Remarks of John M. Reich, Director
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to the Financial Services Roundtable Housing Policy Council
Chicago, Illinois
May 17, 2007

Good morning. It is a pleasure to be here to meet with the Financial Services Roundtable's 4th Annual Housing Policy Council. For many reasons, today's meeting is particularly timely. There are numerous housing issues that are currently the topic of significant policy debate. These include the current state of the mortgage markets with concerns about the subprime and Alt-A markets; predatory lending and continuing attention on oversight of the mortgage origination process; questions about the mortgage securitization process; GSE reform; prospects for the future of affordable housing; the availability of homeowners insurance in certain parts of the country; and, until recently, the proliferation of nontraditional mortgage products by lenders unfamiliar with the risks.

In my remarks today, I will give you a brief update on the OTS and the thrift charter, and then focus the remainder of my remarks on two housing-related issues. These are the current regulatory issues in the subprime lending markets, and concerns with the availability of homeowner's insurance and affordable housing in natural disaster-affected areas.

The Thrift Charter

The OTS and the charter we oversee have unique and inherent strengths that continue to reap rewards for the industry we regulate. Since I joined the agency less than two years ago we have increased our overall staff by more than 15 percent. By September 30, 2007, we expect to have a professional staff of almost 1000 people dedicated to the mission of maintaining the safety and soundness of the thrift industry, and improving the regulation, oversight and flexibility of the charter.

Our priorities include placing greater emphasis on outreach and visibility for the agency at state and national conferences and conventions, such as yours. The OTS oversees an industry and charter that is primarily engaged in retail banking or, more precisely, retail community banking. This is a rapidly growing segment of the financial services world, yet its story does not have the visibility it deserves.

As the retail banking sector grows, I believe the thrift 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. The combination of branching and preemption powers, coupled with seamless consolidated institution and holding company supervision, ensures 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.

At the end of 2006, there were 845 OTS-regulated thrifts, holding assets of $1.4 trillion. We also oversee 475 thrift holding company structures with consolidated assets of approximately $8.0 trillion. While financial services consolidation has reduced the overall number of savings institutions, industry asset growth remains strong. In fact, in the past five years, industry assets grew 44.3 percent, representing a robust average annual growth rate of 7.6 percent. This is due to growth within existing thrifts and to the fact that various financial institutions continue to choose the thrift charter for the reasons I just mentioned.

The thrift charter is deployed in neighborhood community banks all across America. It is 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 seem to show that it has been a profitable decision.

Current Issues with Subprime Lending

You are all aware of the existing issues with subprime lending in the mortgage markets. Clearly, the existing problems in the subprime and Alt-A markets are considerable. By some estimates, more than 20 percent of the $567 billion of subprime hybrid mortgages that are scheduled to reset this year will involve a serious delinquency that could lead to foreclosure.

There have been many discussions the past several months among regulators, industry participants, legislators and administration officials about how to address this problem and the potential fallout on the mortgage markets. A few weeks ago, the federal banking agencies hosted a roundtable discussion at the FDIC for key industry players to discuss options and solutions for addressing a significant increase in troubled subprime loans in the next several quarters. Senate Banking Committee Chairman Dodd held a similar event a few days later. In addition, there have been numerous hearings in the House and the Senate in which the issues have been extensively discussed.

Generally, several themes have emerged from these discussions. First, all agree that foreclosure is in no one's interest. Rather, we need to identify solutions and ways to avoid foreclosing whenever possible on borrowers who are struggling to stay in their homes. Second, there is considerable dissatisfaction with certain aspects of the mortgage origination process, particularly with respect to accountability in the underwriting process. Third, predatory and abusive lending practices should be identified and eliminated in the mortgage origination process. Finally, mortgage fraud must be addressed with an appropriate enforcement response at the local, state and federal level.

On the issue of foreclosure, the OTS is committed to working with our regulated institutions to provide the supervisory flexibility and regulatory encouragement to address problems in the subprime market. However, as I and my colleagues at the other federal banking agencies have noted, a considerable part of the problem lies outside insured institutions. While federal standards and guidelines may be helpful, we need a way to ensure that the net we cast is inclusive of all participants in the mortgage process.

The intersection of preserving sound subprime lending and shutting down predatory lending abuses in the subprime markets is particularly troubling. It goes to the very heart of affordable housing. We need to weed out predatory lending, and particularly the potentially predatory features of certain lending products in the subprime market, without shutting down the availability of credit to subprime borrowers.

We also need to address the problem of key participants in the mortgage process escaping accountability. One obvious solution is imposing regulation where it is needed; but it is equally important not to interfere where market solutions can be more effective and efficient – and impose less regulatory burdens that run counter to the efficient allocation of credit in the housing markets. Again, too much government can create inefficiencies that run counter to the best interests of the mortgage market, including the subprime market. It can also shut down credit and make matters worse all around. We have witnessed this phenomenon several times within the last several decades.

We also have to make it clear on a coordinated basis at all levels of supervision and oversight that mortgage fraud, whether practiced by the borrower, lender, or other participant in the mortgage loan process, will not be tolerated.

Lenders and consumers have benefited significantly from lower interest rates and a mortgage boom over the past several years. However, the recent moderation in housing has added pressure to exploit efficiencies developed to handle greater volume in the mortgage underwriting process. Today, many mortgage decisions are made by underwriters with no firsthand knowledge of the property, the borrower or the seller in a transaction. In many cases, the relationships among the parties can be measured in a matter of hours, if not minutes.

Increased reliance on automated underwriting and property valuation processes, as well as relaxed underwriting standards and heavy reliance on unaffiliated third parties has invited fraud into the mortgage origination process. And mortgage fraud is causing significant losses to financial institutions and borrowers alike. According to the FBI, federally regulated institutions alone reported over $1 billion in losses due to mortgage fraud in 2005. It is estimated that losses from all sources in the mortgage process total more than $6 billion.

Because of the number of participants and complexity of the mortgage process, fraud prevention is difficult. Mortgage fraud occurs both inside and outside financial institutions, and is limited only by the imagination and resourcefulness of the perpetrators. Complicating the problem is that mortgage fraud is often engaged in systematically on a wide scale basis. This, however, presents the opportunity to combat mortgage fraud on a large-scale.

There are various proposals to address the problem, including creating a safe harbor for information sharing within the industry to identify potentially fraudulent activities. This would help prevent fraud from migrating from one institution to another. The creation of a national database for real estate appraisals would also help identify situations where multiple appraisals on the same property signal that someone is "shopping" for the highest value. An appraisal database would also help validate the appraisal process by limiting access to the system only to documented appraisers.

A final proposal is instituting a national licensing system for loan officers at brokerage firms and the development of a facility to associate loan officers with fraudulent loans. It is estimated that between 70 to 80 percent of subprime loans are originated through mortgage brokers. Thus, oversight of this segment of the mortgage pipeline is critical to the success of combating mortgage fraud as well as preserving and promoting sound subprime underwriting and lending activities.

Unfortunately, there are wide variations in estimating the number of licensed mortgage brokers in the U.S. The scope of regulation, oversight, and supervision of mortgage bankers and lenders in various states is also uncertain. While some states license mortgage brokers with respect to the activities involved in originating a loan, the entity that funds the loan, i.e., a mortgage banker or lender, may not be regulated. More rigorous oversight and enforcement of the mortgage origination process may be the best prescription for addressing mortgage fraud as well as predatory lending abuses and poor underwriting practices that have created problems in the subprime market.

In this regard, I note that the Conference of State Bank Supervisors (CSBS) is developing a national licensing system for residential mortgage lenders and brokers that, among other things, will provide a central repository of information about state licensees and publicly adjudicated enforcement actions.

As you may be aware, the federal banking agencies issued proposed guidance on subprime lending in early March. The comment period for that proposal closed last week, on May 7. I hope you had an opportunity to share your thoughts with us on the proposal, particularly with respect to your views on the appropriate underwriting standards that should apply in the subprime markets.

The OTS will continue to be an active participant in many aspects of subprime mortgage market issues as they unfold over the next several months. We are partnering with community groups and industry participants on a host of housing-related issues involving affordable housing and addressing predatory lending. We will also continue to explore the appropriate use of various industry, community and regulatory forums to increase awareness and discuss solutions for the subprime market and address predatory lending abuses.

The Impact of Natural Disasters on the Housing Economy

When a hurricane or other natural disaster strikes, more often than not what we see on the news is the devastating impact on our homes. We are all familiar with these aftermath pictures and our heart reaches out to the families impacted by these devastating events. For those who have not lost loved ones, however, you often sense an undertone of "We all survived, it's just brick and mortar – we can rebuild." Katrina changed all that. No longer do we have the sense that no matter what Mother Nature sends our way we will somehow come through it if we pull together and rebuild.

Like it or not, some things are bigger than all of us acting together – at least in the context of the post-disaster timeframe that we are accustomed to. Yes, we can and will rebuild, but many are asking "Is it worth it? There are many reasons for this question. I want to talk about two in my remaining time this morning – affordable housing and the availability of affordable homeowner's insurance.

I have visited post-Katrina New Orleans on six separate occasions in the last 18 months. Last week, I spoke to both the Louisiana Bankers and Florida Bankers Associations on the issue of homeowners' insurance in a post-Katrina world. I noted that institutions in the Gulf Coast states are currently confronting what most agree is an extremely challenging set of issues regarding the affordability and availability of homeowner's insurance. As a result of the many hurricanes and the significant damage these caused, insurance companies have made adjustments that are fundamentally altering the lending business in Louisiana and other Gulf Coast states.

The insurance issue presents a number of problems that manifest themselves in various ways. For instance, homeowners and business owners in coastal areas often cannot find affordable hazard and windstorm insurance. When they find affordable insurance coverage, they often find that the insurance is offered by lesser-rated or unrated companies, and that deductibles are high and coverage is reduced. When disasters hit, they also find that there may be questions as to whether damage was caused by wind or water, and hence whether they are covered or not covered under hazard and windstorm policies.

Financial institutions are concerned about the adequacy of insurance coverage of their residential and commercial loan customers' collateral properties. They also worry whether borrowers can afford heightened escrow payments to cover the cost of insurance, and they worry whether their customers can afford to rebuild given the immediate and potential long-term costs of doing so. Institutions also worry about having to force place insurance coverage for their customers who cannot afford insurance, or who rely on the institution to provide force placed coverage when they cannot find it themselves. Institutions sometimes even have to scramble to find insurance coverage on their own offices.

Coastal state insurance regulators are working hard to have affordable insurance coverage available in their states. State insurance regulators are encouraging well capitalized insurance companies to continue offering insurance in the states, but there are serious issues with exposure to coastal areas. Potential insurance payouts from a direct hit by a significant hurricane are further exacerbated by coastal property values that have mushroomed. Not only have the number of people moving to the coast skyrocketed, but the square footage of residences has ballooned, and the density of waterfront living has jumped due to the prevalence of multi-story condominiums. Reinsurance costs have also exploded since the 2004 and 2005 hurricanes that hit the southeast and gulf states. Some reinsurers stopped offering coverage in the most exposed states.

I am also aware that this is an issue that is very much on your minds. I read the report prepared by the Financial Services Roundtable Blue Ribbon Commission on Mega-Catastrophes. I want to commend the fine work of the Commission and, in particular, the strong leadership of the Commission's Chairman, State Farm Chairman and CEO Edward Rust, and the Commission's Vice Chairman, Washington Mutual Chairman and CEO Kerry Killinger. I am proud that two of the entities that we oversee spearheaded the Commission's outstanding work in this area.

I particularly commend the Commission for providing both an analysis and specific recommendations for a blue print to minimize America's future exposure to mega-catastrophies such as Hurricane Katrina. Among the 23 consensus recommendations are improving building codes for structures in higher risk areas, expanding the role of the capital markets in financing catastrophe risks, considering an optional federal charter for insurers, and federal support to state guaranty funds. The Commission also noted the need for public policy measures that enhance the availability and affordability of catastrophe insurance, and improved risk-based pricing and incentives for reducing individual exposure to catastrophe losses.

In addition to the Louisiana and Florida Bankers, banking groups in other Gulf Coast states continue to offer advice and counsel to their state legislators and others as they deal with the daunting issues raised by the escalating cost, affordability and/or unavailability of hazard insurance coverage. We are monitoring our affected institutions, and attending meetings with insurance commissioners and other regulators on the subject. While a number of avenues are being explored, and remedies are being put into place or considered, there is still a lot of hope pinned on 2007 being like 2006, which was relatively free of major hurricanes. However, I think we all recognize that this is not a good approach.

While homeowners' insurance is a monumental issue, addressing the availability of affordable housing in a hurricane-devastated area such as post-Katrina New Orleans is daunting. We are not talking about finding ways to create additional affordable housing in a hot housing market or one that is squeezing low – and moderate-income families to less desirable neighborhoods. What we are talking about is finding a place to live for people who have lost everything – their home, car, everything but the clothes on their back and, more often than not, their job. These are hard-working people who built a life in New Orleans or some other natural disaster devastated community and, suddenly, have nowhere to go and no job to support them.

Last week, I announced that this fall the OTS will be sponsoring its second annual national housing forum to address both of these very important aspects of the economic housing fallout of natural disasters – future hazard insurance coverage and recovering and restoring affordable housing to disaster affected communities. I hope all of you will be able to attend or listen in to this important event.

Conclusion

Thank you for the opportunity to meet with you, the Housing Policy Committee of the Financial Services Roundtable. The Roundtable continues to be one of the premier financial services associations addressing important national policy issues. I am honored to have had an opportunity to meet with you today. I am happy to answer your questions as time permits.