REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE INDEPENDENT COMMUNITY BANKERS OF AMERICA
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Good morning. It is always an honor and a pleasure to talk to the Independent Community Bankers of America. As I stand here before this wonderfully large assembly of community bankers from around the country, I am fondly reminded of my 23 years as a community banker in Illinois and Florida, ten of those years as President and CEO of the National Bank of Sarasota, in Sarasota, Florida.

Recently I looked at the ICBA's website to review again your mission statement. I wonder how many of you can recall the mission of your organization? It is a well-crafted statement of purpose that says, "The ICBA is a strong and dynamic trade association working to provide its members a competitive edge by effectively aggregating political, economic and marketing power. The ICBA is dedicated exclusively to enhancing the franchise value of the nation's community banks for the benefit of their customers and the communities they serve."

What struck me most about your mission statement were two things. First, the focus of the statement is clearly defined and, in its very words, "dedicated exclusively" to enhancing community banking. Second, the statement articulates a clear and important benefit derived from this exclusive focus: that is, to benefit the customers and communities you serve. This is the essence of community banking: community service with a clearly drawn focus on the bottom line.

ICBA's mission to give a voice to the thousands of community bankers across our country is critical. And, as I will discuss in a few minutes, I believe it is particularly critical right now. I believe we are at the crossroads of a regulatory burden crisis that threatens to reshape our industry forever, with the ultimate price being paid by the customers and communities you serve.

I will come back to these ideas in a few minutes, but before stepping onto my regulatory relief soapbox, I want to share with you a few observations about my first six months at the Office of Thrift Supervision (OTS). And I will conclude my remarks today with a brief discussion of three "hot button" issues that will have play in the months ahead. These are Basel II and I-A, and two pieces of proposed interagency guidance, one dealing with non-traditional mortgage products, and the other with commercial real estate lending.

With 23 years as a community banker under my belt, I wasn't sure quite what to expect when I came to OTS. After six months on the job, learning about the agency and getting to know its capable staff, I come to you with the impression that OTS and the charter we administer do indeed have some unique and inherent strengths I did not fully appreciate.

OTS operates today with a minimum of overhead. A skilled staff with tremendous experience in nearly every sector of modern banking enables our agency to quickly adapt to market demands. And we are continually striving to improve our staff. This year, we will hire 60 new examiners, bolstering our exam staff by 11.5 percent. We are also boosting training and hiring in certain critical areas, including capital markets, economic analysis, and compliance management. And we are re-establishing at our Washington headquarters a centralized direction for Compliance, Community Reinvestment Act (CRA) and Consumer Protection — a function delegated to the regions in recent years, but one that I feel needs central policy direction and coordination from Washington, DC.

OTS oversees an industry and charter that is primarily engaged in retail banking; or, more precisely, retail community banking. You already know firsthand that this is a rapidly growing segment of the financial services world. Two weeks ago, we reported that, for 2005, assets for the segment of the industry we regulate were up 12.0 percent from the prior year to a record $1.46 trillion. And in the past five years, industry assets grew 57.7 percent, representing a robust average annual five-year growth rate of 9.5 percent. By any measure, these are excellent numbers.

Earnings, too, were strong last year, and have been strong and steady for the last five years. For 2005, earnings were up 17.6 percent from 2004, and industry earnings more than doubled the last five years, climbing from $8.0 billion in 2000 to a record $16.4 billion in 2005.

As the retail community banking sector grows, I believe our charter is well positioned to provide a structural and regulatory alternative both to established financial services businesses and to new entrants that are working to grow market share in this area. Well-established and well-recognized powers of branching and preemption ensure savings institutions are able to follow their customer base and the growth of their business from one end of the country to the other — all with minimal regulatory burden. And OTS's seamless supervision at all levels of an organization — at the bank level as well as at savings and loan holding companies — ensures a comprehensive supervisory regime with minimal regulatory overlap.

The charter we oversee is remarkably flexible in adapting to the many products and structures present in today's financial services marketplace. It 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 savings bank 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.

Notwithstanding a great staff and a dynamic charter, there is always room for improvement. We have requested several statutory changes from Capitol Hill to better align our charter with the realities of the legitimate business activities of modern retail community banking. These are included in the proposals for interagency regulatory burden legislation, and will help us maintain the vitality and competitiveness of our retail

community banking charter. Notwithstanding suggestions to the contrary, I think there remains a good opportunity to get these priorities, and those that your organization has articulated¸ enacted as part of our broader regulatory relief effort – the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) project.

Two years ago this month at your annual convention in San Diego, a number of you stood on your chairs and demanded that we in Washington take seriously your call for much needed regulatory burden relief. The speaker at the time, then FDIC Chairman Don Powell, relayed this scene to me. As leader of the interagency EGRPRA project which had begun almost a year earlier in June of 2003, I was not surprised at this show of frustration, if not outright anger. We are now at a crossroads. If regulatory burden relief is truly something important to you, now is the time to engage yourselves to urge Congress to move forward this year on legislation to make it happen.

Many of you know that regulatory burden relief is a subject near and dear to my heart. 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.

Last week, along with Terry Jorde, I testified before the Senate Banking Committee. My testimony included a statement that accumulated regulatory burden is suffocating the banking industry despite the fact that the industry seems to be doing so well, with successively increasing record profits in recent years. Characterizing the entire banking industry, however, as enjoying record profits is misleading. Not often mentioned is the fact that only seven percent of the industry (630 institutions with assets of greater than $1 billion) accounts for 87.6 percent of industry profits. The remaining 8,200-plus institutions, representing 93 percent of the total number of institutions, share the remaining 12.4 percent of industry profits.

Most significant is that the 3,863 community banks that hold assets of less than $100 million account for only 1.5 percent of industry earnings, yet represent 43.7 percent of total institutions. "Record profits in the industry" is a label not shared by many smaller community institutions. Community bank ROA's have generally declined the last ten years, with their efficiency ratios relatively flat during this period. By contrast, large bank ROA's have generally increased, and their efficiency ratios have declined the last ten years.

While regulatory burden impacts all institutions, large and small, I believe it has a potentially greater competitive impact on smaller institutions. There is considerable anecdotal evidence supporting the notion that regulatory burden is at the top of the list of reasons why community banks sell out. Investment bankers at recent M&A conferences confirm this fact.

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 smaller 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 independent community banks are absorbed by larger non-local competitors, I've 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. I will also tell you that I am concerned about the future of community institutions led by the current generation of community bank CEO's approaching retirement. What is the exit plan? Is it to remain independent and to pass the gavel along to a successor, thereby retaining the unique quality of your institution? Or is it to merge with another institution?

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, with implications that are largely ignored by policymakers.

Ten years ago, Congress enacted 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.

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 Congressional testimony on the subject to both houses of Congress, and, like your staff in Washington, we have met with many Members of Congress to discuss the importance of this issue.

In addition to building awareness in the marketplace and in Congress, 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 increased the small bank threshold under the CRA from $250 million to $1 billion, simplified some of our application and reporting requirements, streamlined examination processes, and made other changes to our regulations and internal procedures to reduce burden. It will probably surprise you to hear that almost every new regulation, process, or procedure now includes a discussion among the FFIEC principals about burden and how to accomplish the objectives while minimizing the regulatory burden on the industry.

Now we must ensure that our recommendations lead to fruition with the passage of a significant bill in the Congress. There are skeptics — even with some people within the industry in Washington, DC, who have the greatest ability and influence to get a regulatory relief bill enacted. But the House Financial Services Committee recently acted on a 67-0 vote to send a comprehensive regulatory relief bill to the House floor. The Senate Banking Committee is poised to take up a similar bill by the end of this month.

This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of recommendations before Congress 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. There is much greater visibility and recognition of the problem now than in the past. Again, it is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

There are three "hot button" supervisory issues that I want to briefly discuss. Each of these areas has involved considerable agency resources, and has evoked significant industry interest and controversy. All three are important and relevant to community bankers.

The first issue is Basel — both the Basel II and proposed Basel I-A capital standards. There has been considerable debate in the U.S. about the need for Basel II. Some believe we should simply update existing capital rules to accommodate advances and changes in the banking system since the original Basel I Accord was adopted and implemented in 1988. Others argue that implementation of Basel II is imperative to advance more sophisticated risk management practices as well as to ensure the continued international competitiveness of our largest institutions. And I'm guessing there is a high percentage of bankers here today who would be content to continue operating under the existing Basel rules.

A prime issue, I believe, will be the trade-off or cost benefit between the value derived from a new set of capital rules and the potentially increased regulatory burden that may result. A significant part of the regulatory community believes our current risk-based capital system should be more risk-based than it is today. The challenge will be to determine if this can be accomplished in such a manner as to add value to you and your directors in the risk management practices of your banks without undue complexity.

While a Basel II-type approach <u>may</u> be best for our largest internationally active banks — about 24 in number — for most institutions either the current Basel I rules or a modified Basel I framework will likely be more appropriate. It is somewhat of a challenge to proceed on these parallel tracks. The goal of the regulatory agencies is to provide an opportunity for a simultaneous review of the proposed Basel II and Basel I-A rules. Currently, we anticipate that the Basel II rulemaking will be available to the public at the end of March and published in the Federal Register in May for an extended comment period. We expect to issue the Basel I-A rulemaking some time this summer, providing a

meaningful overlap between the Basel I-A and Basel II comment periods. I encourage you to make your views known to us when the proposed rulemakings are issued.

The second issue I want to mention is the interagency guidance on non-traditional mortgage products. Not unexpectedly, the guidance generated considerable attention due to the popularity of two products in particular, "interest-only" and "pay option" adjustable rate mortgages, or "ARMs."

The features of interest-only and pay option ARMs, as you know, can temporarily protect borrowers from payment increases resulting from rising interest rates. The experience with these instruments has, so far, been favorable. However, these new 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 assumptions about interest rates, as much as a 100 percent increase or more in the monthly payment.

Products much like these have long been offered by institutions regulated by OTS, with the agency's interest rate risk model helping guide us and the institutions we regulate to manage the risks inherent in these programs. 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. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks associated with these types of loans.

I do believe there is a market for this product in situations where the loan product is properly structured, fully disclosed, appropriately marketed, well underwritten, and safely managed. That said, given the structural complexities and possible payment increases when the loan terms are reset, this product is not appropriate for unsophisticated borrowers or those with weaker credit capacities. I do believe that some negative amortization products may offer qualified borrowers greater financial flexibility than traditional products, which is beneficial to borrowers capable of understanding and managing the possible risks attendant to this product. While it is not a product that should be offered to all borrowers, I would not want to deprive qualified candidates from a homeownership opportunity by declaring this product off limits.

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them 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. As a regulator, that is our recommendation as well as our expectation.

For anyone interested in commenting on the proposed guidance, the comment period was extended for 30 days and will close on March 29.

My final issue today is the proposed interagency guidance on commercial real estate (CRE) lending by insured institutions. The proposed guidance sets out thresholds for assessing whether an institution has a CRE concentration requiring heightened risk management practices. It focuses particularly on concentrations in those types of CRE loans that are vulnerable to cyclical commercial real estate markets. Institutions with these types of concentrations are expected to hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. The guidance sets forth concentration ratios based on loan type. While the concept of capital allocation based on concentration ratios is not novel, the proposed guidance establishes thresholds that are new.

While CRE lending exposure is generally limited in the institutions regulated by OTS, I 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.

If you have an interest in commenting on the proposed CRE lending guidance, the comment period is scheduled to close March 14, but I believe it is likely to be extended another 30 days to mid-April.

Thank you for the opportunity to speak to you, today. Again, I am honored to be here and I look forward to a continued, strong relationship with the ICBA. I will be happy to take questions if time permits.

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