In Focus: Supervising Through the Economic Crisis

*FY **2008** was a tumultuous and historic year that had a disproportionate impact on the thrift industry, exposed gaps in government regulation of the financial services industry and defined the topics of debate for the proposed restructuring of the federal financial regulators in FY 2009.*

The result of that debate will determine the future of the OTS as the agency enters its 20th year.

For the OTS, which oversees an industry that by law concentrates on home mortgages and other retail lending activities, the pivotal question will be whether the nation continues to value a federal banking charter dedicated to consumer and community lending. Once that public policy question is answered, the path ahead will become clear.

One fact remains undisputable: Homeownership is critical to the American economy and society.

Recent events have demonstrated that not every aspiring buyer can afford to own a home. There is a limit to sustainable homeownership and attempts to push beyond that limit can undermine the confidence essential for investors to provide sources of mortgage financing.

However, homeownership continues to be a binding force for strong communities across the nation. A high level of homeownership typically equates to lower crime, higher property values and actively involved neighbors.

Despite the economic downturn, OTS-regulated institutions continued in their role as consumer and community lenders to provide credit to keep alive the American dream of homeownership. This fact speaks volumes about the essential role of the OTS in supporting American families in their quest to own homes — in good times and bad. When times are tough, OTS-regulated institutions cannot abandon their mission and try to pursue more profitable lines of business that would put a majority of their assets outside home mortgages and other retail lending activities.

The OTS and the thrift industry are there for the American homeowner. Those are powerful allies that citizens across this nation — and the very essence of the nation itself — can't afford to lose.

While housing finance lies at the core of the thrift industry, it is also at the eye of the current economic storm. During the savings-and-loan crisis of the 1980s and early 1990s, about two-thirds of the troubled assets of thrift institutions were in commercial real estate loans. During the current crisis, more than 80 percent of thrift institutions' troubled assets are in single-family mortgages.

Trouble began to surface last year when the overheated housing market cooled, interest rates on adjustable-rate mortgages reset and homeowners who were straining to afford their mortgage payments were suddenly unable to refinance. An increasing number of borrowers found themselves "upside down" in their mortgages, owing more on their homes than the homes were worth.

When investors lost confidence in investments tied to home mortgages in the summer of 2007, a defining moment occurred — the credit markets froze. That event set in motion powerful forces that took the financial services industry and the global economy by storm, driving to failure two of the nation's largest thrifts, including home lending giant Washington Mutual.

In time, the damage spread to the national and global economies. Recovery is expected to stretch through 2009 and perhaps beyond. Thrifts, like other financial services institutions, will continue to face enormous pressures. Some will not survive.

Looking ahead to reforms needed in the future, it is clear that a uniform set of rules must apply to the underwriting of all mortgage loans, not just the mortgages originated by federally regulated depository institutions. Allowing loosely regulated mortgage brokers to play by a less restrictive set of rules had a corrosive effect on the entire market and exerted competitive pressure for the weak underwriting that helped propel the crisis.

Secondly, borrowers must have a clear understanding of the terms of their mortgages and investors must have a clear view of the risks inherent in mortgage related investments.

As consolidation in the financial services industry in recent years has reduced the number of financial institutions and the largest banks have grown to become "mega-banks," a rift has grown between large, complex commercial enterprises and the many small or narrowly focused community banks across the nation's heartland that provide traditional banking services to individuals and small businesses.

Two very different types of banking businesses have evolved — one enormous in complexity, focused primarily on commercial lending, the other much simpler in operation, focused on consumer and community retail lending.

As Congress and the Administration move in FY 2009 toward the financial services regulatory framework of the future, they should ponder the wisdom of a two-pronged structure, one for each of these very different business models ■