Remarks of John M. Reich, Director
Office of Thrift Supervision
to the Independent Community Bankers Association
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Good morning. It's wonderful to be here in Orlando with my good friends at ICBA. I had hoped to be here earlier, but Senator Chris Dodd and the Senate Banking Committee had other plans for regulators with a hearing on the condition of the industry yesterday.

This morning, I want to talk about the condition of the thrift industry and recent industry performance, and make some general observations about the housing and mortgage market situation. I will also address the challenges to our industry and what we can do to stimulate liquidity flowing into the market and to help homeowners currently dealing with the threat of foreclosure. I particularly want to describe a new initiative OTS has proposed that we believe may help a larger number of borrowers keep their homes and prevent foreclosures without a government "bailout" or a windfall to investors.

But first, I must say it's great to be back in Florida where I have deep roots, fond memories, three grown sons and their families, including three grandchildren. I'm especially pleased to be with my favorite bankers: community bankers.

Many of you know that I spent many years as a community banker and I am passionate about your mission and service to your communities. I spent a significant portion of my career here in Florida as a community banker in Sarasota, and prior to that in Fort Myers. I look back on those years with many fond memories and great appreciation for the opportunity to be a community bank CEO in a wonderful part of the world.

You are the backbone of your communities. Unlike some of your nationwide competitors, you focus attention on the needs of local families, businesses and community organizations. You are accessible to your customers and deeply involved in local community affairs.

And unlike some of the mortgage brokers and state licensed mortgage banks, you are not responsible for the subprime mortgage debacle and the current and future economic woes that we all face—and that are highly likely to get worse in the coming months.

Our industry (and I'm speaking of both banks and thrifts) is under extreme pressure. Margins are compressed, deposits are increasingly harder to come by, there is more intense competition for loans, delinquencies are rising in most loan portfolio categories and charge-offs are increasing.

Savings institutions lost a record $5.24 billion in the fourth quarter of 2007. A large portion of the quarterly loss in earnings and profitability was the result of goodwill write-downs and restructuring charges by just a few large institutions. For the year 2007, the industry posted profits of $2.9 billion and the return on assets was a meager 0.19.

Despite pressure on the industry, it continues to be fairly well positioned to weather the current storm. The industry has

relatively high capital levels, higher loan loss reserves and more diversified balance sheets than in prior times. Although earnings are under pressure, most of the recently reported industry earnings declines are attributable to a handful of large banks.

Thrifts accounted for approximately 31 percent of total home loans made in the fourth quarter of 2007, up significantly from the previous year. The lack of liquidity in the secondary market highlights the value and advantages of your depository institutions in these troubled times.

Difficult challenges still lie ahead for both the banking and thrift industry, and I would like to mention a few areas of potential concern that our examiners are currently seeing. As you might expect, we are focusing on asset quality very closely.

History continues to repeat itself in our business. During every boom cycle, there is a recurring tendency to forget the fundamentals, the basic blocking and tackling of banking: maintaining good systems of internal controls; insisting on

quality credit analysis and good loan documentation; keeping strong oversight by management; and reporting effectively to your Board of Directors.

Our examiners are looking for appropriate credit analysis and underwriting criteria in loan portfolios. In 2007, we noticed that credit and cash flow analysis, as well as credit documentation, had diminished.

In recent examinations, we have told an increasing number of institutions that they need additional oversight by management or their Boards of Directors for inadequate systems and controls. Additionally, exams revealed further need for increased strategic planning during these more challenging times. In 2007, there was a significant increase in our concerns related to earnings performance. Not surprisingly, exams also reflected volatility in the earnings stream of those institutions involved in mortgage banking. We certainly understand the impact on your portfolios of shrinking interest margins, increasing expenses attributable to growing compliance issues and the effect of a downturn in the

economy. Nevertheless, we have the responsibility to help you maintain the safety and soundness of your institutions, and the duty to encourage that necessary steps be taken to address weaknesses identified during examinations.

The marketplace today is fraught with risks and challenges. Your community banks, however, are the lifeblood of economic growth in your communities and you should continue to do what you do best—assessing the risks and making prudently underwritten loans. The entire international financial community has had to re-learn what you have known all along: there is no substitute for sound underwriting of loans. Relying on stated-income, or basing repayment capacity on a starter rate or a teaser rate, or assuming never-ending home price appreciation, or passing credit risk along to the secondary market are not good strategies either in the long run or the short run.

Innovative products (such as "interest only" and "pay-option ARM" loans) may be perfectly appropriate for some borrowers, and in fact they are; but they are certainly not for

everyone. When they are used to get people into homes who could not otherwise afford them, they are proving disastrous for some borrowers and lenders alike.

But even if you have managed your portfolios well and exercised prudent underwriting, you are likely feeling the impact of larger market issues. Although community banks did not cause the major disruptions in the housing and mortgage markets, you are feeling many of the negative effects, including downward pressure on bank stock prices, pressure to keep CD rates higher than you would like, liquidity pressures, and now more intense focus by regulators on your loan portfolios. The secondary market has added much value to the market by spreading risk and providing liquidity, but it has also widened the impact of less regulated mortgage market players to the entire global economy.

We have learned at least 3 lessons from our subprime mortgage experiences:

1. **Underwriting was bad.**

2. Transparency didn't exist, either to the borrowers or to the investors.

3. A level playing field between regulated institutions and unregulated mortgage brokers does not exist.

There needs to be more transparency in the functioning of the capital and mortgage markets. Secondary market participants need to have a much better understanding of their risk—and there needs to be a superior method to rate the risk. Only then will a reliable, viable secondary mortgage market come back.

But an eventual market comeback will not help the many homeowners who are in danger of losing their homes. This is the current priority topic of Congress and the regulators in Washington, D.C., today as we work to develop strategies to minimize foreclosures. The debate between the Administration and Capitol Hill is whether there will be government funds used in any manner that would be perceived as a "bailout," either to lenders, borrowers, or investors.

On February 20th, I announced a proposal to aid the growing number of borrowers who will find themselves in financial difficulties, and find their mortgages "underwater" —meaning that their outstanding mortgage balances are greater than their homes are worth. As you well know, home values across the country have fallen and, in some regions or neighborhoods, prices have depreciated very significantly. Our most recent numbers indicate, for example, that home prices in 10 cities fell for the eleventh consecutive month in November 2007, for a year-over-year decline of 8.4 percent—a record drop. Miami continues to have the weakest price performance, falling 15 percent from November 2006 to November 2007. San Diego follows, with a drop of 13.4 percent, and Las Vegas, with a 13.2 percent decline. Only three metro areas saw year-over-year increases in home prices: Charlotte, North Carolina; Portland, Oregon; and Seattle, Washington.

This negative equity position leaves all stakeholders— homeowners, lenders and investors—in a precarious position. Obviously, borrowers can lose their homes, but many may also

choose to walk away from the properties and their obligations to pay their mortgages.

The OTS proposal is specifically targeted to help prevent avoidable foreclosures against distressed homeowners who are unable to refinance their underwater mortgages on properties held in securitizations. The proposal would benefit all stakeholders in troubled mortgages, without letting any party off the hook and without a government "bailout," or the creation of a new government entity or assistance program. It offers a solution intended to optimize investor incentives to participate. It also enables insured institutions to participate in solving the problem, without transferring undue risk to the insured institutions' balance sheets.

There are a number of details that still need to be worked out. We are currently working with representatives of Treasury, our fellow regulators, FHA, Congressional leaders and staff members, and with investor and industry groups to refine our proposal. So, I want to share our thoughts in general terms, understanding that it is a work in progress.

In general, the proposal works like this:

- **Assume a family purchased a home two years ago for $240,000.**
- **They financed it by paying $20,000 down and obtained a mortgage of $220,000.**
- **Assume the value of their home today has fallen to $200,000 and their interest rate is above market.**
- **They refinance through FHA at a current rate, with a new high loan-to-value ratio mortgage for $196,000, which the servicer of the old loan accepts as a partial pay-off. In addition, the homeowner gives the servicer a negative equity certificate for $24,000 that is non-interest bearing.**
- **When the home is eventually sold, if price appreciation has taken place, the servicer will have the potential of recovering up to the amount of the certificate and the homeowner will benefit from any appreciation in excess of the certificate.**

- **The negative equity certificate could become a potentially marketable financial instrument.**

We have some work yet to do on this proposal. But I hope it will gain widespread support as we make our refinements, and I would welcome your observations and suggestions for improvement.

There are many other actions being taken or proposed to try to help borrowers and to mitigate the downturn in the economy caused by mortgage market distress. These include far-reaching stimulus packages and lender forbearance. The OTS proposal is not a panacea—not a silver bullet—but I believe it can be an effective component of the solution along with the administration's HOPE NOW proposal and other proposals, both public and private.

The recent economic news points to a very challenging banking environment for 2008: up-ticks in inflationary pressure and a decline in consumer confidence to a level not seen since March 2003. As of Friday, the S&P 500 index was

down 9 percent year-to-date; oil is at record highs and gold was near $1,000 an ounce.

So, we are at a difficult time in the economic cycle. I've been through many downturns in the economic cycle since I began my banking career in the 1960s. They have always passed. Well managed institutions have always survived and usually were stronger. This too shall pass, but it will require patience, tenacity and vigilance. It is the time to review your business plan and to think strategically about your future. It is time to review and improve the weaker areas of your organization.

In conclusion, let me say it is a great privilege for me to be here among the Independent Community Bankers. My respect and regard for the association has grown tremendously in my 12 on Capitol Hill and now nearly eight years in the bank regulatory arena in Washington, D.C.

Our working relationship over the years has been excellent. It is truly a pleasure to work with people like Cam Fine and

Karen Thomas, and bankers like Jim Ghiglieri, Terry Jorde and David Hayes. Your future leadership is in good hands with Cynthia Blankenship and Mike Menzies taking up the gavel this year and next, and I look forward to working with them.

Thank you.