



***Remarks of John E. Bowman, Acting Director
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At the 21st Special Seminar on International Finance
Continuity and Change Management - The "New Normal" in Banking
Tokyo, Japan
November 17, 2010***

Thank you, Mr. Matsushima, for that gracious introduction. I would also like to thank Nikkin, the Japan Financial News Company, for sponsoring this seminar and for extending the generous invitation for me to join you today. This is my first trip to Japan and I have been looking forward to my visit with great anticipation. I am very happy to be with you in your beautiful country.

As you know, the theme for this seminar is *Continuity and Change Management - The "New Normal" in Banking*. In my remarks today, I would like to talk about change, which has become the “new normal” for the financial services industry in the United States.

In the last few years, change has been constant at the agency that I lead, the Office of Thrift Supervision, a federal banking regulator that is part of the U.S. Department of the Treasury. I can say without hesitation that I have become very familiar with change in financial services regulation. I am pleased to share with you some insights on past events and what I expect for the future.

The Office of Thrift Supervision, or the OTS, has been in existence only since 1989. However, the birth of the industry that our agency regulates dates to 1831, when leaders of a town near Philadelphia met in a local tavern to discuss how town residents could pool their money to help each other purchase their own homes. This meeting led to the establishment of the nation’s first savings association, the Oxford Provident Building Association. This association had key characteristics that remain at the heart of the thrift industry today – fulfilling the American dream of homeownership and focusing on the financial needs of the local community.

From my understanding of the banking system here in Japan, these early savings associations, which were typically formed by people who lived in the same neighborhoods or worked in the same factories, had some similarities to Japanese cooperative financial institutions, such as labor banks.

The U.S. thrift industry thrived during the decade of the 1920s, when Americans flocked to the cities from farms and small towns across the United States, driving up the demand for housing, spurring industrial growth and bringing an increase in the number of savings associations to about 12,000. These institutions were known by various names, including savings and loans, thrifts, savings banks and savings associations.

The Great Depression of the 1930s took a huge toll on the financial services sector and, in making post-Depression reforms, the U.S. Congress established a federal charter for savings associations. The thrift industry rebounded in the years after the Depression and, by the 1950s and 1960s, sprawling suburban communities had emerged outside cities across America. Thrift institutions provided mortgages for many of the homes in those suburbs.

At that time, thrifts originated two-thirds of the country's home mortgages. Their business model was a simple one: receive a rate of interest from mortgage loans higher than the interest paid to depositors. This is somewhat jokingly known as the 3-6-3 model – paying 3 percent interest to depositors, receiving 6 percent interest from borrowers and being on the golf course by 3 o'clock in the afternoon.

In the late 1970s and early 1980s, the thrift industry's business model was undermined by competition for depositors, combined with sharp increases in interest rates. After the government tried to help the industry "grow" out of its problems by allowing thrifts to expand beyond their core businesses, some institutions engaged in risky practices that led to the savings-and-loan crisis of the late 1980s and early 1990s. Hundreds of institutions failed.

The Office of Thrift Supervision was born out of this crisis, but as I stand before you today, the U.S. government is in the process of implementing a new financial regulatory structure and the agency that I lead will be eliminated.

The OTS is nearing its end for several reasons, including a desire by U.S. leaders to show a response to the economic crisis. Other reasons developed over time as the industry changed. Although the health of the thrift industry stabilized in the 1990s, consolidation brought a decline in the number of all types of financial institutions through the decade and into the 2000s. You may recall that I said there were about 12,000 savings associations, or thrifts, in the 1920s. Today, there are about 750.

Not only have thrifts declined significantly in number, but thrifts and national banks have become more alike over the years. Banks have taken a larger share of the home mortgage market and thrifts have branched into other areas of banking beyond home mortgages. By the middle of 2007, thrifts were originating less than a quarter of the nation's home mortgages and, as a hedge against the dangers of concentration risk, they were making more commercial loans and small business loans. However, the thrift charter still required that thrifts maintain at least 60 percent of their assets in home mortgages and other types of consumer retail lending, including credit cards.

This was the state of the industry when the economic storm that has become known as the Great Recession hit the United States and much of the rest of the world.

It is not surprising that this storm would strike the thrift industry with such savage force because, as I mentioned, thrifts traditionally specialize in making mortgage loans. Homeownership is a bedrock of communities across America and we at the OTS are proud of the agency's history of regulating this important financial services sector. However, the recession in America had its beginnings in the housing market. As a result, the recession dealt a severe blow to the thrift industry.

Economic storm clouds began to gather in the U.S. in 2006 and early 2007, as home prices skyrocketed, the nation's homeownership level reached record heights and mortgage underwriting – the due diligence that banks and non-bank mortgage companies perform to ensure that borrowers are able to repay their loans – grew weak.

The storm began in earnest in August 2007, when the private secondary mortgage market collapsed. Up until that time, the business of some financial institutions such as IndyMac Bank in California depended on originating mortgage loans and selling them to investors in the secondary market. When the secondary market collapsed, that type of business model collapsed with it. IndyMac tried to reinvent itself but could not. I will never forget the day – July 11, 2008 – when IndyMac failed with assets of \$32 billion.

Since then, more than 40 other thrift institutions have failed. Among them was the country's largest thrift – Washington Mutual – which toppled in September 2008 with assets of more than \$300 billion.

Of course, the OTS was not the only federal banking regulator to supervise financial institutions that failed during the crisis. Since the IndyMac failure, about 300 U.S. financial institutions have failed, including state-chartered banks and national banks. And institutions much larger than Washington Mutual — for example, Citigroup and Bank of America — collapsed. However, the federal government deemed these larger institutions too big to fail and provided open bank assistance to prevent their failures. As I have said in the past, the OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were *allowed to fail*.

I think it is notable that more traditional thrift institutions in cities, towns and rural areas around the country generally have weathered the economic storm quite well. These are institutions that stuck to their traditional ideals of lending to local families and businesses, many of whom the bank managers know by name. These bankers resisted the temptation to open loan offices outside their areas of expertise, in what were “hot” real estate markets in 2005 and 2006 – states such as Nevada, California, Arizona and Florida that have been at the eye of the storm.

These successful bankers have also resisted the temptation to loosen their mortgage underwriting standards and they refused to make option adjustable rate mortgages available to families that could afford only to repay their loans until their low introductory “teaser” interest rates expired.

In short, most of the more traditional thrift managers survived, or even thrived, while other institutions failed, or are struggling to survive under the weight of delinquent loans.

For the OTS, the beginning of the end came in March 2008, when the Treasury Department issued a blueprint for U.S. financial services regulation that called for the OTS and the thrift charter to be phased out of existence.

At the time, a top treasury official gave a speech explaining the logic for the blueprint. Here is what he said: "If we were starting from scratch, no one would choose to design today's system. Nor is it a system we would design in order to ensure that the United States remains the global leader in financial services. Our current regulatory framework has been largely knit together over the last 75 years – with Act on top of Act, initiative on top of initiative – each a reaction to various crises or innovations in the financial services industry. Today we have a series of individual regulations, each designed in response to specific circumstances and lacking an overarching set of guiding principles. Our system has multiple federal and state regulators with unclear and sometimes overlapping boundaries."

I think it is instructive to view those words in light of the new U.S. financial services framework mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law on July 21 of this year. Have we succeeded in designing a regulatory structure for the 21st Century, or have we ended up with a system that is politically feasible, rather than truly optimal? My conclusion is that, like any result of compromise, the new structure is not necessarily the ideal structure, it is merely the structure that was able to muster enough votes to pass through the legislative process.

Of course, the blueprint of 2008 – issued in the final year of the Bush Administration – never became law. However, President Obama took up the call for regulatory restructuring shortly after taking office in 2009. In June of that year, the Obama Administration released its Financial Regulatory Reform plan, calling for the elimination of the thrift charter and the establishment of a new federal banking regulator, formed through the merger of the OTS and the Office of the Comptroller of the Currency, or OCC. The OCC regulates national banks, including the largest U.S. banks, which issue not only mortgages and credit cards but also, unlike thrifts, can engage in unlimited commercial lending.

During the debate over the proposal, the OTS agreed that reform was essential. For example, companies should never be too big and too interconnected to fail, and the government should never award an invaluable, implicit guarantee granting any company an unfair advantage over competitors. The too-big-to-fail syndrome warps the system of proper risks, rewards and consequences underpinning the financial system and the economy.

It is also unacceptable for financial institutions to engage in the trading of opaque and complex derivatives outside the scope of federal regulation.

Nor is it acceptable for any provider of home mortgages or other financial products to escape the reach of nationwide consumer protection rules that apply to others offering the same products.

Although the OTS supported the creation of a new agency to write uniform nationwide rules to protect consumers, the Dodd-Frank law went further and empowered the new agency to enforce those rules for large financial institutions.

The OTS also took the position that consolidating financial regulatory agencies would not solve the problems that caused the current financial crisis – and might cause such a crisis in the future.

One argument often cited in favor of consolidation was that banks engaged in so-called “regulator shopping” and would switch their banking charters in favor of a charter issued by the most lenient regulator. OTS critics contended that the OTS was a lax regulator. However, I and other OTS officials noted that banks were not flocking to OTS supervision. In fact, more financial institutions – and more assets – have converted *away* from OTS supervision in the last 10 years than have converted *to* OTS supervision.

Although the Dodd-Frank law eliminates one regulator – the OTS – the law leaves plenty of opportunity for regulator shopping among the 50 states and between federal and state banking charters.

The OTS favored a different approach to reform – a regulatory framework with two types of federal banking charters, one for complex commercial banks and one for community banks. The thousands of community banks in the U.S. have almost nothing in common with megabanks like Bank of America, JPMorgan, Wells Fargo and Citigroup. Nor do they have anything in common with the large, complex commercial banks that have not yet grown to megabank proportions. The vast differences involve not only scale, but also complexity, risk management, lines of business and daily operations.

The OTS was concerned that, if community banks were supervised by the same agency overseeing complex commercial banks, the one-size-fits-all regulator would, by necessity, pay the greatest attention to the complex commercial banks, because they posed the greatest potential risks to the financial system. As a result, community banks would receive “afterthought” supervision, rather than a regulatory approach tailored to their unique business model. With the enactment of the Dodd-Frank Act, this concern remains.

During the legislative debate, Congress considered – but did not adopt – a proposal to consolidate all of the federal banking agencies into a single financial services regulator, such as the one in Great Britain and your own Financial Services Agency here in Japan.

In the final version of the law, the OTS will be eliminated and will merge *into* the Office of the Comptroller of the Currency, presenting an historic opportunity to take the best systems, talent and leadership of both agencies to forge a new OCC. Time will tell whether we will seize this opportunity and make the most of it.

Of course, the Dodd-Frank law and the aftermath of the Great Recession will have a profound impact that extends far beyond the impact on the OTS. Opponents of the law express concern about its unintended consequences and there will surely be some of those, but there will also be intended consequences felt by the larger financial services industry in the U.S. and across the world.

The law made significant changes to address the “too-big-to-fail” phenomenon and changes to regulate systemic risk are already taking hold. The law will also unleash a torrent of new regulations. U.S. banks and thrifts are bracing for more than 200 of them and community bank executives are rightly wondering how they will be able to summon the resources to comply.

Financial institutions worldwide are also bracing for the impact of Basel III and potential changes in standards for bank capital and liquidity.

Taken as a whole, the changes on the horizon are a daunting source of uncertainty for the financial services sector and their customers.

As I mentioned earlier, the OTS certainly supports addressing “too-big-to-fail,” bringing transparency to opaque derivative products and providing consistent, uniform regulation of nonbanks that provide financial products to consumers. However, I can also understand the apprehension of the financial services industry about what the future will hold.

For the thrift industry in the U.S., there is an additional layer of anxiety and uncertainty about what the future will be like without a dedicated thrift industry regulator. In a compromise adopted under the new law, the federal thrift charter is preserved. So, will the thrift industry prosper under the supervision of the OCC? States are strongly arguing otherwise and are trying to persuade thrift managers to change charters to become state-chartered banks. Only time will tell how many OTS-regulated thrifts choose state supervision over the OCC, or decide to stay with the OCC, but eventually abandon their thrift charters in favor of national bank charters.

In any case, I wonder what the future holds for the industry that has promoted home ownership in the U.S. since 1831. Before the Dodd-Frank Act, the thrift charter had three unique benefits:

1. **Branching** capability nationwide, without restriction or condition, under a single charter;
2. **Preemption** authority, with federal law superseding state and local laws on lending and deposit taking; and,
3. **Consolidated supervision**, with the OTS supervising not only thrifts but also their holding companies.

The Dodd-Frank law eroded those three benefits, while retaining the charter’s limitations on commercial lending and loans to small businesses. The law provided uniform branching capability for banks as well as thrifts, weakened preemption authority and put an end to consolidated supervision by transferring responsibility for regulating thrift holding companies to the Federal Reserve.

So, with the benefits of the thrift charter significantly decreased and its limitations retained, how attractive will the charter be for today’s financial services enterprises? Again, only time will tell.

Meanwhile, at the OTS, we are busy figuring out how to help build the nation’s new financial regulatory framework by transferring our functions and employees to other bank regulators, while continuing to perform our mission of supervising the thrift industry until next July.

The situation is a little bit like riding in a row boat and trying to get into another rowboat without ending up in the water. Right now, I feel like I have one foot in one boat and the other foot in the other boat. But as I said earlier, I am something of an authority on change, so I am starting to get used to it.

Thanks again to all of you and to Nikkin for your wonderful hospitality and for your attention today. I look forward to responding to any questions you may have.