the needs of its members, communities and employees."

Amen! Strategic planning at this $620 million institution has been successful because it involves all levels of management and staff. Directors participate in an annual three-day board/management planning retreat. Mr. Swiontek says that planning has enabled Gate City to refocus its commitment to mutuality and provide increased benefits to its members, communities and employees. Over the past decade, the institution has become the top mortgage lender in its state and a leader in consumer lending. The institution is healthy and profitable—which is not only not always where it has been, but is also at odds with the trend for many small institutions in that part of the country.

The competitive and technological changes swirling around us make this a good time to emphasize for the entire industry what Gate City already knows—the importance of strategic planning. Therefore, I am pleased to formally announce today our very first OTS-sponsored Thrift Industry Leadership Conference, subtitled "Charting the Course of Competitive Community Banking," to be held in Atlanta next April 23 and 24. We've appreciated ACB's support in this endeavor, and look forward to continuing to work with you.

This conference, for thrift directors and CEOs, will go well beyond discussing the importance of effective strategic development. On Monday morning, we will survey the national financial and demographic trends that have implications for your local communities and explore a strategic approach to harnessing those trends to build long-term customer equity. Monday afternoon we will explore four different customer market segments that illustrate the potential opportunities for new businesses in your community. On Tuesday morning, we will address managements' and the boards' responsibility for assuring a sound operational structure to enable the institution to attain its goals. We will wrap up Tuesday afternoon by addressing how to develop and evaluate your institution's strategic planning choices. Throughout, you will have an opportunity to hear from both expert speakers and your fellow bankers who have achieved success in these areas, and to talk to them informally. Conference brochures are available at our table in the registration area of this conference, and will be mailed shortly to thrift CEOs and directors. As leaders in your institutions and your community, I hope you will be able to join us, and I urge you to sign up early.

Thank you again for having me on your program today. I look forward to seeing you in Atlanta next spring.