

***Remarks of John M. Reich, Director
Office of Thrift Supervision
to the New Jersey League of Community Bankers
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Good morning. I'm very pleased to be here with you on the 100th anniversary of the New Jersey League of Community Bankers. The banking industry has undergone tremendous change in the century since the founding of this organization and I'd like to congratulate the League for its continuing ability to serve its members over this long period of industry transformation. I also congratulate all of you, the member bankers and your predecessors who have served your communities' needs for the past century through booms and busts.

Today I'm going to take both a "look back" and a "look forward" at the housing and regulatory climate. In looking back, I'll address some of the factors that caused the current housing crisis, brought the U.S. economy to the edge of recession and plunged global financial markets into turmoil. I'll also talk about some of the important lessons we have learned from the troubles in the housing and financial markets.

In looking ahead, I'll suggest some ways we can avert a recurrence of the housing crisis. In particular I'll discuss the need to establish a level playing field with consistent regulation for all segments of the mortgage business. As part of that, I will propose expanding OTS authority to regulate mortgage bankers and brokers. I think it has become clear that we need federal oversight to ensure that mortgage banks and brokers compete by the same set of standards as insured depository institutions.

As we look back, we need to ask what happened during the past few years to bring about this crisis and what lessons we have learned. From 2000 to 2005, we saw runaway housing appreciation, with home prices in the U.S. increasing by an average of 57 percent and workers' average income going up by only 10 percent. This imbalance could not be sustained. The mismatch between income growth and home price appreciation made homes less affordable and led to the development of new and risky mortgage products. There is an old proverb that says "an empty purse and a new house make a man wise, but too late." As we all know, too many homeowners are now under water, owing more on their homes than the homes are worth.

There were clearly breakdowns in loan underwriting, inadequate risk management, ineffective disclosures to both borrowers and investors, and the expansion of former niche products to consumers who were poorly suited for them. These and other factors contributed to the significant challenges we are facing.

Bad events rarely occur by themselves; correlated risks surface unexpectedly. Although most economists initially predicted that the problems in the subprime market would be self-

contained, it did not take long before serious disruptions reached the broader credit markets and the securities industry. Reverberations also shook the global economy, where international investors had sought high yields in the lucrative US mortgage market.

Securitization proved to be a double-edged sword. On one hand, it provided more liquidity for mortgage lenders, spread the risk of mortgage lending and increased the supply of mortgage credit in the United States. On the other hand, the “originate to distribute” model prompted lenders to loosen their underwriting standards because they could pass on the elevated risks to investors at prices that did not truly reflect those risks.

Investors’ appetite for high-yielding subprime mortgage securities put pressure on the mortgage banking community to generate a high volume of mortgages without paying enough attention to quality. Additionally, the secondary market held insufficient liquidity in reserve against unanticipated losses. Huge losses among investment banks and other less regulated players in the mortgage market affected the financial system around the world.

By and large, community banks didn’t originate imprudent mortgages or engage in predatory practices. You continued to provide home mortgages responsibly to people in your neighborhoods and in the many towns and rural areas across this country.

But don't assume that the only losers are the ones who deserve it. Even well-run companies suffer if there is a severe shock to their markets. Many subprime and non-regulated lenders have ceased operations, but some thrifts, community banks and their holding companies have also encountered issues related to liquidity, asset quality, earnings and capital. Deterioration in the quality of mortgage credit, disruption in the secondary markets, and rapid decline in home prices have led to an increase in adverse ratings for some community banks and holding companies.

Both banks and thrifts are under heavy pressure. Margins are compressed, new deposits are increasingly hard to find, competition for loans is more intense, bank stock prices are falling, delinquencies are rising in many loan categories, charge-offs are increasing and regulators are focusing more intensely on credit quality and the adequacy of your response to deteriorating conditions.

That’s quite an imposing list, but the good news is that we have learned a number of lessons from our recent mortgage lending experiences.

First, underwriting was bad at some institutions and the entire international financial community had to re-learn what most community bankers have known all along: there is no substitute for sound underwriting of loans. Relying on stated income, basing a borrower’s ability to repay on a starter or teaser rate, assuming never-ending home price appreciation, or passing along credit risk to the secondary market are flawed strategies for the long run and the short run.

Innovative products, such as “interest only” and “pay-option ARM” loans, are perfectly appropriate for some borrowers, but they are certainly not for everyone. When they are used to put people in homes they cannot otherwise afford, the results are disastrous for borrowers and lenders alike.

The second lesson is that we need improved transparency for both borrowers and investors. Borrowers must receive an honest, simple and clear explanation of the terms and conditions of their mortgage contracts. Investors need more transparency about the true risks of potential investments and the credit rating agencies need to do a better job of rating those risks. Only then will there be a reliable and viable secondary mortgage market again. However, we cannot assume markets will return quickly, even after fundamental changes occur.

We have also learned there is much room for improvement in identifying and measuring risk. Managers who have operated in prolonged periods of positive results tend to underestimate the severity of emerging problems until they become fully evident.

Another lesson is that a proactive media and communications plan is a must. Negative information, even if untrue, is spread instantaneously and can lead to a loss in confidence. There is typically little recourse if short sellers, press, Internet bloggers, analysts or others make statements based on limited or incorrect information that causes an adverse impact.

A systemic lack of confidence can mean that funding sources and relationships that were stable and thought to be firm no longer are. After experiencing losses and declines in asset quality, financial institutions are finding that capital is difficult to obtain and extremely costly. Community banks and holding companies must find stable and diversified sources of funding at reasonable cost, while examiners must have a clear understanding of individual institutions’ liquidity needs. This can lead to more monitoring reports and regulatory review.

Insurers and regulators become ever more conservative during times of stress and deterioration. Regulators will require managers to improve modeling and to conduct stress scenarios that combine several related events, not simply a series of isolated events, to ensure that thrifts have robust contingency plans for liquidity.

Overall, I believe the thrift industry is fairly well positioned to weather the current storm, but we must improve our capacity to develop more diversified balance sheets and maintain adequate loan loss reserves. I am encouraging CEO’s to be aggressive in provisioning for loan losses and building loan loss reserves.

The most important lesson, perhaps, is the need for all mortgage originators to be subject to the same rules and regulatory scrutiny. Mortgage brokers and mortgage banks are largely regulated at the state level and are generally subject to somewhat less and certainly more inconsistent regulation than banks and thrifts. In short, a level playing field simply does not exist.

Looking ahead, we must devise ways to address the underlying weakness in the mortgage market and in our regulatory regime. We must establish a level playing field with the same rules for all competitors in the home mortgage sector, so standards do not fall to the lowest common denominator. All entities that originate home loans should be required to comply with basic credit principles, such as a reasonable assessment of the borrowers' ability to repay.

Players in the capital markets and unregulated lenders must also come under adequate regulation and must hold ample capital to absorb unexpected losses. Depository institutions are required by regulation to hold a significant amount of capital, while unregulated lenders without such requirements have been highly leveraged. Some of them went under, or had to be rescued during the recent mortgage crisis.

An argument can be made that if bank-like regulation had applied to home mortgage lenders of all stripes, the barrage of subprime lending and the intensity of the current crisis could have been prevented. Federally-insured depository institutions were held to a higher standard of underwriting, transparency, and capital to withstand losses when home prices inevitably turned south and the market began to unravel.

Now that we have seen the impact of largely unchecked lending by unregulated and loosely regulated firms, the federal government is forming strategies for improving regulation of the financial markets. In this regard, it is proposed by Treasury that the OTS Director will serve on the President's Working Group on Financial Markets to participate in the evaluation and debate of Treasury's proposed far-reaching realignment of financial services regulation in the U.S. Members of Congress also recognize the need for stricter regulation of certain financial players, particularly unlicensed and lightly regulated mortgage brokers and mortgage companies. A bill by House Financial Services Committee Chairman Barney Frank, which has passed the full House, would establish a system for registering and licensing mortgage brokers and other non-federally supervised originators. Separately, Senate Banking Committee Chairman Dodd's bill, which recently passed out of Committee, sets up a similar system.

I agree that filling the gaps where regulation is insufficient or nonexistent must be an immediate short-term priority. As head of the regulatory agency that oversees most of the federally-insured home mortgage lenders in the U.S., I believe the keys to success for our industry include having strong management, a strong board and a strong regulator. I intend for OTS to be a strong regulator.

Federal oversight of the entities that fund the mortgage process is crucial. Establishing a partnership between the states and a federal regulator to set and enforce minimum mortgage funding standards would ensure accountability, consistency and transparency throughout the mortgage lending process. This partnership could be similar to the current one between the FDIC and state banking commissioners in overseeing state-chartered banks. This change need

not involve establishing a federal mortgage banking charter, but rather institute federal-state cooperation to regulate these entities consistently and ensure nationwide uniformity.

Selecting a strong regulator to monitor this new level playing field is critical for protecting consumers and avoiding another mortgage market meltdown. The OTS has the most extensive expertise of any regulatory agency in the oversight and supervision of mortgage banking operations and I believe the OTS is in the best position to assume federal authority to regulate the currently unregulated players in mortgage banking.

OTS has a solid budget, healthy reserves and a growing workforce to take on this challenge. We employ more than 1,000 people, having increased our staff by about 15 percent since I took office in August 2005. Our staff has vast experience relevant to the home mortgage business. Our regulatory approach focuses on maintaining a safe, sound and thriving mortgage lending industry and protecting consumers who rely on our institutions to fill their financial services needs. We strive to achieve those goals without unnecessary burden on the industry. We believe that the private sector must be allowed to innovate, compete and prosper—but without harming consumers.

At the OTS, we have begun to study the best ways to implement a new regulatory system that would provide us the authority to supervise currently unregulated mortgage banking entities. We plan to complete our own regulatory blueprint later this year.

The next 100 years will bring many challenges we can't anticipate today. But we can learn from our past mistakes and strive not to repeat them. As long as you and your colleagues continue to dedicate your time and energy to your customers and local communities, I am confident that community banks will not only continue to exist but will thrive. Rest assured that as a former community banker, I will continue to do everything in my power to support community banking in America.

Thank you very much.