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Statement of

**John M. Reich, Director
Office of Thrift Supervision**

**Oversight Hearing
on the
Office of Thrift Supervision**

before the

Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
U.S. House of Representatives

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Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

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**STATEMENT OF JOHN M. REICH
DIRECTOR, OFFICE OF THRIFT SUPERVISION**

**OVERSIGHT HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

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I. Introduction

Good morning, Chairwoman Kelly, Congressman Gutierrez, and members of the Subcommittee. Thank you for the opportunity to testify at today's oversight hearing on the Office of Thrift Supervision (OTS). It is my pleasure to report on an agency that has established itself as a multi-skilled and versatile regulator of insured depository institutions and their holding companies; and a thrift industry that is strong, growing in asset size, and evolving to meet the housing and retail credit needs of American communities.

The OTS has met many challenges since its inception in 1989. First and foremost, the agency has developed and continually improved its supervision and oversight of the savings institutions and holding companies that we regulate. During the course of the last 17 years, the OTS has worked closely with the industry to maintain the profitability, integrity and viability of the thrift charter. At the same time, the industry has changed dramatically to adapt to the evolving nature of the financial services business and the demands of its customers. While mortgage lending remains the dominant business activity of the industry, it is no longer the exclusive activity of the industry, nor should it be. As we have seen in the past, overexposure to one part of the economy without the benefit of some diversification creates risks that can lead to further risk-taking and problems with safety and soundness.

A favorable interest rate risk environment, accompanied by record mortgage originations and sales, has produced strong profitability for the thrift industry for the past five years. Equally important to this sustained period of profitability are good stewardship by thrift managers, earnings diversification, and good asset quality. Statutory and regulatory reforms, including comprehensive capital standards, stronger corporate governance controls, uniform standards for lending, operations and asset growth, and prompt corrective action (PCA) requirements have also significantly

strengthened our banking system. In addition, the banking agencies have been effective in keeping pace with changes in the institutions we regulate.

For its part, the OTS continually works to provide specialized training, rigorous accreditation and professional development programs, and other supervisory tools to our staff to ensure that we are capably equipped to supervise a dynamic and growing industry. In addition, our employees are of long tenure and well-seasoned with an average of more than 15 years of OTS experience, and more than 23 years of overall bank regulatory experience.

In my testimony, today, I will review the current financial condition of the thrift industry, address the evolving nature of the industry, and review the major risks and obstacles facing the industry in the foreseeable future. I will conclude my testimony by reporting to you on the health of the OTS and on our regulatory and supervisory focus and strategies to address the risks and obstacles we see on the horizon for the industry.

II. Regulatory Burden Relief

Before getting into the details on oversight of the industry and agency, I want to commend the Members for their hard work on passage of H.R. 3505, the “Financial Services Regulatory Relief Act of 2005,” which includes many important regulatory relief initiatives. The Senate Banking Committee also recently voted out of Committee its version of regulatory burden relief legislation, the “Financial Services Regulatory Relief Act of 2006.” I am hopeful that the full Senate will act quickly to pass that bill, so that regulatory relief legislation can be enacted this year.

Both the House and Senate bills include many important regulatory relief provisions. Although the Senate bill does not include several provisions that we believe are important for the thrift industry, it includes many important provisions that will improve the competitiveness of our nation’s banking industry, particularly community-based banks and thrifts that help form the backbone of our local communities. In particular, both bills remove the disparate treatment of thrifts under the federal securities laws. This provision would provide thrifts the same exemptions as banks from registration as investment advisers and broker-dealers under the federal securities laws. We strongly believe the existing inequity—which exists not under the relevant banking laws, but instead under what should be charter-neutral federal securities laws—undermines our efforts to maintain a strong and competitive banking system.

Another important legislative priority in H.R. 3505 is an amendment revising statutory limitations on the ability of federal savings associations to meet the small

business and other commercial lending needs of their communities by providing businesses greater choice and flexibility for their credit needs. The Home Owners' Loan Act (HOLA) currently caps the aggregate amount of loans for commercial purposes at 20 percent of a savings association's assets. Commercial loans in excess of 10 percent of assets must be in small business loans. OTS supports section 212 of H.R. 3505, which removes the current limit on small business lending and increases the cap on other commercial lending from 10 percent to 20 percent of assets.

This change is important for several reasons. First, it will give savings associations greater flexibility and promote safety and soundness through diversification. Additional flexibility, particularly in small business lending, will provide opportunities to counter the undulations of a cyclical mortgage market. This will enable savings association managers to continue to meet their ongoing customers' mortgage and consumer lending needs while providing additional resources to manage their institutions safely and soundly. In addition, some savings associations are at or near the current statutory limits and must curtail otherwise safe and sound business lending programs. Finally, this proposal will enable savings associations that have a retail lending focus to be able to achieve the economies of scale necessary to engage in this activity safely and profitably. We encourage you to support this amendment if you have the opportunity to do so in conference.

While we recognize that some provisions that we support may not get enacted in regulatory relief legislation this year, my greater concern is having no regulatory burden relief legislation enacted. I have testified and spoken many times regarding the impact of regulatory burden on our nation's banks, particularly our community banks. 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.

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.

To those who say let market forces determine the future of community banking, my response is that our industry is not a free market. It is a highly regulated market and this fact is having great influence on the bottom line and market behavior of many community banks. Regulatory forces that unduly impact industry

competitiveness are not good for institutions of any size when they skew market forces; and that is what we are faced with today.

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. When community banks are absorbed by larger non-local competitors, I have seen firsthand what usually results. The absorbed banks lose their personal touch and their communities lose the leadership previously provided by senior bank officers and their directors who are business owners with vested interests in their communities.

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.

Ten years ago, Congress enacted the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), which required the federal regulators to review all of their regulations in an effort to reduce regulatory burden on the industry. We have taken this mandate seriously and are approaching the conclusion of our effort in the next few months. I fear all of this work may be for naught if a regulatory relief bill is not enacted this year.

When this project began in June of 2003, we began to increase awareness of the burden issues facing both large and small banks. We worked with the other banking agencies to publish more than 125 regulations for comment, and received more than 1,000 comment letters with suggestions for change. We held 16 banker and consumer group outreach sessions around the country, have given numerous speeches, offered testimony on the subject to you and your colleagues in the Senate, and I have also met with some of you to discuss the importance of this issue.

In addition to building awareness on this issue, we have worked to reduce burden where we can; that is, where we already have the authority to act. Along with the other federal banking agencies, we have simplified application and reporting requirements, streamlined examination processes, and made other changes to our regulations and internal procedures to reduce burden. And every new regulation, process, or procedure today includes a discussion among the Federal Financial Institutions Examination Council (FFIEC) principals about burden and how to accomplish regulatory objectives while minimizing regulatory burdens.

This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of provisions included in both the House and Senate bills is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. I believe we have a limited window of opportunity this year to move forward on regulatory relief legislation. It is my hope this issue will be addressed before too many more of our community banks disappear from the landscape.

III. Condition of the Thrift Industry

As of March 31, 2006, there were 856 OTS-regulated thrifts, holding assets of \$1.5 trillion. While financial services consolidation has reduced the overall number of savings institutions, industry asset growth remains strong. This is due to growth within existing thrifts and to the fact that various financial institutions continue to choose the thrift charter because of the advantages it provides in the delivery of financial services.

As of the first quarter 2006, OTS also regulated 481 thrift holding company structures with consolidated assets of approximately \$7.5 trillion. As the only consolidated federal regulator both chartering the depository institutions and overseeing their holding companies, OTS has a unique supervisory role. This provides us with the opportunity to monitor and regulate all aspects of the institution's operations and holding company activities. The holding companies we oversee are quite diverse, ranging from large, multinational corporations to small companies with few assets other than their thrift charter.

The demographics of savings associations are also diverse. While numerous larger thrifts provide financial products and services nationwide or across sizable regional markets, most thrifts are generally smaller, community-based organizations that provide retail financial services in their local markets. As of March 31, 2006, 63 percent of thrifts had assets of less than \$250 million. Although small, these institutions reach into many small American towns fortunate to have the option of a local community banker.

Thrifts provide substantial services that encourage home ownership and affordable housing, and contribute to economic growth. Thrifts hold over \$1 trillion in housing-related loans and securities, including \$847 billion in whole single-family loans, which comprise 57 percent of total thrift assets. In addition, the industry maintains approximately 84 million insured deposit accounts. As described later in my statement, thrifts compete effectively with other financial services providers to deliver a wide range of products and services to American consumers.

Thrifts utilize the secondary market effectively, selling approximately \$599 billion in single-family mortgage loans to Fannie, Freddie, and other secondary mortgage market participants in 2005, and another \$135 billion in the first quarter 2006. In addition, as of March 31, 2006, the Federal Home Loan Banks advanced \$270 billion to thrift institutions, funding 18 percent of thrift assets.

A. Earnings and Profitability

Recent earnings and profitability of the thrift industry have been strong, with consecutive annual records in each year 2001 through 2005. For 2005, the industry reported record earnings of \$16.4 billion, eclipsing the prior record of \$14.0 billion in 2004.

The industry has posted quarterly earnings exceeding \$4 billion in each of the most recent five quarters, including a quarterly earnings record of \$4.3 billion in the fourth quarter 2005. First quarter 2006 earnings were \$4.2 billion, down slightly from the record earnings, but higher than earnings of \$4 billion in the same quarter one year ago.

The industry's annual return on average assets (ROA), a key measure of profitability, was 1.19 percent for 2005, up from 1.17 percent in 2004, but down from the record 1.29 percent posted in 2003. Industry ROA has exceeded one percent for the past five consecutive years, a feat not seen since the mid-1950s. ROA for the first quarter 2006 was 1.14 percent.

While the historic level of thrift earnings is partially attributable to strong loan origination and sales volume, the underlying strength and stability of thrift earnings has also been driven by diversification of income sources and continued strong asset quality. The industry's success over the past decade in expanding its line of products and services, such as mutual fund and annuity sales, trust activities, and transaction accounts, has enabled it to diversify its income stream and generate more stable earnings. Income from these activities measured 1.10 percent of average assets for 2005, up more than 500 percent from 0.17 percent in 1990. Together with improved risk management techniques, higher proportions of non-interest income have helped stabilize thrift income and provide better insulation against interest rate fluctuations.

The thrift industry was an active participant in the nation's recent refinancing boom and home ownership expansion. Thrifts originated over \$656 billion in single-family mortgages in 2005, accounting for one in every four mortgages made in the U.S. for this time period. Income from mortgage lending, loan servicing, and other mortgage banking activities helped boost recent earnings, and represented 0.63 percent of average assets in 2005 compared to 0.44 percent in 1990.

We anticipate that mortgage loan refinancing and overall mortgage lending activity will decline from the current high levels if interest rates continue to rise. Slowing loan demand will likely affect earnings, at least in the short-term. Although interest rate risk is not an immediate threat for thrift institutions, OTS continues to monitor the industry for changes in interest rate risk.

B. Asset Quality

Key measures of asset quality problems, including delinquency rates and troubled asset ratios, remain at or near historical lows. The ratio of troubled assets (noncurrent loans and repossessed assets) to total assets, was 0.64 percent at the end of the first quarter, unchanged from the prior quarter. Accounting and regulatory reporting changes for banks and thrifts now require loans repurchased or eligible for repurchase from Government National Mortgage Association (GNMA) mortgage pools to be included in past due loans.¹ Excluding these repurchased GNMA loans, troubled assets were 0.47 percent in the first quarter, up slightly from 0.44 percent in the prior quarter, but level with the comparable year ago quarter. Troubled assets peaked at 3.8 percent of industry assets in 1990, and have since declined steadily to the present level. Similarly, the volume of troubled assets peaked at \$39.1 billion in 1990, while standing at \$9.6 billion at the end of the first quarter 2006.

Noncurrent loan ratios (loans over 89 days past due or in nonaccrual status) fell to 0.57 percent of assets in the first quarter, down from 0.59 percent in the prior quarter. Excluding GNMA repurchased loans, first quarter noncurrent loans were 0.40 percent of assets, up slightly from 0.39 percent in the prior quarter, but down from 0.41 percent at the end the first quarter one year ago.

Another measure of asset quality, the ratio of net charge-offs to total assets, has been trending down for several years. That ratio peaked in 1993 at 0.61 percent. For the first quarter 2006, the charge-off ratio (annualized) was 0.17 percent, 0.22 percent for 2005, and 0.24 percent for 2004.

Though asset quality remains very strong, OTS is closely monitoring thrift loan performance since recently originated – or “unseasoned” – loans now comprise a significant proportion of thrift loan portfolios. These loans have been originated and underwritten during very good economic times and have not been stressed through different economic cycles, including a rising rate environment. Moreover, newer loan

1. GNMA mortgage-backed securities are fully guaranteed by the U.S. Government. Individual loans repurchased from GNMA pools are fully or partially guaranteed or insured by agencies of the U.S. Government.

types such as interest-only mortgages and adjustable-rate mortgages with flexible payment options, are being given close supervisory scrutiny, especially those loans made to borrowers with weaker credit capacities.

C. Capital

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. At the end of the first quarter 2006, over 99 percent of the industry exceeded well-capitalized standards, and no thrift was less than adequately capitalized. Equity capital at the end of the first quarter was 9.36 percent of assets, up from 9.18 percent in the first quarter one year ago, but down from the record 9.45 percent at the end of 2005.

D. Funding Sources

Retail deposit growth at thrift institutions has increased recently, increasing at an annual rate of 10.3 percent from March 2004 to March 2006. The recent rise in deposit account demand was attributable to rising rates paid on deposits. In comparison, retail deposit growth was much lower (2.8 percent) in the two-year period March 2003 to March 2005. Despite this recent increase, retail deposits as a source of funds are down from levels seen in years past. Total deposits and escrows at the end of the first quarter 2006 were \$867 billion, accounting for 58 percent of the industry's total sources of funds (versus 67 percent for commercial banks). As recently as June 2003, deposits accounted for 62 percent of total thrift funding sources.

Federal Home Loan Bank (FHLB) advances have been an important source of incremental funding for thrifts, accounting for 18 percent of total funding sources at the end of the first quarter 2006. Other borrowings funded 13 percent of total assets at the end of the first quarter.

E. Problem Thrifts

As the thrift industry continued to perform at or near record levels, the number of problem thrifts has remained at a low level. At the end of the first quarter 2006, problem thrifts – those with composite examination ratings of 4 or 5 – declined to 6 from 7 in the prior quarter and 8 one year ago. Assets of problem thrifts were \$1.1 billion at the end of the first quarter, down from \$1.9 billion in the prior quarter and \$1.6 billion one year ago. One OTS-regulated institution, holding assets of less than \$15 million, failed in the last three years.

Thrifts with composite ratings of 3 declined to 44 at the end of the first quarter from 45 in the prior quarter and 53 one year ago. Thrifts with composite ratings of 3 exhibit some weaknesses that may range from moderate to severe in one or more of the ratings components. These institutions are more vulnerable to adverse conditions and require more supervisory attention. All of the 3-rated thrifts at the end of the first quarter were well-capitalized, providing them with some degree of cushion to work through their problems.

Supervisory attention is also focused on concerns identified at institutions in the areas of Compliance, Community Reinvestment Act (CRA), and Information Technology (IT). At March 31, 2006, there were 60 thrifts rated “3” or below in Compliance, including three thrifts with “4” ratings. Five thrifts were rated less than satisfactory in their CRA examinations. Reflecting the rapid changes in technology, focus on privacy and security concerns, and increased demand for technological expertise, no thrifts were rated “4” or “5” on their IT exam, and 25 thrifts were assigned “3” ratings. In all cases, we initiated prompt supervisory strategies to effect management corrective actions to address areas of concern. The vast majority of OTS regulated institutions are in compliance for CRA and IT.

IV. Evolving Role of the Thrift Industry

A. Unique Characteristics of the Thrift Charter

The thrift charter has several unique characteristics that make it particularly well suited for retail banking. These include nationwide branching under a single charter; a holding company structure offering a single regulator for the holding company and its subsidiary depository institution; and preemption authority that is unsurpassed. These features enable savings associations to follow their customer base and the growth of their business from coast to coast with minimal regulatory burden. And seamless supervision at all levels of an organization ensures both a comprehensive supervisory regime and minimal regulatory overlap.

The charter is deployed in neighborhood community banks all across America. It is also used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerates involved in a wide array of diverse businesses – to name just a few. These organizations have all come to the thrift charter at different times and for reasons as diverse as their underlying businesses and the markets they serve. And the facts bear out that it has been a profitable decision.

B. Community Lenders with Residential Focus

While thrifts provide a wide variety of loan products, including consumer and commercial loans, they continue to focus primarily on residential mortgage lending. Thrifts originated approximately 24 percent of all single-family mortgage loans made in the United States in 2005. Thrifts are major originators of adjustable rate mortgage (ARM) loans. In 2005, more than one-third (36 percent) of all new ARMs were originated by thrifts.²

In addition to originating \$656 billion in single-family mortgages in 2005, the second highest annual volume on record, exceeded only by the \$730 billion originated in 2003, thrifts originated an additional \$143 billion in single-family mortgages during the first quarter of 2006, representing about one-in-four mortgages made in the United States. Since 2000, the thrift industry has originated \$3 trillion in single-family home loans, which, at an average home value of \$200,000, represents 15 million homes in America. Single-family mortgage loans and related securities comprised about 68.3 percent of thrift assets at the close of the first quarter 2006. Thrifts are also active lenders for multifamily lending. In 2005, thrifts originated \$20.6 billion in multifamily mortgages, and an additional \$4.5 billion in the first quarter of 2006. At the end of the first quarter, thrifts held in portfolio \$66.7 billion, or 4.4 percent of their assets, in multifamily mortgage loans. This brings the percentage of assets held in residential-related loans and securities to 72.7 percent.

Thrifts also provide vital services to other segments of their communities by making commercial real estate loans to hospitals, nursing homes, farms, churches and stores, and on other commercial properties. Such loans comprised 3.7 percent of thrifts' assets at the end of the first quarter.

While thrifts continue to focus on mortgage lending, they have steadily expanded their product offerings in the areas of consumer and commercial business lending. The industry's ratio of consumer loans-to-assets was 5.7 percent at the end of the first quarter, up from 3.8 percent at the end of 1990. Utilizing the expanded small business lending authority granted by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the industry's ratio of commercial loans-to-assets stood at 2.9 percent at March 31, 2006, up from 1.6 percent at the end of 1997.

Based on our subprime lending survey, there were 19 OTS-regulated thrifts with subprime lending programs as of the end of 2005. These thrifts have formal lending strategies directed to subprime borrowers as opposed to lenders that may make an occasional loan to a borrower with a low credit score, for example. Aggregate subprime lending for these 19 thrifts increased 33.5 percent to \$50.6 billion at December 2005 from the prior year.

2. Based on data from the Mortgage Bankers Association of America and Federal Housing Finance Board.

C. Diversified Financial Services Providers

In addition to core lending products, thrifts continue to expand the range of savings and investment products offered to their communities. The thrift charter provides an excellent platform with a comprehensive and uniform regulatory structure that allows for the efficient delivery of a wide range of financial products and services. Thrifts have taken full advantage of the strength of their charter to serve retail customers both in their local communities and beyond.

The success of thrifts in providing a broad range of financial services is evident in the industry's level of trust assets administered, which has risen dramatically over the past eight years. The facility of the charter in this area has also attracted a number of new firms to use the thrift charter as the vehicle for providing these services. For 2005, trust assets administered by the industry totaled \$696.5 billion compared with \$13.6 billion at the end of 1995. This represents a 50-fold increase in trust assets administered by the industry in the last ten years.

Another area in which thrifts have expanded their operations is in small business lending. In many communities, particularly in agricultural areas, savings associations are active small business lenders. The reasons for this are as simple as the fact that the institution may be one of the only available sources of small business loans in the community or that a small business owner or farmer has a longstanding relationship with a savings association. And in many instances, small business owners use their homes as collateral for their small business loans. Thus, small business lending is a natural outgrowth of the retail community lending activities of many savings associations.

D. Complex and International Organizations

Another aspect of the thrift charter is the growing number of financial services firms, including insurance, securities and similar businesses that utilize it in connection with both their domestic and international financial services operations. As I mentioned earlier, OTS currently oversees 481 holding company structures holding over \$7.5 trillion in assets. While many of the holding companies we regulate are small companies, we also oversee 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. Typically, these entities pose unique supervisory and regulatory challenges. As I will describe later in my testimony, OTS has a well-established Complex and International Organizations

(CIO) program for meeting these challenges and discharging our statutory responsibilities with respect to these holding companies.

V. Risks Facing the Thrift Industry

A. Interest Rate Risk

OTS closely watches interest rate risk given the thrift industry's natural concentration in longer-term mortgage loans, which are generally funded with shorter-term deposits and borrowings. As interest rates rise, monitoring interest rate risk becomes especially important. Interest rate sensitivity can manifest itself in several ways in a rising rate environment, including a declining value of long-term assets with below market rates and increased funding rates which tends to compress thrifts' net interest margin.

Our primary supervisory tool in monitoring interest rate risk and trends in the industry is the Net Portfolio Value Model (NPV Model), a comprehensive interest rate risk model that was developed by OTS in 1991 to monitor the interest rate exposures of thrift institutions' balance sheets. The NPV Model is an off-site, interest rate risk model that estimates the extent to which changes in interest rates affect a thrift's economic value. We are unique among the federal banking agencies (FBAs) in the development and application of this model.

At present, the NPV Model is capable of producing valuations for a wide variety of financial instruments, including fixed- and adjustable-rate, single-family mortgages, multifamily mortgage loans, certificates of deposits, and financial derivatives. Pursuant to the NPV model, a report is made available to each participating institution on a confidential basis, and is used by OTS to assess the overall quality and effectiveness of the institution's interest rate risk management process.

OTS regulations also require thrift management to monitor and manage interest rate risk on an ongoing basis and maintain exposure at prudent levels. These efforts are closely scrutinized as part of our regular on-site examinations.

Clearly, the current interest rate environment is extremely challenging for all financial institutions. In the past 12 months, interest rates have risen considerably and the yield curve has flattened. At the typical thrift, these changes tend to decrease the value of long-term, fixed rate mortgages, increase borrowing costs and compress net interest margins. Furthermore, the rising rate environment has drastically curtailed mortgage refinance activity, which has been a significant source of fee income for thrifts in recent years. In fact, Wall Street research indicates that only seven percent

of the 30-year fixed rate loans are refinancable. Coupled with rising interest rates and an expected slowdown in mortgage prepayments, longer-term, below market rate mortgage loans pose a higher degree of interest rate risk for many institutions due to higher funding and similar costs relative to income.

Despite the current interest rate environment, however, OTS believes the thrift industry is on sound footing from an interest rate risk perspective. Based on the NPV Model results for the quarter ended December 31, 2005, the median pre-shock capital-to-assets ratio for the industry stood at 13.65 percent and the median post-shock capital-to-assets ratio was 11.79 percent. Accordingly, the median change in economic value after a 200 basis point adverse shift in the yield curve (i.e. the sensitivity measure) was 177 basis points (1.77 percent) for the quarter ended December 31, 2005.

For the same period, only seven institutions were classified as having “high” interest rate risk under our supervisory matrix. This number is far below the 106 thrifts that were classified as having high interest rate risk in December 1991. In general, thrifts with “high” interest rate risk have a post-shock capital-to-assets ratio below four percent and a sensitivity measure in excess of 400 basis points. Personnel in OTS’s regional offices closely monitor all thrifts with interest rate risk-related problems.

Despite these encouraging results, there are certain developments within the industry that we are closely monitoring. For example, the proliferation of interest-only mortgages and option ARM mortgages, which allow borrowers a wider variety of payment options, present unique challenges. These products contain a variety of complex options that are often difficult for the typical thrift to model.

In an effort to better gauge the impact of these products, OTS is in the process of making the first major upgrade to the NPV Model since 1993. As currently envisioned, the upgraded NPV Model will be expanded to include pricing routines for a wider variety of mortgages, structured borrowings, and securities. In addition, OTS is considering certain improvements that would permit net interest income analysis, and the effects of non-parallel yield curve shifts. OTS expects to release the first version of this updated model by the end of the year.

B. Credit Risk

The thrift industry’s sound financial condition permits it to address potential credit quality problems from a position of strength. Thrift industry credit risk is primarily driven by the performance of residential mortgage loans. As a result of the

strength of the housing market in most areas of the country in recent years, single-family residential loan delinquencies and charge-offs have remained at low levels.

Future deterioration in any of the fundamentals that affect housing strength, such as worsening unemployment rates or rising interest rates, could adversely affect thrifts' asset quality. As community-based lenders, the majority of thrifts' loans are made to consumers. Direct loans to consumers, including single-family mortgages, measured 62.2 percent of thrift assets as of March 31, 2006. Given this concentration, thrifts' asset quality is very dependent on stable real estate values and consumers' continued employment and ability to service their debt. While there are no known systemic problems in either regard, certain local economies are facing weaker than average housing markets and employment prospects. In addition, we are closely monitoring the effects of rising interest rates and energy costs on both housing demand and employment.

Thrift credit exposure is not limited to the consumer loan sector. Thrifts are also exposed to the business sector, with 2.9 percent of thrift assets held in commercial loans and another 11.2 percent of assets held in construction loans and nonresidential and multifamily mortgage loans. A slowdown in the economy could pressure the cash flow of commercial borrowers. Alternatively, a steep rise in interest rates may also impact commercial borrowers, since business loans typically carry floating rates of interest. Credits that are highly dependent on low interest costs for positive cash flow would be most vulnerable to rapid increases in interest rates.

Credit review is a significant priority in our examination process, with the scope of our review formed by economic trends and expectations. Our analysis shows that as interest rates rise after a trough, many mortgage lenders lower credit underwriting standards to maintain high loan origination volumes. Such vintages often significantly underperform other vintages. Consequently, as rates have begun to rise, OTS examiners have begun focusing even greater attention on thrifts' underwriting processes, credit quality, reserve policies, and capital adequacy.

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 some of the responses we are seeing to this phenomenon.

For example, in an effort to maintain current loan volume, some institutions are purchasing loan participations that lack complete documentation. This practice is unacceptable and will be scrutinized by our examiners. 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, we have seen some evidence of slippage in underwriting due to increased competition in certain markets segments and areas. Some OTS 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 evidence of 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.

We are remaining vigilant in assessing the industry's credit risk exposure, particularly for institutions heavily concentrated in a very narrow product mix. We support the industry looking for ways to be less reliant on interest income. We emphasize, however, that expanding into new areas requires investment in the right people, systems, internal controls, and internal audits.

1. Alternative Mortgage Products

The proliferation of alternative or nontraditional mortgage lending products presents a unique hybrid of credit risk and interest rate risk. The risks posed by these products are discussed under credit risk since that is the fundamental risk to institutions that fail to underwrite these products effectively. Two products in particular, "interest-only" and "pay option" adjustable rate mortgages (ARMs) have 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. However, 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.

In December, the FBAs issued proposed guidance on nontraditional mortgage loan products. The comment period on the proposed guidance closed at the end of March and we are currently working with the other FBAs to review and analyze the comments in an effort to finalize the guidance.

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 require the institutions we regulate 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.

2. Commercial Real Estate Lending

Another credit risk issue prompting interagency policy guidance is the concentration in commercial real estate (CRE) lending by some insured institutions. The proposed guidance set forth thresholds for assessing whether an institution has a CRE concentration requiring heightened risk management practices. Institutions with these types of concentrations are expected to have appropriate risk management practices and to hold capital commensurate with the level of risk in their CRE lending portfolios. The guidance establishes concentration ratios based on loan type. While the concept of capital allocation based on concentration ratios is not novel, the proposed guidance suggests new standards.

We 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 were expressed about the guidance during the comment period, which closed last month. We are currently working with the other FBAs to address these concerns in order to finalize the guidance.

C. Compliance Risks

Compliance risk is another risk that the industry faces and one that OTS also closely watches. The increased volume of consumer transactions, along with the increase in consumer protection and other regulations governing those transactions, necessitates an active compliance management function within financial institutions and in oversight programs within the banking agencies. Certainly in today's environment, the importance of effective compliance management is elevated by: (1) the need to ensure the privacy and security of consumer financial information as more information is shared and outsourced, and as the threat of identity theft persists; (2) the need to guard against money laundering and terrorist financing activities; and (3) the need to stem the tide of abusive lending practices and ensure fair and equal access to credit for all Americans.

OTS conducts a comprehensive examination combining safety and soundness and compliance reviews to eliminate multiple reviews of the same area for different purposes. This approach eliminates redundancy, increases efficiency, underscores compliance risk control, minimizes regulatory burden on institutions, and improves the agency's staffing resource management. To ensure thorough and accurate examinations, OTS examiners are trained in both safety and soundness and in compliance. To ensure OTS has the requisite resources to examine complex or highly specialized areas of an institution's operations, such as trust activities and Community Reinvestment Act compliance, OTS maintains a group of specialized examiners to address issues arising in such situations.

We use a risk focused examination process. This requires us to adjust the scope of examinations to reflect the inherent risk profile of institutions, and to examine more frequently institutions that pose the most risk. This approach also ensures that examiners perform a more detailed review of areas with greater risk or with deteriorating performance indicators, which enables us immediately to pursue issues or concerns uncovered during the examination process. For example, examiners may expand the depth of review of any given area as additional facts surface that necessitate a more comprehensive review. The use of the top-down, risk-focused approach starts with a comprehensive review and analysis of internal policies and procedures, monitoring, and self-assessment programs.

Our fundamental examination objective is to ensure that institutions have in place the resources to support an effective compliance management program that is commensurate with the size, complexity and risk profile of the institution. To

promote and reinforce full compliance with these critical laws, OTS routinely conducts in-depth training for its examination staff.

1. Bank Secrecy Act Compliance

An area posing significant compliance challenges for institutions is the Bank Secrecy Act (BSA). During the 15 months from January 1, 2005 through March 31, 2006, OTS conducted 900 BSA examinations. During those 900 BSA reviews, OTS cited 222 institutions for 500 violations of either Title 31 or Title 12 regulations. As has always been our experience in BSA examinations, most of these violations were remedied during the examination process and resulted in no further action. Some, however, were not, and as a result, OTS initiated 27 formal and informal enforcement actions during those 15 months.

Originally enacted in 1970, the BSA requires financial institutions to file certain currency and monetary instrument reports and maintain certain records for possible use in criminal, tax, and regulatory proceedings. The BSA's purpose is to prevent financial institutions from being used as intermediaries for the transfer or deposit of money derived from criminal activity. Consequently, the BSA requirements provide a paper trail of the activities of money launderers serving the interests of terrorists, drug traffickers, and other elements of white collar and organized crime.

Congress amended the BSA several times over the years to strengthen its anti-money laundering (AML) and counter-terrorism financing purposes. The most recent, and perhaps most significant, set of amendments is found in Title III of the USA PATRIOT Act (Patriot Act). The Patriot Act contained strong and far-reaching measures to prevent, detect, and prosecute terrorism and international money laundering, and has resulted in the recent promulgation of several new regulations that have a direct impact on a thrift's BSA/AML compliance program.

OTS, in partnership with the other federal banking regulatory agencies and the Financial Crimes Enforcement Network (FinCEN), has been working to protect regulated institutions from money laundering and terrorist financing. In order to achieve this goal, the agencies have worked to promote examination and enforcement consistency and provide guidance to financial institutions for developing policies and programs to comply with BSA and anti-money laundering requirements.

Regarding the question in the invitation letter for this hearing about OTS's position on a "seasoned customer" exception for the filing of currency transaction reports (CTRs), we support this provision in the House regulatory relief bill. Similarly, we support the efforts of Chairman Bachus to address this issue in his bill,

H.R. 5341, the Seasoned Customer CTR Exemption Act of 2006. As I have testified in the past, OTS is fully supportive of efforts to provide meaningful BSA relief to the institutions we regulate consistent with the requirements of the BSA and the needs of law enforcement. We will support any burden reduction proposal to streamline existing BSA requirements, provided it is supported by FinCEN, not opposed by law enforcement, and it provides meaningful relief that outweighs any diminished utility to the BSA.

2. Data Breach Risks

The safety and confidentiality of personal information has taken on great importance in the regulatory environment. Data security has long been a significant part of the supervision and exam work that OTS has performed at thrifts and their third party technology services providers. With the enactment of the Gramm Leach Bliley Act (GLBA) it became a statutory requirement that all financial institutions establish programs to meet certain standards with regard to protecting the personal information customers share with them. As a part of our supervision and examination process, OTS regularly evaluates institution compliance with GLBA. This includes supervision and exam work at significant industry service providers.

In addition, OTS along with the other FFIEC regulators, have issued guidance to the industry regarding Data Security, Security Breach Notification Requirements, and Electronic Authentication in an Electronic Banking Environment. All of these issuances deal with the protection of sensitive personal information and the prevention of identity theft, credit card fraud, check fraud and other forms of financial crime.

Pursuant to the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), a major focus of OTS's compliance program is to ensure that the institutions we regulate keep credit information confidential, fight identity theft and ensure the accuracy of consumers' credit reports. Towards this end, OTS, along with the other FBAs, the National Credit Union Administration (NCUA) and the Federal Trade Commission (FTC), proposed a regulation implementing Section 114 of the FACT Act. This provision requires the establishment of procedures for the identification of possible instances of identity theft. Specifically, section 114 requires the agencies to:

- Establish, maintain, and update identity theft guidelines;
- Establish reasonable policies and procedures for implementing the guidelines in order to identify possible risks to an institution or its customers; and
- Prescribe regulations applicable to credit card issuers to ensure that replacement cards cannot be obtained by fraudulent means.

As you are aware, this is an area of extreme interest to the industry, consumers and policymakers. Data breach poses significant safety and soundness, legal and reputation risks for any institution that fails adequately to protect its databases and systems from hackers and others interested in exploiting institution information security weaknesses.

D. Competitive Pressures and Industry Consolidation

Business convergence and continued consolidation in the financial services industry have created an increasingly competitive environment. This stimulates thrift managers to focus on strategies to improve efficiencies in the delivery of financial products and services, customize product offerings to meet customer needs, and ensure quality customer service. Some managers may seek to enter new business lines that are not fully served by the financial community. Subprime lending, whether home equity or credit cards, is one such business. Well-managed subprime lending, with responsible marketing, pricing, and terms, is an important element in improving and expanding credit access. While it is critically important to provide access to credit to subprime borrowers, institutions and their regulators must be vigilant to assure the subprime loans are not delivered in a predatory manner. In connection with our examinations of the institutions we regulate, any pattern or practice of predatory lending is immediately criticized and eliminated.

Guiding an institution through lending expansion is, of course, the responsibility of each institution's management and board of directors. The willingness of management and directors to understand and manage risk is one of the primary underpinnings of a safe and sound operation. Thrifts must adopt prudent strategies to operate successfully in an increasingly competitive environment. We emphasize to our examiners and supervisory staff the need to focus on ensuring that thrifts have the requisite managerial expertise, sound policies and procedures, and adequate systems before entering new lines of business. We also encourage institutions to work with our examiners and supervisory staff when pursuing new business activities in order to address problems as they arise and to avoid surprises between examinations. Our best performing thrifts also have strong internal controls and internal audit procedures.

E. Business Transitioning Issues

We are closely monitoring how a number of the institutions we regulate make the transition from the recent intensive "mortgage-banking" mode to a more diversified lending environment. Until recently, low mortgage rates spurred refinancings and record origination volumes, and income from these increased

lending activities helped boost overall thrift profitability. As interest rates have risen, lending activity – especially refinancing activity – has moderated to more stable levels. At the same time, thrift managers continue to be pressured by shareholders to maintain current earnings levels despite reduced lending activity. These pressures may include reducing overhead costs to help maintain earnings or entering into new activities or reaching for greater fee income.

While we expect some industry staff reductions in response to decreased lending volumes, our examination and supervisory staff will closely evaluate thrifts' responses to ensure that the quality of loan underwriting and internal controls is not compromised. And we will continue to follow-up with thrift management to ensure that institutions effectively manage new business lines.

F. Technology/Operational Risks

Operational risk, including the risk of loss due to technical failures and human error, seems to be an ever-present concern in the financial services industry. Advances in technology have created new opportunities for thrifts, especially in marketing and broadening customer services. Thrifts also utilize technology to increase their understanding of certain credits, enabling better product pricing. The growth of Internet banking, outsourcing of core banking functions, and the rapid pace of technological and financial innovation creates new challenges and concerns for thrift management. The use of technology for these purposes is encouraged.

Our IT examiners, and, increasingly, all of our examiners, focus on how well institutions' use of technology is designed and monitored to minimize operational risk and ensure the security and privacy of the institutions we regulate and their customers. The lessons learned from financial difficulties experienced by many "high tech" companies, disruptions from various natural and man-made disasters, and the impact of the September 11th attacks have illustrated the need for contingency planning. Thrift institutions' contingency planning, backup, and recovery programs are receiving increased supervisory attention from our examination and supervisory staff.

G. Disaster and Emergency Preparedness

Information technology risks are a component of a larger set of risks that have become more prominent in recent years as a result of both natural and man-made disasters, and real and potential acts of terrorism. Historically, disasters have been viewed as "point-in-time" events that happen suddenly and then pass. Organizations' recovery plans have, until recently, been designed to deal with such short-lived events. Institution experiences operating in the months after the September 11th

terrorist attacks, with hazardous material spills, and recently with hurricane Katrina have taught us that not all disasters are short lived. People and businesses that have to evacuate an area may not be able to return for a significant period of time, or not at all. It is important that institutions update their disaster planning initiatives and procedures to reflect this “ongoing” disaster element.

In a similar vein, institutions must also plan for issues such as a pandemic disaster. This type of event differs even from the Katrina type of event in that there is no place to go to avoid its potential effect. Our supervisory processes and industry guidance are currently being updated to help institutions to plan for this type of disaster risk. In March of 2006, OTS, along with the other FFIEC agencies issued an Interagency Advisory on Influenza Pandemic Preparedness to alert institutions to consider the unique challenges a pandemic event could pose and to update their business continuity plans appropriately.

H. Federal Home Loan Bank System Issues

Savings associations are the largest constituent and member base of the twelve Federal Home Loan Banks (FHLBanks). Savings associations and the FHLBanks enjoy a history of a sound and successful partnership. Savings institutions rely on FHLBank advances as a primary source of low-rate funding, and for meeting their liquidity needs. Thrifts have also derived significant earnings over the years from FHLBank dividends, and thrifts regularly participate in partnership with FHLBanks in a variety of lending programs. In addition, the FHLBanks offer alternative, secondary market products to savings associations, often with terms more competitive and attractive than similar products offered in the market, and by other government sponsored enterprises (GSEs).

Due to this strong and intertwined relationship, significant changes to the FHLBank system generally produce a spin-off of issues affecting OTS-regulated savings institutions. As a result, OTS routinely monitors FHLBank activities, and regularly assesses how FHLBank changes could impact our caseload.

The FHLBank System is rapidly changing and continues to have a tremendous impact on the banking and thrift industries. FHLBank System assets are currently more than \$1 trillion. This is close to the total assets of Fannie Mae, and may surpass Freddie Mac’s total assets. Assets of the FHLBanks have increased significantly in the past several years, largely due to the favorable loan market and significant increases in FHLBank advances and non-advances.

The changing financial picture of the FHLBank System, its members and the economy, combined with other factors, including recently proposed Federal Housing

Finance Board (FHFB) capital requirements, will continue to highlight issues and concerns with the relationship between the FHLBanks and their members. In addition to increased FHLBank advances, mortgage holdings and consolidated debt have grown significantly.

On April 12, 2006, the FHFB published for comment a proposed rule to require the FHLBanks to raise their retained earnings significantly. While we are generally supportive of efforts to bolster capital at the FHLBanks, I am concerned about the impact of timeframes that could require a buildup in reserves that is too quick. A rapid buildup could significantly affect member institutions, with a number of OTS-regulated institutions potentially severely impacted.

Other issues affecting the FHLBank System and its stock valuation include recent fluctuations of FHLBank stock value due to issues related to the FHFB proposal, downgrades in the S&P rating to less than AAA status for (Type B) FHLB stock and concerns with over-reliance on GSE status to set FHLBank stock prices. In addition, the FHFB's position requiring Securities and Exchange Commission (SEC) reporting and registration of all FHLBanks has impacted the System. To date, eight FHLBanks are designated SEC registrants.

Finally, FHFB mandated capital plans for each of the FHLBanks, a recent exodus of key senior managers of several FHLBanks with uncertain succession plans, and ongoing discussions regarding GSE reform legislation, including the possibility of reorganizing the FHLB System and/or its regulatory oversight structure, all raise uncertainties and pose potential risks to the System and its members, many of which are regulated by the OTS.

There are numerous complex and ongoing issues affecting the FHLB System, and the outcome of these changes are uncertain as well as extremely significant to System members and the financial industry. The OTS supports a strong regulatory body responsible for oversight of the FHLBanks, and we remain vigilant to monitoring the risks posed by various outstanding FHLBank System issues with respect to our oversight of the thrift industry.

VI. OTS Mission, Personnel, and Internal Operations

A. Overview

OTS was created on August 9, 1989, as part of a major reorganization of the thrift regulatory structure mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). OTS assumed responsibility for the

regulation and supervision of savings associations, their holding companies, and their affiliates, and chartering authority for federal savings associations.

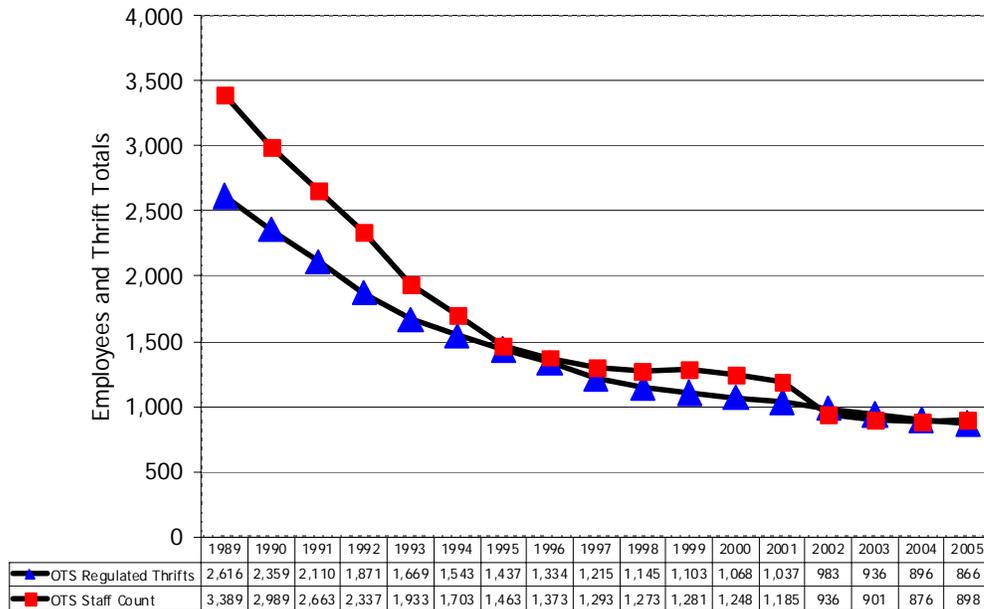
The OTS mission is to supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs.

OTS is a bureau of the U.S. Department of the Treasury and is headquartered in Washington D.C. with four regional offices located in Jersey City, Atlanta, Dallas, and Daly City, just outside San Francisco. The headquarters office develops nationwide policies and programs and coordinates the operations of OTS. The regional offices examine and supervise institutions and process most applications.

B. OTS Personnel

OTS has just over 900 employees, with approximately 75 percent of OTS's staff assigned to regional offices. Approximately 80 percent of OTS staff is directly involved in supervising the thrift industry, including about 525 examiners. Remaining OTS staff support their efforts. OTS staffing levels have declined since its creation in 1989, generally commensurate with the reduction in the number of thrifts over this period. Staffing levels have stabilized in recent years, however, as aggregate industry assets continue to grow and OTS's supervisory and oversight responsibility of holding companies and their affiliates has increased both in terms of aggregate holding company assets and the complexity of holding company structures. While industry assets have climbed steadily, and now stand at a record level of approximately \$1.5 trillion, fewer thrifts permit OTS to take advantage of economies of scale in conducting its examinations. The following chart shows how the number of thrifts and the number of OTS employees have generally tracked since 1990.

OTS Staff Size Adjusts as Industry Changes
(Fiscal Year)



OTS is continually assessing its staffing needs to ensure that we have sufficient well-qualified staff to meet our supervisory and oversight responsibilities under the HOLA. Due to demands arising out of certain aspects of our supervisory program and in anticipation of attrition in our examination workforce in the next several years, we recently made a decision to hire 60 new examiners. We have been recruiting to fill these positions and we have also recently hired a number of senior and mid-level managers to bolster our supervisory staff and complete our management team.

OTS values its employees as critical assets necessary to achieve excellence in regulating the thrift industry. Our compensation program enables us to attract, retain, and reward the high caliber of staff necessary to achieve its mission. OTS has statutory authority to set the pay and benefits of staff in a way that seeks to maintain comparability with the other FBAs. The program is a pay for performance system with high performers receiving greater annual increases.

As a top priority, OTS works to develop a professional and highly motivated workforce that provides exceptional service to the institutions and holding companies we regulate and supports achievement of the OTS mission. To achieve this goal, OTS provides a competitive salary and benefits plan.

Other programs include an on-line referral service for employee assistance and wellness needs, a telecommuting program, and the availability of flexible work programs to accommodate certain employee's specialized needs. OTS also has a program that reimburses approved employees for home-based communication expenses to ensure continuity of operations during emergencies and to reduce travel costs and burdens on the thrift industry and our examination staff.

OTS utilizes specialized programs to help attract and retain minority status candidates to OTS. OTS is also using student employment programs to offer college students an opportunity to work on projects supporting our examination program with a goal toward making them permanent employees when they graduate. The OTS Fellows Program helps us bring on specialized talent from the private sector to meet our short-term needs in specialty areas such as accounting, finance, economics, and information technology in mid-level and top-level positions.

We also provide opportunities for professional growth to our workforce through several programs. OTS implemented an electronic Individual Development Plan in 2000, which sets out learning objectives and allows managers and employees to identify work-related developmental activities. The OTS Management Development Program, initiated in 2002, focuses on leadership development with an emphasis on improving the effectiveness of managers in their current positions while preparing them to take on higher level responsibilities in the future. OTS is committed to developing a diverse workforce and implemented an Emerging Managers Program in 2003 that encourages more minorities to develop management skills for the future.

C. Financial Performance

For fiscal year 2006, OTS's projected operating expenses are approximately \$215 million. The agency does not receive appropriated funds from Congress to finance its annual operating costs. About 93 percent of OTS operations are funded by assessments paid by OTS-regulated savings associations and their holding companies.³ The amount of assessments is based on each institution's size, financial condition, and complexity. Holding companies are assessed under a similar system. The OTS budget is affected by numerous factors, with compensation and benefit costs driving the most significant portion of annual expenses.

Annual employee compensation and benefit costs, including funding for retirement, health and life insurance, and similar employee benefit expenses, currently

3. Application fees, interest on Treasury securities, and rental income provide the remainder of OTS's annual funding.

account for approximately 82 percent of OTS's annual budget. Despite fluctuations in employee health and benefit costs that have significantly impacted our budget in recent years, OTS has made no change to its semi-annual assessments on savings associations other than for an annual inflation adjustment.

In fact, OTS has operated with a budget surplus the last four fiscal years. To the extent that our revenue has exceeded our expenses in each of these years, the overage has been added to our existing reserves. Current OTS reserves are approximately \$120 million, an amount representing approximately nine months of expenses. Current reserves include a special reserve of \$25 million to cover unforeseen expenditures and/or unforeseen changes in our revenue stream. We also have a contingency reserve of approximately \$95 million to cover a catastrophic interruption of our funding stream. Finally, based on our first six months of fiscal year 2006, we have unaudited net income of approximately \$24 million. As in past years, net income, if any, at the conclusion of the current fiscal year will be added to our reserves.

D. Financial Management

OTS is committed to financial management excellence. Our financial management systems provide timely, useful, and auditable information that promotes the incorporation of financial and performance measurements in the planning, budgeting, and reporting processes. OTS has received unqualified opinions on its financial statements each year since it became an agency in 1989.

OTS managers meet quarterly to integrate financial performance and program information. Program managers receive online access to financial and budgetary information allowing them to monitor performance and use the information for operational evaluation and decision-making. Financial data is updated monthly. We close our books within three days of the end of each month, and our independent auditor is able to issue its report within 45 days of the end of our fiscal year. Quarterly performance results are provided to management and are posted on the OTS Strategic and Performance Planning intranet site. Senior managers discuss performance and financial results during Regional Manager meetings that are held ten times annually.

The OTS budget directly supports our strategic and performance goals (discussed below) that provide for proactive and efficient supervision of a safe, sound and competitive industry, reduced regulatory burden, improved credit availability, and fair access to credit and other financial services by thrifts to their customers. Our 2006 fiscal year budget enables OTS to continue tailoring supervisory examinations to the risk profile of the institutions we regulate, while effectively allocating resources

to oversee and assess the safety and soundness and consumer compliance record of savings associations and their holding companies.

The OTS's program and budget activity are focused on the supervision of thrift institutions and their holding companies. The agency's strategic goals guide our annual budget preparation process, in conjunction with the evaluation of our current annual resources and projected needs for the upcoming year. The annual budget process begins in May. Washington and Regional Offices submit online requests using the OTS Budget Request System. The proposed budget is developed after analyzing projected regulatory and statutory change, industry risks, operational costs, and economic challenges. After several layers of extensive review, the proposed budget is then presented to the Director for approval in late August with the final Performance Budget provided to Treasury in September.⁴

OTS also makes use of the administrative efficiencies available through our affiliation with the Treasury Department. For example, we are part of agency-wide contracts for travel and credit card services, we use Treasury programs for executive and procurement training, and we have obtained savings in purchases of both computer hardware and software by making use of contracts negotiated by the Internal Revenue Service.

E. Emergency Preparedness

1. External Coordination

OTS is actively involved in Emergency/Disaster Preparedness initiatives. In conjunction with other FFIEC agencies we have for at least 20 years issued guidance to the industry with regard to Disaster Recovery and Business Continuity Planning. During examinations, OTS reviews each institution's plans for continuity of operations and emergency preparedness.

In the post-September 11th world, in particular, disaster contingency planning and preparedness are key strategic issues. OTS participates on the Financial and Banking Information Infrastructure Committee (FBIIC) that is chaired by the Treasury Department. FBIIC works with the Department of Homeland Security and the Office of Cyberspace Security to improve the reliability and security of the financial industry's infrastructure. Pursuant to its mission statement,⁵ FBIIC:

4. OTS programs and goals also support several of the Department of the Treasury's strategic objectives.

5. FBIIC has as its mission statement, "working with appropriate members of financial institution regulatory agencies, coordinate efforts to improve the reliability and security of financial information infrastructure."

- Identifies critical infrastructure assets, potential vulnerabilities, and prioritizes their importance to the financial system of the U.S.;
- Establishes secure communications capability among the financial regulators and protocols for communicating during an emergency; and
- Ensures the availability of sufficient staff at each member agency, with appropriate security clearances, to handle classified information and to coordinate in the event of an emergency.

FBIIC works closely with the Financial Services Sector Coordinating Counsel (FSSSC), which is composed of representatives from private industry working on critical infrastructure issues in the financial services sector. Together FBIIC and FSSCC represent the public and private partnership working to enhance the critical infrastructure for the financial services sector in the U.S.

To communicate with the industry, OTS also has emergency contact information for each of its regulated institutions. Since May 2004, OTS's Secure Message Center has facilitated information sharing between the agency and industry. Through FBIIC, OTS can maintain secure communications with the financial regulators and other critical financial service sector entities.

2. Internal Coordination

The OTS's own emergency preparedness and continuity of operations (COOP) plans protect our employees and buildings and help ensure we will continue to function in the event of an emergency. The plans cover succession order and backup capabilities in addition to problem assessment, damage control, evacuation, and communications.

The OTS COOP plan identifies teams of individuals with primary responsibilities in the event of an emergency and an emergency notification plan that establishes contact procedures and includes contact information. It also addresses our physical security posture at the various threat levels as defined in the Homeland Security Advisory System. The plan addresses restrictions to facilities, increases and modifications to security guard posts and duties, external assembly points, and physical dispersion of members in the line of management succession for OTS.

The OTS Southeast Regional Office in Atlanta, Georgia serves as an OTS COOP site. OTS has the ability to operate its computer systems from that location. The Atlanta COOP site is also equipped with secure communications equipment and within the next few months will be set up with high frequency radio equipment that links Treasury Department COOP sites.

OTS also recently launched an emergency preparedness education campaign for its employees. As part of this campaign (called VIP for Vigilant, Informed, Prepared), OTS will conduct a series of drills to test its emergency response plans. The campaign will also focus on testing emergency communications. OTS makes use of toll free employee hotlines, broadcast email and voice mail, cell phones and Blackberry devices, as well as government emergency telecommunications service (GETS) cards and phone trees. Our emergency communications program has been expanded to include satellite phones, which will be disseminated to OTS headquarters and regional offices this month.

OTS communication methods are currently focused on pushing information out to employees. Currently being investigated are methods that will allow employees to check in with OTS in the event of emergency to provide status and contact information. Implementation is scheduled during the third quarter of this year.

F. Information Technology (IT)

OTS's Office of Information Systems and Finance (ISF) oversees the planning, operations, and development of all programs that support the data processing and financial management needs of OTS. The Managing Director of the office serves as the Chief Information Officer (CIO) and the Chief Financial Officer (CFO) for OTS. The CFO oversees the OTS budget and all aspects of financial operations.

1. Infrastructure Management and Oversight

The CIO manages all Information Technology (IT) infrastructure involved in the process of collecting, analyzing, and storing OTS data. The office's responsibilities include supporting and securing all personal computers and servers, network operations, national information systems, and electronic messaging. ISF manages the content of data on OTS's Intranet and Internet sites and administers the OTS Records Management program.

ISF administers the collection and validation of information reported on the quarterly Thrift Financial Report (TFR) by all OTS regulated savings associations. The TFR includes the balance sheet, income statement, and supporting schedules providing information on assets, liabilities, interest rate risk, and regulatory capital.

OTS standardized its server and personal computer platforms in 1997 and migrated all staff to notebook computers in 2004 to reduce maintenance costs and facilitate remote usage.

2. Information Security and Integrity

Protection of the agency's data and infrastructure is critical. OTS certified and accredited all of its 19 information technology systems and continues to update policies and procedures based on recent guidance from Treasury, OMB, and NIST. This year, OTS will begin the process to reaccredit systems that were initially certified three years ago. OTS's Continuity of Operations data center is located in the OTS Southeast Regional office where Washington production servers, systems, and data are replicated.

OTS strives to provide timely and efficient technological assistance and solutions to our examiners and the industry to meet regulatory responsibilities and enhance communication channels. OTS installed virtual private network software on all of our examiners' notebook computers to enable them to securely access OTS systems and data over high-speed, broadband connections from OTS-regulated institutions or other locations. In May 2004, OTS implemented a service to enable the exchange of encrypted messages and documents directly with institutions. The OTS Secure Messaging Center service meets the industry standards for secure electronic data transmission and facilitates the timely exchange of sensitive data and information with the thrift industry.

3. OTS Electronic Services

OTS attempts to identify and implement electronic and technological solutions in order to assure effective and efficient information dissemination and sharing by the agency. For example, OTS developed software that savings associations use to electronically file their quarterly Thrift Financial Reports. The OTS website includes a free service that provides subscribers with an e-mail alert when new material is posted to the site. OTS also implemented a program in 2004 to collect and process examination workpapers electronically.

4. IT Investment Review

The OTS IT Investment Review Board (IRB) provides overall direction and vision for how OTS's information technology should contribute to OTS's goals and objectives and serves as the forum for senior OTS executives to make decisions regarding IT expenditures and investments. I serve as the IRB Chair, and our CIO serves as the Executive Director of the IRB. As the IRB Executive Director, the CIO is responsible for policy, oversight, and improvement of all information systems, information management, and data communications used by OTS to carry out its mission.

Current IT initiatives include notebook replacement and client software upgrade for our examiners; corporate systems modernization; electronic records system upgrades; enhancements to our (previously described) NPV interest rate risk model; and infrastructure upgrades due to a recent Homeland Security Presidential Directive.

VII. OTS Regulatory and Supervisory Focus and Strategies

A. Early Detection and Resolution Strategies

OTS uses regular on-site examinations and quarterly off-site financial monitoring to identify thrifts that warrant closer supervision. When problem institutions are identified, OTS acts promptly to ensure thrift management and directors institute corrective actions to address supervisory concerns. In addition to a host of financial analytics and early warning systems, two processes that we use to monitor problem institutions are the Regional Managers Group meetings, which are held ten times annually, and quarterly high risk case briefings. These meetings enable senior OTS staff and regional managers to discuss high risk or high profile institutions regularly throughout the year. The tools are effective to share our collective experiences, develop effective supervisory strategies, and enhance consistency across the agency. These processes allow senior Washington staff to closely monitor problem institutions, while the regions retain primary responsibility for ongoing supervision.

We have refined our off-site monitoring process by increasing early warning systems to help identify adverse industry trends and potential problem areas. We maintain dedicated financial analysts at our headquarters and in the regions to ensure that off-site tools are maximized. OTS examiners and analysts utilize our Risk Monitoring System (RMS) to assist off-site financial analysis. This risk identification model utilizes combinations of financial ratios to identify areas that need prompt attention and further analysis. The RMS also provides our examiners and analysts with direct links to thrift web sites, thrift stock price data, securities filings, and general economic information, all used to closely monitor and analyze thrift operations between on-site exams. In addition to the RMS, we operate our previously described NPV model to simulate the potential interest rate risk exposure resulting from a variety of interest rate shock scenarios.

B. Examination and Supervisory Structure

OTS supervision of the thrift industry comprises national and regional operations. In Washington, DC, our office of Examinations, Supervision, and Consumer Protection (ESCP) oversees all aspects of the agency's examination and supervision functions for savings associations and their holding companies. Multiple specialized groups operate within this office to oversee key risk areas. For example, the capital markets group has responsibility for maintaining our previously described, proprietary NPV model used for analyzing interest rate risk for the industry. Our Complex and International Organizations (CIO) group, which I describe more fully below, oversees financial conglomerate holding companies; and a regional monitoring group conducts financial analysis and monitors each region's examination caseload.

Each of our four regional offices has a regional director with one or more deputy directors, who in turn oversee multiple assistant regional directors. Deputy and assistant regional directors each are in charge of specific areas of regional operations including examinations, human resources, and legal. Assistant regional directors that oversee examinations each monitor a group of field managers. The field managers are each responsible for a caseload of financial institutions. Field examiners report directly to a field manager.

Our examination staff comprises generalists (certified in both safety and soundness and compliance areas), specialists (certified in a single examination type including trust, information technology, or specialized compliance areas), and a core specialty group of examiners (i.e. capital markets examiners, consumer lending specialists, commercial lending specialists, alternative mortgage specialists, etc.). Scheduling examinations is a regional function that also includes a national coordinator to facilitate the exchange of resources from caseload to caseload. This ensures that OTS utilizes staff expertise in the most efficient manner possible.

OTS regularly conducts comprehensive safety and soundness and compliance examinations at the majority of OTS-regulated organizations. In 2002, OTS initiated a program to meld its separate safety and soundness and compliance examinations to attain greater efficiencies in its examination process and provide examiners with broader developmental opportunities. Examination teams conduct on-site joint examinations every 12 to 18 months, depending on the institution, that produce one examination report that incorporates both safety and soundness and compliance matters. In the past, we had two separate exam teams on two separate examination cycles.

Consolidated exams eliminate redundancy and improve OTS staffing resource management. We also achieve a more comprehensive assessment of an institution's risk profile by examining its compliance with consumer laws and regulations as an integral part of an institution's business. Consolidated exams are less intrusive, and reduce the costs and burden of examinations on institutions. Institutions have responded favorably to this examination approach. Finally, having compliance examinations performed on a safety and soundness exam cycle of 12-18 months results in compliance matters being reviewed more frequently, particularly for core areas, such as BSA/Patriot Act, which are reviewed at every examination.

OTS relies on a risk focused examination approach in order to ensure that we more frequently examine institutions with the most risk. The approach also ensures that examiners perform a detailed review of higher-risk areas or areas with deteriorating performance indicators. This top-down, risk focused approach provides a mechanism for examiners to expand review when facts warrant additional scrutiny. We also conduct information technology, trust, holding company, and CRA examinations independent of the comprehensive examinations.

Our examiners are cross-trained in both safety and soundness and in compliance issues to have the full knowledge and skills necessary to lead these consolidated examinations. Our examiners must take a comprehensive test as the first step in working towards Commissioned Thrift Examiner (CTE) accreditation. Once examiners pass the comprehensive test and complete extensive on-the-job training requirements for the new CTE accreditation, they are qualified to perform as examiners-in-charge of institutions examinations.

C. Complex and International Organizations

1. The EU Conglomerates Directive

Several pieces of legislation from the European Union (EU) impose a requirement that there be an identified consolidated non-EU supervisor for foreign financial services firms operating in the EU. The legislation includes directives on financial conglomerates, investment firms, insurance groups, and credit institutions. The directive on the consolidated supervision of financial conglomerates (Directive) outlines coordination in the EU among various financial services regulators overseeing the activities of diversified multinational financial services companies doing business in the EU. The purpose of the Directive is to implement a framework for supervising the risks arising in cross-sector business groups containing securities firms, credit institutions, and insurance companies.

The Directive requires EU authorities to determine whether a financial conglomerate with a non-EU parent has equivalent consolidated supervision in its (non-EU) home country. If the EU determines there is not an equivalent supervisor for a particular firm, the Directive sets out several requirements to ensure appropriate supplementary supervision. For example, if the EU authorities identify no equivalent supervisor for a firm, the EU member states can impose additional capital requirements, increase regulatory scrutiny on the group, or test the qualifications of key personnel. Because these requirements could result in regulatory overlap and additional burden to thrift holding companies operating in the EU, it is important OTS achieves this equivalency determination for the supervision of the firms involved.

2. OTS and EU Equivalency

The Directive affects certain OTS-supervised holding companies with operations in the EU. In the U.S., OTS was the first regulatory authority to be designated a consolidated coordinating regulator under the Directive. The EU designation was made in December 2004 for OTS oversight of GE Capital Services, and we are in discussions regarding an equivalency designation for American International Group, Inc. In addition, OTS is in discussions with EU authorities regarding equivalency for Ameriprise, the American Express spin-off of its financial services arm. OTS remains the only U.S. banking agency granted equivalency under the Directive, although the SEC acts as consolidated coordinating U.S. supervisor for several financial conglomerates with broker-dealers in their structure.

In late 2005, OTS decided that holding companies for which OTS is the consolidated supervisor in accordance with EU requirements are of sufficient size and complexity to warrant a separate group within our ESCP office devoted to their supervision. The supervision and examination of GE, AIG and Ameriprise are now managed by the CIO group from the Washington office of OTS by a staff of seven. The examiners-in-charge for each of the three conglomerates within this group report to the Washington office. This structure allows for improved coordination and a more consistent approach in our treatment of these firms.

OTS has identified approximately 25 savings and loan holding companies based in the U.S. with financial services offices in the EU. In addition, there are another ten thrift holding companies with offices in countries outside of the EU. To better discharge our responsibility as holding company supervisor, as provided in the HOLA, and to facilitate communication with foreign supervisors for internationally active firms, OTS entered into information sharing agreements with several foreign supervisory and regulatory authorities, and we are currently negotiating agreements with several other foreign regulators. Our outreach efforts include OTS participation as an observer to the Basel Committee on Banking Supervision and the International

Association of Insurance Supervisors, and participation in working groups of the Joint Forum.

D. Basel

OTS is working with the other FBAs on both the Basel IA and Basel II proposed capital rules. Both projects continue to require extensive staff resources to focus on the many and varied issues posed by consideration of the proposals. We remain concerned about the potential competitive impact of Basel II on the vast majority of institutions that we regulate, as well as the effect it may have on OTS-regulated institutions that are defined as core banks or that choose to implement the Basel II capital rules. Similarly, we are taking a cautious approach on the development and implementation of Basel IA and, at this juncture, we are of the view that the existing Basel I capital rules should remain an option for institutions that prefer to retain them.

1. Basel IA

Basel IA would address the need for increased risk sensitivity in the existing Basel I capital rules and mitigate competitive inequities that may arise with the implementation of Basel II. The FBAs issued the Basel IA Advanced Notice of Proposed Rulemaking (ANPR) seeking comments on several possible revisions to the current risk-based capital rules. The ANPR was published on October 20, 2005 and the comment period closed on January 18, 2006. The FBAs are currently working on a Basel IA Notice of Proposed Rulemaking (NPR) based on the following guiding principles:

- Promoting safe and sound banking practices and a prudent level of regulatory capital;
- Maintaining a balance between risk sensitivity and operational feasibility;
- Avoiding undue regulatory burden;
- Creating appropriate incentives for banking organizations; and
- Mitigating material distortions in the amount of regulatory risk-based capital requirements for large and small institutions.

Issuance of the NPR is targeted for August or September of this year in order to promote meaningful overlap with the Basel II NPR comment period.

2. Basel II

The Basel II rulemaking process began in 2003 with the issuance of an ANPR. Currently the Office of Management and Budget (OMB) is reviewing the FBAs draft of the Basel II NPR. OMB clearance is required before the NPR can be published in the Federal Register. Depending upon the outcome of that review, the FBAs may be ready to issue a NPR in the second or third quarter of 2006. The Basel II NPR would be followed by proposed Basel II guidance and reporting requirements, with a 120 day comment period. After reviewing comments and making adjustments as necessary, the FBAs hope to produce a final Basel II rule in 2007.

OTS has been an active participant in the development of Basel II and, while I believe that we are on the right track toward its implementation, nothing is etched in stone. Basel II is still a proposal, drawn from a number of years of hard work and research. While I have testified in support of Basel II generally, I am cautious about whether we are doing this optimally. I 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 through the rulemaking process and into the structured parallel run and phased-in implementation period.

Basel II warrants close scrutiny by all interested parties and I encourage Congress to remain engaged in the continued development and refinement of the proposal. My hope is that the notice and comment process will further improve Basel II where needed.

E. OTS Applications Process

The HOLA, certain other laws, and OTS rules and regulations impose a number of application filing requirements on OTS-regulated savings associations and their holding companies for a variety of activities or proposed transactions. These include filings to OTS for approval to become OTS-regulated entities, as either holding companies or savings institutions. The requirements include applications to convert to or organize a savings association; conversions by a savings institution from mutual to stock form; a change in control of an OTS-regulated institution; savings and loan holding company acquisitions; mutual holding company reorganizations; application by a savings association to engage in or exercise certain activities or powers, such as trust powers; and various other transactions.

The OTS charges application fees for processing applications. The fees are intended to cover agency costs to process an application. Certain applications require pre-filing meetings with the Regional Offices prior to submission of an application. Certain applications require that notice be published that the application is filed, and invite the general public to comment on the application. Certain application types apply solely to federally chartered institutions, while some apply to all OTS supervised institutions.

The review and processing of a majority of OTS applications is delegated to our Regional offices for processing and decision. However, applications involving significant issues of law or policy are concurrently processed in, and subject to approval by, our Washington office.

1. Filing Requirements and Timeframes

Depending upon the proposed activity or transaction, or the overall rating and condition of the applicant, an applicant may be required to make a filing in the form of a notification, notice, or application. A notification is generally an informational filing related to an activity that is pre-approved by regulation that does not require action by OTS. A notice, by contrast, is for an activity or transaction that requires approval but generally involves information filing requirements and a relatively short processing timeframe (typically 30 days).

More complex transactions and activities require the filing of an application that involves more extensive information filing requirements and a longer processing timeframe (generally, an initial 30 day review period for the agency to determine if an application is complete; 30 days for an applicant to respond to questions on an application not yet deemed complete; another 15 days for the agency to determine completeness; and 60 days for the agency to act on the application).

In all cases, a notice or application may be treated differently where unusual or significant issues of law or policy are raised by a proposed activity or transaction.

2. OTS's Charter Conversion Process

You have asked that I provide our views on H.R. 3206, the Credit Union Charter Choice Act. As you know, our Deputy Director, Scott Polakoff, testified before the House Subcommittee on Financial Institutions and Consumer Credit. Attached is a copy of our testimony from that hearing. Regarding the question of our views on credit unions converting to thrifts and the regulatory process for such transactions, I will reiterate what my Deputy Director stated two weeks ago.

Charter choice is a fundamental precept at OTS. Since the agency was established in 1989, many institutions have both left and entered the thrift charter. These so-called “charter flips” are a normal course of business at OTS and throughout the banking industry. In our view, it is the role of the regulator to minimize regulatory obstacles, reduce burden and facilitate legitimate business decisions regarding charter choice made by the institutions we regulate.

It is my understanding that all of the FBAs handle charter flips similarly. Each requires an application to obtain a charter within their jurisdiction, but not to leave their jurisdiction and oversight. While an agency may forward supervisory information to a new regulator, there is generally not a requirement that an institution obtain permission from one of the FBAs to leave its jurisdiction, except where an institution has pending enforcement or similar issues or is in potentially troubled condition.

The charter conversion process at OTS is the same for any entity or group seeking a new thrift charter. In this regard, I want to clarify several misperceptions regarding membership rights of account holders of a mutual savings association. Similarly, I want to set the record straight on the issue of management benefits when a mutual savings association converts to a stock institution or into a MHC structure.

Some have advanced the notion that credit union members’ rights are compromised when a credit union converts to a federal mutual savings bank. I believe this is inaccurate. While there are certain differences in the rights of credit union and mutual thrift members, suggestions that one set is more equitable than another do not bear scrutiny. In fact, an analysis of the differences suggests that the rights accorded thrift mutual members may be more equitable than the rights accorded credit union members.

For example, credit union voting is conducted on a one vote per member basis, while the federal mutual thrift charter provides for one vote per \$100 on deposit, with the association being able to set, in its charter, the maximum number of votes per member at any number from one to one thousand. In our view, this type of voting provision, while different, is arguably more equitable than the one member-one vote rule since it provides greater voting rights, up to a limit, to members that have made a greater contribution to the institution. Even in a small institution, a member with the maximum number of votes could not exercise any appreciable amount of control of the institution.

Another issue that has been raised is the fact that members of federal mutual associations may, in most matters, vote by proxy, while credit union members vote by mail ballot. We do not find this to be a meaningful distinction. Members of a mutual

thrift have the right to exercise their vote, whether by proxy or directly. The fact that members have the flexibility to grant management discretionary authority with respect to their vote does not make the voting process less meaningful. Mutual thrift members always have the right to revoke a proxy and vote their shares directly.

Finally, the economic nature of membership interests in mutual associations and credit unions is quite similar. When a person becomes a member of either entity, the person has the same rights as other members to participate in dividends, or any liquidation of the entity. When a person ceases to be a member, they have no continuing interest in the institution. Membership interests in either entity cannot be transferred, and members of either entity cannot compel management to declare dividends. Although liquidations of either type of entity are extremely rare, liquidation rights in both entities are similar, with depositors sharing in any remaining equity after liquidation in proportion to the amount of their deposits. I note that this is consistent with providing greater voting rights to members with a greater deposit investment in an institution.

The other notion that I want to dispel is the suggestion that thrift management unfairly benefits in the conversion process. This is based on the idea that credit union management is conducting a charter flip to a mutual thrift with the intent of subsequently conducting a mutual-to-stock or a mutual holding company (MHC) conversion to enrich themselves. In fact, management benefits are limited in a mutual-to-stock or MHC stock issuance. Most importantly, before a conversion or MHC stock offering occurs, the members of the institution must approve the transaction. Full disclosure is provided regarding all aspects of the transaction, including management benefits. If members object to management benefits, they may vote against the transaction.

While managers may purchase stock when an institution converts to stock form, such purchases are subject to the same terms applicable to other members. All purchases, including those by management, are subject to maximum limits so that no party acquires control in the conversion. In addition, purchases by all managers are subject to an aggregate limit.

Converting savings associations may also establish employee stock ownership plans in mutual-to-stock conversions. These are tax qualified employee benefit plans, and are subject to requirements regarding distribution of stock under the plans. Congress has encouraged the use of these plans, and we believe they are no less appropriate for newly converted stock associations than they are for any other type of entity. Again, these transactions are subject to member votes, so that if members object to the transaction, they may vote it down.

Finally, an institution may establish management recognition and stock benefit plans after the conversion. OTS rules provide that these may not be established until at least six months after the stock conversion. And these plans are subject to a separate shareholder vote. We believe these plans are appropriate since these institutions compete on the same basis as other stock entities, and stock benefit plans enable institutions to retain and attract qualified management in the same manner as other stock entities.

In summary, there are differences in certain aspects of the operations of a stock savings association from a mutual thrift or credit union. And this may be the very reason why an institution decides to pursue that charter strategy. All entities should be accorded the right, with member approval, to pursue whatever charter best meets their business strategy and needs.

OTS supports all efforts to ensure effective communications between an institution considering a charter conversion and its members. In our view, H.R. 3206 sets forth a clear set of guidelines that clarify appropriate standards of conduct in communications between an institution and its members. Freedom of charter choice only has meaning if members are able to exercise an informed choice.

OTS believes in charter choice and supports the efforts of depository institutions to organize under the charter that best supports their business plan and operating strategy. It is important for all regulators to uphold the basic right of freedom of choice. Regulatory barriers that do not protect consumers or institutions, but rather that serve as regulatory obstacles should be eliminated. I believe the integrity of our financial services system requires this.

F. OTS Consumer Complaint System

The OTS consumer complaint process has several purposes, including:

- Contributing to OTS's supervisory mission by identifying and remedying savings association regulatory deficiencies or violations identified in the course of processing consumer complaints;
- Supporting OTS oversight responsibilities and policy development by analyzing consumer complaint issues and trends;
- Facilitating consumers obtaining appropriate redress for injuries caused by savings association conduct that violates federal consumer laws or regulations;
- Encouraging improved communication between savings associations and their customers with respect to non-regulatory disputes; and

- Assisting consumers with questions about the industry or related financial services.

Our Regional offices handle information requests or complaints for the institutions and holding companies they supervise. The Washington office establishes policies, procedures, and systems for the OTS-wide consumer complaint function; monitors consumer trends and OTS response efforts; disseminates incoming phone messages, e-mails, and written correspondence to the appropriate Regional offices for response; and coordinates interagency initiatives.

OTS maintains an electronic system for tracking and monitoring complaints and inquiries submitted by complainants. The Consumer Complaint System (CCS) is the agency's primary tool to manage the Consumer Affairs function. OTS recently added a Katrina (hurricane) complaint code to better track complaints related to recent disasters.

The FBAs meet regularly to coordinate and compare notes on the consumer complaint function. The agencies share complaint codes and are working toward having common complaint codes. The agencies also share information about the types of complaints received and refer complaints to the appropriate FBA or functional regulator (SEC or State Insurance Regulator) if they receive complaints about an institution or charter type they do not supervise.

The FBAs recently participated in an interagency consumer complaint conference on April 24-26, 2006. The purpose of the Interagency Consumer Affairs Conference was to:

- Share best practices among consumer affairs specialists and staff;
- Provide guidance related to emerging compliance and consumer protection issues;
- Provide an opportunity to identify and evaluate, in group discussions, current banking practices and consumer trends that increase compliance risk; and
- Address recommendations and concerns.

OTS maintains a toll free number and an e-mail account in Washington for incoming complaint calls and e-mails. Each Region also maintains a phone line specifically for incoming complaint calls.

OTS has a performance goal of resolving complaints within 60 days of receipt. If for some reason we do not resolve a complaint within 60 days, we generally notify the complainant by phone or mail that we are continuing our review of the matter.

For 2005, OTS received 5115 written consumer complaints. Of those, 4742 (or 93%) were resolved within the 60-day time period. For the first 5 months of 2006, we received 1797 written complaints. Of those, 1680 (or 93%) were resolved within the 60-day time period.

When a complainant requests a review of the findings of a Regional office, the Regional office sends the file to our Washington office. The OTS Ombudsman's office reviews the entire file and, within 60 days of receipt of an appeal, OTS advises the complainant and the appropriate Regional office of its findings. If our review indicates a complaint involved a violation of federal consumer laws or regulations, we inform the complainant of any pertinent corrective action that OTS requires of the savings association.

G. Regulatory and Supervisory Coordination

Convergence in the financial services markets continues to proceed at a rapid pace as companies attempt to maximize synergies across business lines. OTS has supervisory responsibility for savings associations and their holding companies, many of which engage in insurance and securities activities. These activities are often conducted by multiple legal entities within a corporate structure and across numerous regulatory jurisdictions. Given the scope of these activities it is critical that we maintain healthy relationships with all financial regulators and supervisors.

OTS maintains regular contact with state and federal functional regulators. In particular, we work closely with our sister banking agencies. Our goal is to coordinate supervisory activities and knowledge to limit overlapping regulatory efforts, and to identify regulatory gaps that may exist across functionally regulated business sectors. As I previously highlighted, we also expanded our regulatory contacts abroad to ensure effective supervision of holding company structures that maintain significant operations in foreign markets.

1. Functional Regulator Coordination

Domestically, our regional offices have working relationships with insurance and securities regulators in states where these companies conduct operations. Our coordination activities also involve meetings, regular communications, and joint activities and programs, often through various supervisory coordinating entities such as the National Association of Insurance Commissioners (NAIC), the National Association of Securities Dealers (NASD), and the North American Securities Administrators Association (NASAA).

We have worked extensively with the NAIC to minimize regulatory overlap as more insurance companies acquire thrifts. Pursuant to these efforts, we have information sharing agreements with insurance regulators from 48 states and the District of Columbia. Our activities include shared attendance and participation in official agency programs, conferences and training seminars. These events foster cross sector learning and provide opportunities to cultivate regulatory relationships.

OTS staff also coordinates closely with regional counterparts at the NASD to identify issues of common interest involving securities activities by thrift service companies engaged in securities brokerage activities. Similarly, we have developed relationships with staff of the NASAA that enable us to coordinate and leverage our resources to achieve success in areas of mutual interest. We continue to work with other federal agencies, including the Securities and Exchange Commission and the Federal Trade Commission on policy matters and, when appropriate, on matters involving specific institutions.

2. FFIEC and Federal/State Cooperation

Domestic and international financial services supervisors know well that supervisory cooperation produces innovative solutions to industry issues and provides invaluable perspective on cross sector trends and risks. OTS works closely with the other FBAs and State bank regulators, including the Conference of State Banking Supervisors (CSBS), in various forums and capacities.

VII. Conclusion

The thrift industry has grown and diversified over the past several years while reporting excellent financial results. Thrifts continue to play a vital role in providing mortgage funding and other retail products and services to their communities. At OTS, we will continue to evaluate our policies, staffing, and infrastructure to ensure that the agency is well prepared to handle new and emerging risks. We strive to provide the appropriate level of supervisory support to the institutions we regulate through guidance, industry training, and regular communications. We are confident that the industry will continue to fulfill its primary focus of serving retail customers with mortgage funding and other financial services in a profitable and prudent manner.

Thank you for the opportunity to testify before the Subcommittee on the activities of the OTS and the current state of the industry we regulate and oversee.