

**Remarks of John M. Reich, Director
Office of Thrift Supervision
To the British Bankers' Association, London, England
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Good morning. It is an honor to be here today to address the British Bankers' Association. Throughout my years as a regulator and in prior positions, I have had the opportunity to speak to many groups of American bankers. This is a first for me to have the opportunity to address their British colleagues here in England.

When I planned this visit last spring, I expected the top agenda item for the international regulatory community to be the implementation of Basel II. But a lot has happened since then, so I have shifted the focus of my remarks today to discuss the current situation in the U.S. mortgage sector and what is happening in our credit markets. I will also speak about the U.S. regulatory response to these issues.

First, let me briefly familiarize you with the Office of Thrift Supervision, or OTS – an agency name which surely could have been invented by your very own Charles Dickens. The nature of the thrift industry and the OTS's role in the U.S. bank regulatory system is quite unique. At the OTS, we are charged with licensing and regulating thrifts and their holding companies. "Thrift" is a U.S. euphemism for "savings bank" and the roots of the thrift charter date back to 1831, when a group of townspeople met in a local tavern outside of Philadelphia to plan how to pool their money to accomplish together what they lacked the financial resources to do alone—buy their own homes. In doing so, they

established America's first savings association, the Oxford Provident Building Association, modeled after mutual building societies here in England.

The federal charter under which most thrifts currently operate stems from the American Great Depression. It was established to encourage saving as well as home lending. Over the years, the activities of thrift institutions expanded. Today, they operate similarly to traditional banks. They take deposits – insured by the FDIC – and they make all types of loans to their retail customers. Although thrifts are limited in their commercial lending, many retail-oriented commercial banks could structure their activities to operate as thrifts.

That said, our industry is still very much consumer focused – specializing in home mortgages, credit card lending, and other forms of consumer credit. For the most part, they are community banks with strong ties and affiliations to their customer base for funding and lending.

Some thrifts are regional, or even national, powerhouses in the retail lending space. Others are owned by large insurance, securities, and commercial firms and are deployed as key elements in their global financial services strategies. The charter we grant has many strengths, but certainly the ability to branch and do business seamlessly from coast to coast is key to the thrift charter's retail lending focus.

In addition to licensing and regulating these depository institutions, the OTS has supervisory authority over the companies that own them. This is a bit different from the bifurcated regulatory approach that applies to national banks, which are regulated by our sister agency the Office of the Comptroller of the Currency, and their holding companies, which are regulated by the Federal Reserve. Our streamlined, single regulator approach is appealing to our charter holders and is often of interest to international banks entering the U.S. market.

The OTS's role in supervising global holding companies such as General Electric, the AIG insurance company, American Express, Merrill Lynch, Morgan Stanley and Lehman Brothers brings us into regular contact with supervisors in Europe and Asia that regulate significant portions of our holding companies' businesses. These supervisory relationships are invaluable in helping us understand the companies' performance in overseas markets. They also provide opportunities to discuss best practices and refine and improve our supervision. The events of recent weeks and months remind us all of the close interplay between domestic and international capital flows and the importance of good regulatory coordination and cooperation.

Now I would like to turn to the credit markets to take a look at how the recent disruptions occurred, what the impact has been on financial institutions and what lessons we can learn from everything that has happened. This regulator's perspective is that of a former community banker, so you are going to see some history coming to the fore here. The capital markets provide a brutally efficient, self-correcting method for funding virtually

any legitimate business activity. In the case of U.S. mortgage lending, the markets financially engineered a mortgage pipeline leading from borrowers to ultimate investors. Regulation typically provides a mechanism to smooth out the capital market process, but when regulation is lacking, market self-correction is the only backstop. I believe turmoil in the recent U.S. mortgage markets is the direct result of not enough regulatory oversight in places where it was needed most.

The decline in involvement of regulated financial institutions in the mortgage funding process the past number of years had two results. First, it dramatically increased the available pool of liquidity, allowing mortgages to move from Main Street to Wall Street and beyond with remarkable efficiency. Generally, this is something we should want to encourage. U.S. home ownership approached 70 percent and credit became available to people who would not otherwise have been able to own their own homes.

For some time, the mortgage pipeline appeared to be producing good returns for investors; however, it was flawed by one important factor. Mortgage brokers driving the originations were largely unregulated and had no economic interest in the ultimate performance of the borrower. The result was that underwriting was determined not by risk assessment but by whatever would sell in the securitization markets. The bottom line dictated market activities. As a former community banker, this type of thinking is anathema to me and I imagine it is to you as well.

The efficiency of the pipeline led us further and further out on the credit spectrum. Commercial banks set up off-balance-sheet conduit facilities to raise more funding for the pipeline. New terms entered our vocabulary – alt-A, option ARMs, teaser rates. Innovative products that were invented at regulated financial institutions and closely monitored by regulators spread quickly to the unregulated marketplace and were modified and applied without an adequate understanding or oversight of the risks. This, in turn, furthered a housing boom in key markets like California, Florida and the American Southwest. U.S. buyers were suddenly able to afford the houses of their dreams at amazingly low initial payments and little or no documentation of income or employment.

The continuation of this boom depended on two key ingredients: the continued uninterrupted abundance of liquidity and the continued appreciation of housing prices. As adjustable-rate mortgage payments reset, borrowers would refinance into another short-term mortgage product or flip the house for a profit, and reinvest the proceeds into another place in the housing market.

This all worked fine until housing prices leveled off, and the 2004 and 2005 subprime loans began to reset. Borrowers with little equity and insufficient income had nowhere to go. Housing prices began to sag further – leading some borrowers to begin handing over the keys and walking away from their mortgages rather than make the higher payments. Finally, this spring and early summer, things began to unravel and the markets responded predictably – by pulling back and making matters worse. This was the direct response to

the struggles of investors to understand what they had bought – and borrowers suddenly confronted with a dramatically altered risk appetite for mortgage loans that were readily available less than a year ago.

The culmination of all of this activity was that the credit markets seized up. Despite the fact that almost 85 percent of subprime mortgages are performing on schedule, the appetite for that commercial paper disappeared almost overnight. Despite great loan-to-value ratios and strong borrower creditworthiness, the market for jumbo mortgages disappeared, further feeding the decline in the U.S. housing market. The disappearance of investors – and the resulting liquidity problems – forced the hand of central bankers to pump in liquidity, facilitate less-costly discount window borrowing, and shock the markets with reduced interest rates. The easing we have seen in recent weeks is encouraging. The appetite for commercial paper is returning, bond issuances are on the rise and, although fragile, things appear to be improving.

So let me step back a bit. What is the impact on the OTS and the institutions we regulate? We supervise 836 banks, with roughly \$1.5 trillion in assets. Further, we have about 450 holding companies with over \$8 trillion in assets. The overwhelming majority of these banks, by their very nature, have significant exposure to the mortgage markets and would – theoretically – have the most to lose from this sort of market disruption. You would be forgiven for assuming that many OTS-regulated institutions are barely holding on right now. And, rather than here giving a speech, you might be thinking I

should be home managing a crisis. After all, as I mentioned at the outset, our institutions are disproportionately exposed to the mortgage markets.

In fact, our industry is feeling the effects of recent events, but it is far from experiencing a crisis. The data we are receiving and information we are hearing from our examiners in the field point to an industry that is generally performing well given the market conditions. Capital levels were strong to begin with and remain high. Earnings are not what they were a year ago, but we are not experiencing widespread reductions in income levels. Our banks have access to diverse sources of funding, including broad deposit bases, advances from the U.S. Federal Home Loan Bank System, and liquidity from the ability to sell mortgage loans directly to the U.S. government sponsored housing enterprises, Fannie Mae and Freddie Mac. Another important factor is our institutions' specialized knowledge of their local markets and the deep roots in the communities they serve.

All this provides a degree of insulation to our regulated institutions from the recent volatility in the investor community. It positions them well to meet the credit needs of their communities and fill the gap left when the more exposed elements of the lending sector exit the market – either through bankruptcy or by choice.

What we have seen in the markets is an extreme liquidity event. Highly leveraged firms dependent on investor-driven funding streams are either no longer with us or are in

bailout status. Well capitalized banks with diversified balance sheets are weathering the storm.

Now that I have described the events of the last couple of months, I want to discuss the lessons that we can learn—or I should say, must learn—so we can prevent problems like this in the future.

What seems obvious now, as always, is that a conservative business model relying on solid underwriting, limited exposure to the risky ends of the market, and diversified funding sources is the key to navigating through turbulent times and turbulent markets. Yes, this is basic and perhaps a bit simplistic, but maybe it is not such a bad thing to go back to basics and stress some of the time-tested fundamentals of our business – rules that are universal whether you are in London or Washington, D.C.

One, diversification is always important – both on the asset and the liability side of your balance sheets. Mono-line businesses have greater exposure than diversified financial institutions, especially when you are dealing with the riskier ends of the credit spectrum.

Two, underwriting is fundamental. Bankers should never outsource their credit decisions to Wall Street or the investor community.

Three, transparency is paramount to the proper functioning of markets. Much of what we have seen recently is from market participants' lack of understanding of the value of their

current positions or potential investments. This shortage of reliable information is what causes investors to leave, or pull back, neither of which is helpful during a credit crunch. And just as transparency can protect the markets and calm investor fears, it also protects the banking system and individual institutions that may come under fire. In this regard, the role of a transparent federal deposit insurance system in the U.S. is a tremendously stabilizing force both for our insured depository institutions and our entire banking system.

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

I believe the last point may be the most important. I have heard comments from executives at federally regulated financial institutions that a level playing field does not currently exist in the mortgage lending market and I have to agree with them. There is a side of the mortgage market that is outside the reach of federal regulators, and in many cases also outside the reach of the states. The current U.S. supervisory structure provides minimal accountability for this segment of the market, thereby generating competitive pressure to try to play by less stringent rules.

This gap in regulatory oversight is gaining attention in Congress and in the news media. A Time magazine article at the end of August focused on fixing what the article called,

and I quote, “a porous patchwork of state oversight.” Two weeks later, a key member of Congress in financial matters, House Financial Services Committee Chairman Barney Frank of Massachusetts, wrote in an opinion article in the Boston Globe that, quote, “Mortgages made and sold in the unregulated sector led to the crisis.” And just three days later, the Congressional Research service, the research arm of the U.S. Congress, released a report again focusing on this gap and outlining possible solutions.

The point is very valid and one that could also apply to regulatory oversight internationally. As the financial marketplace becomes more global, financial regulators from all nations must work together to prevent regulatory gaps that could weaken the global financial system. This is equally applicable in the context of discussions on the global implementation of Basel II, international consistency in the application of accounting and auditing standards, and the application of consistent regulatory standards that minimize burden on internationally active corporations subject to regulatory oversight in numerous jurisdictions.

Those are my takeaways from the recent market challenges – based on our experience at the OTS and my own experience as a longtime community banker. I believe a return to the fundamentals is warranted in today’s market and perhaps a more wary eye cast in the future, by both market participants and regulators, toward the approaches that move us away from the safe and sound methods of good banking and good regulation.

Again, I appreciate your kindness in inviting me to speak today. I am happy to take your questions.