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OVERSIGHT OF THE OFFICE OF THRIFT SUPERVISION

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OVERSIGHT OF THE OFFICE OF THRIFT SUPERVISION

Thursday, May 25, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett presiding.

Present: Representatives Garrett, McHenry, Gutierrez, Moore, Maloney, Davis of Alabama, Cleaver, and Scott.

Mr. GARRETT. [presiding] Good morning. This hearing of the Subcommittee on Oversight and Investigations will now come to order. Good morning to everyone. And as we await some late arrivals, presumably people who are still partying after watching American Idol last night, we will get things in order.

And I assume you realize that Sue Kelly is not with you this morning. Instead, Mrs. Kelly had some pressing business elsewhere, other legislative matters, and I am honored to fill in, in her place, to handle things this morning.

This morning the subcommittee will take a look at the Office of Thrift Supervision, a very important bureau, obviously, within the Department of the Treasury. The OTS, as it is referred to generally, was created by an act of Congress in 1989 in response to the savings and loan crisis of the late 1980's.

The Financial Institutions Reform, Recovery, and Enforcement Act, FIRREA, became law in August of 1989. This legislation addressed the S&L crisis by abolishing the Federal Home Loan Bank Board and creating the OTS to regulate thrift institutions, and by giving the deposit insurance function to the FDIC. It also created the RTC, the Resolution Trust Corporation, to help resolve any of the difficulties that existed with the insolvent S&L's.

In general, the new regulatory framework, as we can see, has done an adequate and good job. We have no repetitions of the crisis that shook the thrift industries back in the 1980's. And the problems that have—there have been no significant problems that have cropped up. Those that have come up have been dealt with, most likely, efficiently.

This record of success, however, does not relieve our obligation, as Members of Congress on both sides of the aisle, to conduct periodic oversight and review of this—or, for that matter, any other—Federal agency. It has been pointed out that it's been a few years since this committee has looked into the OTS in this context.

One of the broader issues that has occurred since the last review has been September 11th. And since September 11th, we have seen terrorists, as well as other criminals, use our financial system to further their own goals. And so, therefore, we are reminded of the importance of vigorous regulatory oversight so that we may ensure the stability of our financial systems, basically, to make sure that they are not used for illicit purposes.

Regulatory compliance through the Bank Secrecy Act and the Office of Foreign Assets Control is an essential bulwark of the protections that we look to. We know that money is a fuel of terror and crime, and the goal of most criminals.

So, therefore, this morning we will start by hearing from Director John Reich of the OTS. The Director will be followed by a panel of three witnesses, whom I will introduce as they appear.

So, I thank Director Reich and all the other panelists we will be hearing shortly. And at this point, I now recognize Mr. Gutierrez, the subcommittee's ranking minority member.

Mr. GUTIERREZ. Good morning, and thank you, Mr. Garrett. I am grateful to the chairwoman for calling this hearing. I am sorry that she couldn't be here with us today. I am particularly pleased that we are joined today by Geoff Smith, from the Woodstock Institute in Chicago. Mr. Smith will talk about the Community Reinvestment Act.

Last year, the OTS departed from a tradition of joint CRA regulation, and established a separate but weaker standard for CRA compliance than other regulatory agencies. There, "small institution exemption" means that thrifts with $1 billion or fewer in assets are no longer required to meet the service or investment tests under CRA.

Moreover, the thrifts with assets in excess of $1 billion can meet their CRA obligations without any service or investment requirements.

One of the most vital services that a financial institution can provide is low cost basic banking, bringing the "unbanked" out of the lightly regulated, high-cost world of check cashers and payday lenders. This is particularly true for senders of remittances, many of whom are not native English speakers, or who come from a country where banks only serve the wealthy.

Banks that offer low-cost remittance services often serve as a gateway to getting those "unbanked" into regulated financial institutions. Ever since I was elected to Congress I have worked to increase disclosure and lower the cost of remittance sending.

Last year, with Mr. Frank and other members of this committee, I wrote to the regulators, all of whom agreed to grant CRA credit to institutions that provide low-cost remittance services. I am glad that the OTS joined with other regulators on this point, and included low-cost remittance services in its Q&A.

However, since the OTS CRA regulations eliminated the service requirement for small thrifts, and permit large thrifts to meet their obligations without a service requirement, the potential for a real breakthrough was virtually wasted in the world of thrifts, and that is a shame.

I truly hope that Director Reich will re-evaluate the OTS CRA regulations, and that the thrifts will continue to fulfill portions of

their CRA obligations through service and investment, despite their current ability to avoid these valuable components of community re-investment all together.

Director Reich's testimony indicates concerns about certain alternative mortgage products, particularly interest only and pay option, adjustable rate mortgages that often contain negative amortization features.

I am also troubled by the popularity of these products. Some of these pay option mortgages are appropriate for a very limited universe, possibly Donald Trump in his immediate pre-bankruptcy days, but they are being marketed widely. And they are so complex that it is difficult, if not impossible, for the borrower to understand what he is getting into. I urge you to keep this in mind as you work with other regulators on guidance surrounding these products.

Finally, much of our time on the oversight subcommittee is spent on issues surrounding terrorists, finance, and Bank Secrecy Act, BSA, compliance. Your testimony indicates that this is an area posing significant compliance challenges for the OTS.

These are not new challenges. As the Inspector General determined in September 2003, the report indicated that the OTS examiners found substantive BSA violations at 180, or 18 percent, of the 986 thrifts examined during the audited period. These substantive violations included the lack of a BSA policy or systems to ensure compliance. OTS has issued written enforcement actions against only 11 thrifts.

Some of these violations were not fully addressed, even though they had been identified by OTS 6 years previously. At the appropriate time, I will ask the Director to respond in writing, if he prefers.

If BSA complies continues to be a challenge for the OTS, did the Agency not make significant changes in response to the Inspector General's report? Thank you, and I yield back the balance of my time.

Mr. GARRETT. The gentleman yields back. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman, and good morning, Director. How are you this morning?

I want to thank Chairwoman Kelly and our ranking member, Mr. Gutierrez, for holding this hearing to review the Office of Thrift Supervision. It's very important.

Director Reich mentioned in his written testimony that he was concerned about the increasing popularity of alternative mortgage products, and the future shock many homeowners will face when adjustable rate mortgages begin to climb.

I, too, am concerned with what may be the result of too lax of underwriting standards in writing many of these loans. My district is in Atlanta. I represent around 13 counties surrounding the city of Atlanta, the fastest growing region in this Nation. And of those, I represent 7 of the fastest growing counties, 7 of the fastest growing counties in the top 50 counties in this country, especially when you recognize Cobb County, Douglas County, Gwinnett County, and Rockdale and Newton Counties. I am sure that everyone understands the importance of foreclosure rates.

But my district and metro Atlanta is now second only to Indianapolis in foreclosure rates. In the first quarter alone, over 20,000 homes were in foreclosure in the Atlanta area. That represents one out of every 70 homes in foreclosure. That is astounding. In perhaps the fastest growing region in this country, one out of every 70 homes is in foreclosure.

So, you can see how concerned I am about this. And I can only imagine what will happen to many of my constituents when their adjustable rate mortgages increase.

So, I would like to hear your thoughts on ensuring that mortgage products are written in the best interest of the consumer. In addition, I would like to hear from you about the OTS Community Reinvestment Act rules, which are not uniform with the other banking regulators.

And I would also like to learn more about the OTS's relationship with the Federal home loan banking system, and if there are any potential areas of conflicts with the home loan bank regulators.

It's also important for me to hear from your Director on the issue of are you concerned with the impact that rising interest rates will have on consumers who have adjustable rate mortgages, and what are you doing to ensure that lending and underwriting standards are strong, and in the best interest of the consumer?

I would also like to know if you've found problems with thrifts giving out predatory loans, another huge issue in my region that my constituents are facing. And are you concerned that consolidation of the thrifts will decrease revenue for the OTS? And do you expect any problems maintaining sufficient staff levels?

So, you see, this is a very big issue for me, and I am very interested in this testimony. My constituents are very interested in this testimony. And also people all across the country are interested in this testimony. I yield back the balance of my time, and I thank you, Mr. Chairman.

Mr. GARRETT. The gentleman yields back. Mr. Cleaver?

Mr. CLEAVER. Thank you, Mr. Chairman. To Ranking Member Gutierrez, I am going to have to leave. This is a very important issue to me, as it is to my colleague. We have a memorial service for Sonny Montgomery, which I am involved with, but I desperately wanted to be here, and I will try to get back as quickly as I can, because of the significance of this issue. And I would like to thank Chairwoman Kelly and Ranking Member Gutierrez for holding this meeting.

And it seems almost oxymoronic to hold a hearing on oversight with a body that has the word supervision in its name. But one of the top priorities of the Legislative Branch, and perhaps my greatest disappointment, coming from municipal government, having served as mayor before arriving here, was my disappointment that the Legislative Branch has, for the most part, abdicated its responsibilities as an oversight branch of our government.

And one of the top priorities for this subcommittee is oversight of institutions that serve the financial needs of our citizenry, and to ensure that through the Federal level supervisory organizations compliance with existing statutes and laws is being enforced and adhered to.

When statutes and laws are ignored, or top level supervisory agencies fail to perform their functions, it tends to be the little guy who always gets hurt. And too, in a real sense, the institution itself suffers some damage. My role, I think, is, one, to protect the little guy. And in this instance, we're trying to protect the little guy from predatory lenders, financial shysters, greedy bankers, unscrupulous captains of industry, and even people who, on the outside, look like respectable business people.

And so, Mr. Reich, we appreciate you being here, and hope that we can find out what the OTS has done to—over the course of time—to improve or—the worsened financial situation for the little guy.

If we fail to protect the little guy, and it seems to me that we are violating the need for having government, or violating the need to have the Office of Thrift Supervision, the little guy tends to be the one who gets wounded the most, people who are unable to stand up for themselves. And in the long run, the institution itself is belittled if it does not protect the little guy.

I appreciate you being here. I will leave and come back as quickly as I can. Thank you.

Mr. GARRETT. The gentleman yields back. Concluding opening statements, we now turn to our first panel and our first witness, Director Reich.

Director Reich has served as Director of the Office of Thrift Supervision, the OTS, since August of last year. In that capacity, Mr. Reich also continues to serve as a member of the board of directors of the FDIC. Prior to joining the OTS, Mr. Reich served as Vice Chairman of the Board of Directors of the FDIC, starting in November of 2002, and has been a member of the FDIC board since January 2001. He also served as Acting Chairman of the FDIC from July to August of 2001.

Prior to coming to Washington, D.C., Mr. Reich spent 23 years as a community banker in Illinois and Florida, including 10 years as president and CEO of the National Bank of Sarasota in Sarasota, Florida. Mr. Reich also served 12 years on the staff of U.S. Senator Connie Mack of Florida before joining the FDIC.

Director Reich holds a BS degree from Southern Illinois University, and an MBA from the University of South Florida. He is also a graduate of Louisiana State University School of Banking of the South.

I thank the Director for being with us this morning, and it was a pleasure meeting you earlier. We also have a copy of your testimony delivered to us already. I appreciate the detail that it goes into, and would appreciate your comments at this point.

STATEMENT OF THE HONORABLE JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Thank you very much, Acting Chairman Garrett, Ranking Member Gutierrez, and members of the committee. It's a pleasure to be here today. It's my pleasure to report on an agency that is strong, well-staffed, financially sound, and an industry that is profitable, growing in asset size, and evolving to meet the housing and the retail needs of America's communities.

Since 1989, OTS has developed and continually improved its supervision and oversight of the institutions and the holding companies that we regulate. We work closely with the industry to maintain the profitability, integrity, and vitality of the thrift charter. And the industry continues to adapt to the evolving financial service businesses and demands of its customers.

While mortgage lending remains the dominant activity, it is no longer the exclusive activity of the industry, nor should it be. Overexposure to one part of the economy without diversification creates risks that can lead to safety and soundness challenges. A favorable interest rate risk environment, accompanied, by record mortgage originations and sales has produced strong profitability for the industry over the last 5 years.

Equally important to this sustained period of profitability are good stewardship by our institutions' managers, earnings diversification, and good asset quality.

We continually work to provide specialized training, rigorous accreditation, professional development programs, and other supervisory tools to our staff to ensure that we are capably equipped to supervise a dynamic and growing industry. Our employees are of long tenure, and they are well seasoned, with an average of more than 15 years with the Office of Thrift Supervision, and more than 23 years of overall bank regulatory experience.

As of March 31st of this year, there were 856 OTS-regulated thrifts, holding assets of $1.5 trillion. While consolidation has reduced the number of savings institutions, industry asset growth remains strong. OTS also regulates 481 holding company structures with consolidated assets of approximately $7.5 trillion.

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 thrift assets today.

Recent earnings and profitability of the industry have been strong, with consecutive annual records from 2001 through 2005. For 2005, the industry reported record earnings of $16.4 billion, eclipsing the $14.0 billion of 2004. And the industry has posted quarterly earnings exceeding $4 billion in each of the last 5 consecutive quarters, including a record $4.3 billion in the fourth quarter of 2005.

Asset quality also remains strong, with delinquency rates and troubled asset ratios at or near historical lows. Though asset quality is strong, OTS is closely monitoring thrift loan performance, since recently originated or unseasoned loans now comprise a significant portion of thrift loan portfolios.

Capital measures for the industry are strong, stable, and well in excess of minimum requirements. As of March 30th of this year, over 99 percent of the industry exceeded well-capitalized standards, and no thrift was less than adequately capitalized.

And problem thrifts remain low. Currently, out of 856, there are 6 problem thrift institutions, with total assets of $1.1 billion.

The thrift charter has unique characteristics that make it well suited to retail banking. These include nationwide branching under a single charter, a holding company structure offering a single reg-

ulator for the holding company and its institution, and a strong preemption authority. These features enable savings associations to follow their customer base 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.

Notwithstanding these strengths and benefits, there are some risks that we continue to monitor in the industry.

First and foremost is interest rate risk. Given the industry's natural concentration in longer term mortgage loans generally funded with shorter term deposits and borrowings, monitoring interest rate risk is always critical. 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 was flattened. Despite this environment, OTS believes the thrift industry is on sound footing, from an interest rate perspective.

Credit quality is another risk that we carefully monitor. 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.

However, future deterioration in any of the fundamentals that affect housing strength, such as worsening unemployment rates, and rising interest rates, could adversely affect thrift asset quality.

Compliance risk is another issue for the industry, and one that OTS closely watches. The increased volume of consumer transactions and consumer protection and other regulations governing these transactions necessitates an active compliance management function within institutions and in oversight programs within the banking agencies.

Today, the importance of compliance management is elevated by the need to ensure the privacy and security of consumer information, as more information is shared and outsourced, and the threat of identity theft persists. Also, the need to guard against money laundering and terrorist financing activities. And finally, the need to stem the tide of abusive lending practices, and ensure fair and equal access to credit for all Americans.

An area posing significant compliance challenges for our institutions is the Bank Secrecy Act. During the 15 months from January 1, 2005, through March 31, 2006, OTS conducted 900 BSA examinations. During those reviews, 222 institutions were cited for 500 BSA-related violations. Most of these violations were remedied during the examination process, but we did initiate 27 formal and informal enforcement actions during this time.

The safety and confidentiality of personal information has also taken on great importance in the regulatory environment. Data security has long been a significant part of the supervision and examination process that OTS has performed at thrifts and their third-party technology service providers.

OTS regularly evaluates institution data security programs. This includes supervision and examination work at industry service providers. 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 and the delivery of financial products and services, customized product offerings to meet their customers' needs, and ensure quality customer service.

The thrift industry has grown and diversified over the past several years, while reporting excellent financial results.

Mr. GARRETT. If the gentleman can—your allotted time of 5 minutes has expired.

Mr. REICH. All right.

Mr. GARRETT. And I am just watching your pages there, to see if you were coming close to the last page.

Mr. REICH. I was—

Mr. GARRETT. You can continue your last thought, and bring it to a conclusion.

Mr. REICH. Thrifts continue to play a vital role in providing mortgage funding and other retail products. At OTS, we will continue to evaluate our policies, our staffing, and our infrastructure, to ensure that the Agency is well prepared to handle new and emerging risk.

I appreciate the opportunity to be here today, and I am happy to address your questions.

[The prepared statement of Mr. Reich can be found on page 51 of the appendix.]

Mr. GARRETT. Thank you, Director Reich. And as I begin, I may take up somewhere near where you ended, and also along the line that was raised by Mr. Scott, and that is the—along the lines of the question of consolidation.

You gave the exact number, I think, of 856. I thought it was just a little over 800, but 856 is where we're at, at this point in time. If you can, give us a little bit more of the big picture on—both the big picture and down into the weeds a little bit on how that all affects you.

There has been a recent purchase by Wachovia of Golden West Financial Corp., and its thrift, World Savings Bank. Things of that sort and the overall consolidation, I would assume, would eat into the financial base of the OTS. So when that occurs, how are you able to maintain what you have, expand, if you need to, for your past activities?

And another question I will get into in a moment, with regard to terrorists and other crime aspects, as far as the needs in those areas, as well. So, does that hamper or create problems for you?

I realize your agency is also able to enact civil penalties for when they are appropriate. Do those civil penalties then turn around and, if there is a gap in funding—which is the answer to the first question or not—if there is any gaps or shortages to the funding now or in the future, do those civil penalties work in a way to fill those gaps?

And then following that question, along those lines, is how are you able to do a budgeting appropriately, now and in the future, based upon, A, the continued consolidation, B, the use of civil pen-

alties, whatever, to fill those gaps for now and into the future as well?

Mr. REICH. Well, let me first address the subject of industry consolidation. The entire banking industry is consolidating, which affects all charters: State charters, national charters, and thrift charters. Twenty years ago, in 1977, there were over 18,000 financial institutions. Today, at the end of December of last year, there were 8,860 financial institutions. And the reduction in institutions has affected the entire financial services industry.

With respect to the growth of the thrift industry, even though there has been a decline in the number of institutions, there has been an increase in overall thrift assets over the years, which has had a positive impact on the budget of OTS. Our budget 5 years ago was approximately $150 million. Today it's approximately $215 million. So, in spite of a consolidation and a reduction in the number of institutions, we have been able to experience a moderate growth each year in our revenue stream.

Budgeting is a very important activity at OTS. We spend many months a year projecting what our needs are going to be for the forthcoming year, taking into consideration the size of the industry, the number of institutions that we regulate, and our anticipated revenue stream.

With respect to the announcement of Wachovia's purchase of Golden West, the owner of World Savings, it's a significant customer of OTS. It represents about a little less than 5 percent of the revenue of OTS, but it is not a number that is going to have a material effect on our operations. We don't know, ultimately, whether or not Wachovia will retain the thrift charter or not. Preliminary indications are that they will. But in the long term, that will remain to be seen.

Mr. GARRETT. I think the other question was along those lines—

Mr. REICH. You asked about—

Mr. GARRETT. Civil penalty.

Mr. REICH.—whether or not civil penalties were a source of revenue for the OTS, and the answer to that question is no. Those funds usually, I believe, go to either the Justice Department or the Treasury Department. They do not go into the coffers of the Office of Thrift Supervision.

Mr. GARRETT. One final question, and then—with regard to terrorism on the risk finance—terrorism financing and the like, an issue that Sue Kelly has handled extensively in this committee, I note that your bank examination procedures date back to 1999, well before the terrorist attack of 2001.

Is there any need to readdress them, in light of the changing circumstances since 9/11?

Mr. REICH. Well, last year, in July and August of last year, after several months of collaboration, all of the Federal banking agencies—the Fed, the FDIC, the OTS, and the OCC—published a new examination guideline manual for Bank Secrecy Act and anti-money laundering activities. All of the agencies are now on the same page, following the same examination procedures in each of our institutions.

We held a number of outreach sessions with the industry, to let bankers know what they could expect in the examination process.

We got some feedback from them that assisted us before we adopted final procedures. And I think that we have given recent attention to the evolving landscape, with respect to BSA and anti-money laundering activities.

And I really think that there is relatively good news to report, in the sense that we have seen that financial institutions of all charters have taken BSA seriously. They have adopted programs. The number of violations are beginning to decline that are being found in our institutions, as we see that they have improved their programs and made them stronger.

Mr. GARRETT. I thank you. Mr. Gutierrez?

Mr. GUTIERREZ. Thank you. Mr. Reich, would you consider revising your predecessor's CRA regulations to reemphasize the service component and investment component for banks in excess of $1 billion? Will you consider conforming your regulations for small thrifts with that of other regulators?

Mr. REICH. The short answer to that, Congressman, is yes. I was a—I have been at OTS since last August. Prior to that, I was with the FDIC in an active capacity for several years. And I was, in a behind-the-scenes capacity, a participant in the development of the CRA rule that was adopted by the other three agencies.

When I came to OTS, I came to OTS with a predilection to conforming OTS's CRA rule with that of the other agencies. I have asked the staff of OTS to justify to me why OTS deserves to have a different CRA rule than the other three agencies.

Essentially, there is a case. It would be up to one's own opinion as to how strong the case is. OTS is required by law—our institutions are required by law—to have—to abide by the qualified thrift lender test, which requires that approximately 65 percent of their assets are invested in housing-related assets. That restriction, or that stipulation, does not apply to any other Federal banking agency. National bank charters, State bank charters are totally unrestricted as to how their assets may be apportioned.

Secondly, the capabilities of thrift institutions to invest in commercial loans or small business loans or consumer loans is rather limited. Again, there are no limits for the other three Federal banking agencies. Most thrift institution executives feel that they meet their community needs every day, that that's why they're in business, they are retail banking charters, they make housing loans and home loans in their communities, and how they survive and how they thrive.

Having said that, philosophically it has been my view for some time that on major policy issues, the four Federal agencies ought to be on the same page. And so, although we have not changed our rule, it is on the table for consideration, and we may move in that direction.

Mr. GUTIERREZ. I thank you for that consideration. I have always said that if this is what they do, it should be relatively simple and easy, then, to pass any CRA test. I mean, so it seems that the redundancy—we don't need you to ask us to do it, because it's what we do—

Mr. REICH. Right.

Mr. GUTIERREZ. So it should be the easiest part of the test. They should have the forms already filled out for you and say, "Here, we pass, give us an A-plus, it's what we do."

And I can see the difference because of the housing rule. And housing isn't the exclusive one, but it is one of the major components that we see for it. Let me ask you—thank you very much for that answer, and I look forward to—

Mr. REICH. Can I add one more comment?

Mr. GUTIERREZ. Sure, absolutely.

Mr. REICH. Twenty years ago, when CRA was adopted in 1977, there were over 18,000 financial institutions, and there were 16,000 of which, approximately, had assets of under $1 billion. They represented 46 percent, approximately, of the assets of the entire industry. Banks under $1 billion 20 years ago, when CRA was adopted, represented about 46 percent of total assets.

Today, there are about 1,000—1,200—institutions under $1 billion in assets—that's not the right number—there are 8,000 institutions under $1 billion, and they represent about 12.5 percent of the total assets in the industry.

So, I am concerned, I do have concerns that a shrinking part of our banking population in the United States is bearing a great deal of scrutiny about its CRA when it is representing such a small percentage of banking assets in the country.

Mr. GUTIERREZ. Thank you. The other question I wanted to ask you was do you believe that the exotic mortgage products are too widely used? And would you support a ban on negative amortization products? The more I see these products, it's so easy, it seems. They're making it easier and easier.

And so, I'm becoming concerned, especially about negative amortization. How do you see this trend, and what do you see the role of the OTS in this?

Mr. REICH. Well, we have institutions that have been making adjustable rate mortgages for 30 years, payment option mortgages for 20 years, payment option mortgages with negative amortization for 20 to 25 years, and they have been successful, and have been conservatively operated, and have done very well.

I am concerned about what has taken place in recent years, with the proliferation of these types of instruments in institutions that have just recently begun to offer them in the past 2 or 3 years.

I am concerned about the quality of disclosures to consumers. I am concerned that they may be being sold, offered to consumers who don't have a full understanding of the potential risks that take place when the interest rates are reset.

So, I think that the activity that is taking place today with the four Federal banking agencies, with the proposed guidance on alternative mortgages, and on commercial real estate guidance, is an activity that will hopefully result in better disclosures in the industry and more selective offerings of these products in the market.

I would not support an outright ban on negative amortization. Most negative amortization products have caps as to the amount of the negative amortization. So it's not as though negative amortization can grow to an unlimited level. Many institutions have a cap of 110 percent of the original loan amount which, in a rising housing market environment, is not an unreasonable policy to pursue.

Mr. GARRETT. Thank you, thank you. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman. Let me—let's start out with Atlanta. And if you can share with us, what is going on in the Atlanta market that is making it a situation where 1 out of every 70 homes are in foreclosure?

And I particularly raise that, because I believe that you have an office in Atlanta. Is that correct?

Mr. REICH. We do.

Mr. SCOTT. Have you all taken a look at this? And what are the factors involved? Now, from my experience and knowledge about this, I know that unemployment plays a role in foreclosures.

However, Atlanta has a relatively low unemployment rate. We're very fortunate, because we have such a diversified economy—one industry goes down, we're able to make up for it in another area—so can we walk through for a moment, and share with me what's going on with the Atlanta market that is making it where 1 out of every 70 homes are in foreclosure?

Mr. REICH. Well, quite frankly, I'm surprised by that statistic, Congressman. I was unaware that the foreclosure rate in Atlanta was at the level that you quoted.

Mr. SCOTT. Let me just mention to you, so you will know where this information comes from, one of our most highly respected newspapers, the Atlanta Business Chronicle, stated that Atlanta had the second highest foreclosure rate among the Nation's largest metropolitan areas. And it goes on to say that, let's see, that this high rate accounts for 1 out of every 70 homes. And this appeared in, I believe, Tuesday's—2 days ago—Atlanta Business Chronicle.

Mr. REICH. Well, again, I was unaware of that number. I have been aware for several years that the Atlanta market has been an extremely hot market, in addition to other markets in the Sunbelt States. The Atlanta region has been growing tremendously; there has been a great deal of commercial real estate activity in the Atlanta market.

And there have been concerns. The Atlanta market was, I think, one of the reasons that precipitated studies of commercial real estate activities, generally, around the country, which led to the recently issued guidance on commercial real estate by the four Federal banking agencies—proposed guidance.

Congressman, I am at a loss to give you an informed answer as to the explanation for the high—relatively high—level of foreclosures in the Atlanta market. I will be happy to get back to you and submit a written response to you on this subject.

Mr. SCOTT. I would appreciate that, and I look forward to working with you. Maybe there are some things we can do in the market, and maybe there are some activities that we can begin to get engaged to. I would certainly like to address that.

I am the author of our Financial Literacy Act that we are moving through this Congress. We are very much concerned with that.

Also added to that, of course, Atlanta is a very prime market for predatory lending. And some of this could be a lack of financial education, but it would be very, very helpful to me if you would—and maybe your operation in Atlanta could take a concentrated look at that, and we could come out of this with something that could benefit the rest of the country.

Let me ask you another question, if I may, in terms of the adjustable rate mortgages and the rising interest rates with those. How impactful would—do you think that—what impact do you think that would have on consumers, adjustable rate mortgage, and the impact that rising interest rates would have?

Mr. REICH. Well, it's conceivable, for certain types of adjustable rate mortgages, that payments could double. It would be a real payment shock, and that could have, depending on the extent to which interest rates rise, it could have serious ramifications for the thrift industry and for all mortgage lenders.

Mr. GARRETT. Thank you. The gentleman's time has concluded. Mr. McHenry, do you have a—

Mr. MCHENRY. Thank you, Mr. Chairman. I certainly appreciate and I thank you, Mr. Reich, for being here today and representing OTS.

In your testimony you said thrifts compete effectively with other financial service providers to deliver a wide range of products and services to American consumers. A very positive statement.

Some would say, or some have said before this committee, that thrifts typically—thrift members typically—experience higher loan rates, lower savings rates, and additional fees. Is that a true statement, or a misrepresentation?

Mr. REICH. I would say it's an inaccurate statement. Higher loan rates?

Mr. MCHENRY. "Experience higher loan rates, lower savings rates, and additional fees."

Mr. REICH. I would say that's a misrepresentation, and that is it not accurate.

Mr. MCHENRY. All right. Also, OTS I know, with this ongoing executive compensation that the ranking Democrat of the full committee has a large focus on these days—he doesn't talk about the high compensation of supporters such as trial lawyers of their side of the aisle, but nonetheless, I digress—could you address with us today your policies, OTS's policies, on executive compensation and/or stock option plans, and that sort?

Mr. REICH. Are you speaking—

Mr. MCHENRY. During a conversion process, for instance, in particular.

Mr. REICH. During a conversion process to a—from a credit union to a mutual form of organization?

Mr. MCHENRY. Well, actually, the conversion process which you regulate. I wouldn't ask—I would not subject you to that, your Deputy Director did an admirable job before the committee. But I wanted to ask that of you, to address executive compensation and stock options, for instance, that you, OTS, oversee, and the conversion process which you oversee.

Mr. REICH. Well, addressing stock options first, they are not permitted until some period of time after a conversion has been completed, a stock option plan cannot be implemented with a conversion. There is a period of time that has to take place before a stock option plan may be approved.

And in the case of a mutual—a stock institution, the shareholders would have to approve such a plan before it could be approved. It could not occur without shareholder approval.

Mr. MCHENRY. Okay. So, would it be—in the conversion process which you oversee, would it be a fair characterization to say, "Executives of the institution profit by obtaining stock far in excess of that available to the institution's members?"

Mr. REICH. I think that is—again, that is an inaccurate statement, and a misrepresentation. There are limits on the stock that executives of an institution may receive, and there are—there is a prohibition on executives gaining control of an institution, or a group of executives gaining sufficient shares to have control of an institution.

Mr. MCHENRY. So it would be a misrepresentation?

Mr. REICH. Yes.

Mr. MCHENRY. So does OTS have regulations on the books dealing with executive benefits, compensation, and stock options?

Mr. REICH. We make certain that executive compensation is reasonable, compared with similar-sized institutions.

Mr. MCHENRY. So, it would be an unfair characterization to say that executives profit by obtaining stock far in excess of that available to the institution's members?

Mr. REICH. I think that's correct. Management can purchase stock only to the same extent that any other member may purchase it.

Mr. MCHENRY. Okay. In terms of regulations that you have on the books, I know that OTS frequently reviews regulations that you put in place, to ensure that they are doing what they are intended to do. And I know that's an ongoing fashion.

In terms of the conversion process, which I think the chairman mentioned earlier, in terms of the potential with thrifts that are purchased and ongoing conversions in the marketplace, how long have you had the regulations on the books?

Mr. REICH. Since the late 1970's.

Mr. MCHENRY. And have they been changed recently?

Mr. REICH. Within the past 7 years.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you for your testimony, Mr. Reich.

Mr. GARRETT. Mrs. Maloney?

Mrs. MALONEY. Welcome. And I am glad to see that you support the committee action on CTR's. An amendment of mine had been accepted in the regulatory relief, and yet it was cut out in the Senate. And I support Chairman Bachus's efforts to address this issue.

But I want to look at the OTS enforcement of the Bank Secrecy Act, and to hear what you are doing to make sure that we don't have another savings and loan scandal of mismanagement. I would like to hear steps that you have taken in that respect.

But I have here a report on—from FinCEN and others on the BSA enforcement. And in it, it says that in some cases where the OTS issued written enforcement actions in response to the Bank Secrecy Act violations, the IG found—and I'm quoting—"in five instances, Bank Secrecy violations continued for years, or BSA compliance actually worsened."

And it talks about the report from the Inspector General, and it notes that they found BSA violations at 180 of the 986 thrifts examined during that period. And of the 180 thrifts with substantive violations, OTS had issued written enforcement actions against 11.

And the OIG reviewed a sample of 68 of the thrifts for detailed review, and reported that, "In all 68 cases, we found OTS relied on moral persuasion and thrift management assurances to comply with the BSA. And in 21 of the cases, thrift management was not responsive, and did not correct its BSA violations." So, what are your comments on that, if any?

Mr. REICH. Well, my first comment is a question. Was that a 2003 IG report?

Mrs. MALONEY. Yes, it was. September 23, 2003.

Mr. REICH. Okay. I think we have addressed the issues that were raised in that report. And as I mentioned a few minutes ago, in July and August of last year we worked with the other Federal banking agencies to produce a new BSA anti-money laundering examination manual that all examiners of all the agencies are following.

And I think that the procedures that we are using are thorough; they are detailed. And I mentioned a few moments ago that in the last 12, 14 months, we have done 900 BSA examinations. We have found 500 violations, and issued a number of formal and informal enforcement actions.

So, I think the quality of our program is strong, is good, and the quality of the institution compliance is steadily increasing.

Mrs. MALONEY. How many formal actions have you initiated?

Mr. REICH. There were 27 formal and informal. I don't have the exact number of formal actions.

Mrs. MALONEY. If you could, get back to us and—

Mr. REICH. I would be happy to do that.

Mrs. MALONEY. I look forward to the next IG's report, and hope that it is better than the 2003 report. What steps have you taken for safety and soundness?

Mr. REICH. Could you be more specific?

Mrs. MALONEY. Safety and soundness, making sure they are well-regulated, well-run, serving the communities like they should. I think they perform a tremendous service of community banking, but I am still troubled by the S&L scandals. What have you done to make sure we don't have those again?

Mr. REICH. Safety and soundness is the most important part of our mission, to make certain that thrift institutions remain healthy.

The training and education of our examiners is a continuing process, and we strive to keep our examiners up-to-date with changes that are taking place in the financial services environment, with continuing programs.

We have recently employed a new Assistant Managing Director of Supervision for Compliance Consumer Protection. We had previously disseminated that position, distributed that position out to the field. We have centralized it, and we will be giving increased importance to compliance, CRA, consumer protection, as well as safety and soundness, which is our highest priority.

Mr. GARRETT. I thank you very much, and the gentlelady's time has expired.

Mrs. MALONEY. Thank you very much. It should be your highest priority. I am glad to hear that it is. Thank you.

Mr. GARRETT. Mr. Davis?

Mr. DAVIS. Thank you, Mr. Chairman. I may not take the 5 minutes. I wanted to explore one topic that apparently has not come up today, and it deals with the question of preemption.

As you know, in the context of conventional banks, and in the context of savings institutions that you regulate, this committee has been extremely interested in the question of whether or not State laws operate, and are allowed to operate, in areas regarding alleged predatory lending.

Obviously, you are aware of the March 7th decision with the chief counsel issue which has caused some consternation, and I think you're aware of the parallel controversy involving the OCC and a preemption order that it issued several years ago—or preemption interpretation it issued several years ago.

I don't want to necessarily get bogged down with the specifics of the Montgomery County, Maryland, code, but I do want to raise a general question, and get your reaction to it.

A lot of us, obviously, in a theoretical world, would be perfectly happy to have one regulator for mortgage lending, one regulator for the banks, and savings and loans institutions. A lot of us, in an ideal world, would be happy to see a strong regulator take on that purpose. We don't live in an ideal world. We live in a world where, obviously, States' attorneys general have been very active and very vigilant, and are, frankly, often taking on the brunt of the enforcement structure.

So, let me ask you—and I don't want too long-winded an answer—but can you give me some sense of what it is that OTS does right now to detect and to police predatory lending practices?

Mr. REICH. It's a part of every examination that we do, Congressman, and every institution and every safety and soundness examination.

We have consolidated our safety and soundness and compliance function. It is one examination that takes place. We have cross-trained our safety and soundness examiners in with the compliance function. And ferreting out predatory loans is part of every examination that we do.

Mr. DAVIS. How often do you find bad actors? How often do you find savings institutions engaging in predatory practices?

Mr. REICH. Frankly, not very often. It is my view that most of the predatory lending activity that takes place takes place in an—by unregulated entities, rather than the Federal banking agencies. It's a high priority for all of us. I think it's important for me to say that we—

Mr. DAVIS. When you say—just to clarify, when you say unregulated entities, you mean the mortgage industry, mortgage brokers, that kind of thing?

Mr. REICH. Right, correct.

Mr. DAVIS. Let me actually draw on that for one second, because you make an important point. And I know you don't mean to wade into too many policy arguments here, but you make a point.

We do have a species of entities who, obviously, engage in selling homes and credit to individuals to buy homes that are not terribly regulated. Does your experience, which I assume you believe has been a successful one, lead you to think that we should have

stronger regulations in place, with respect to those unregulated entities?

Mr. REICH. Absolutely. At the State level.

Mr. DAVIS. And I think I cut you off as you were making—

Mr. REICH. No, all I wanted to say was that we seek opportunities, and are absolutely ready, willing, and able to meet with State supervisors and local jurisdictions to address consumer complaints.

Mr. DAVIS. Now, let me draw back to your previous observation. You say that you think there is a strong case to be made for greater regulation of the mortgage industry at the State level, the conventional mortgage industry at the State level. Is it your sense that States are often very well equipped to do that kind of regulation, because of their existing enforcement powers?

Mr. REICH. Well, I think that varies from State to State. Some States have greater financial resources than others to devote to that.

Mr. DAVIS. Is it possible that the two can co-exist, that we could have a strong Federal regulatory structure, and a strong State regulatory structure existing in tandem?

Mr. REICH. I believe it is.

Mr. DAVIS. And I would just simply close on that note, Mr. Garrett, because I think it's an important point. A number of us agree with Mr. Reich, that it is possible, in the context of the conventional mortgage industry, to have a strong State regulator, and to have a strong Federal regulator, that the two can coexist; they can work in tandem.

Mr. Reich, I would just close with this observation. I have not examined the statistics as closely in the context of what you regulate, the savings institutions. I have looked at them closely with respect to the conventional mortgage industry and the banking industry, and I happen to represent a city that ranks near the top of every category, in terms of disparities in the subprime lending market, and the disparities across income levels, racial disparities that still exist across income levels.

I close by saying that it's a real and significant question for this committee, and I look forward to continuing discussion on the issue, and I thank you.

Mr. GARRETT. And the gentleman yields back. And Director Reich, again, I appreciate your complete testimony, I appreciate also the testimony that you submitted, and coming to the hearing today and answering the questions.

I noticed a couple of questions were submitted to you in addition, as far as answers that they would like to receive back, and we appreciate those, as well. Thank you, Director.

Mr. REICH. Thank you.

Mr. GARRETT. I would note while we—as the second panel finds its way here, we have been notified that we are looking at approximately a 12:00 voting schedule on the Floor.

Thank you, gentlemen. We are joined, in this second panel, by three gentlemen.

Michael "Mike" Nolan, serves as chairman, president, and CEO of the Fifth District Savings Bank of New Orleans, Louisiana. He is also a member of the board of America's Community Bankers, and Louisiana Bankers Association. He is, by the way, a native of

New Orleans, and earned his JD degree from Loyola University in 1969.

He is also joined by Ted Gurzynski, who is vice president and chief credit officer for Pyramax Bank, FSB. He has been a banker for 39 years, both in the international and commercial fields. He is a graduate of the University of Wisconsin, with a BA in languages, and also holds a graduate degree in international finance from the Thunderbird Graduate School of International Management in Glendale, Arizona.

Finally, we are joined by Geoff Smith. Mr. Smith is a project director at Woodstock Institute. He has conducted research and written policy of housing and community development topics, including mortgage lending policy, bank branching, housing market trends, small business finance, financial institution regulation, access to banking services, and general community reinvestment policy.

He has also authored and coauthored numerous publications, and coauthored research publications published in numerous academic journals, as well. Mr. Smith has a BA in geography from the University of Illinois at Urbana-Champaign, and an MS in geography from the University of Wisconsin, Madison.

Without objection, your written statements, what you have, will be made part of the record.

And now, you will each be given—recognized for 5 minutes for a summary of your testimony. Gentlemen? Mr. Nolan?

STATEMENT OF MICHAEL E. NOLAN, CHAIRMAN, PRESIDENT & CEO, FIFTH DISTRICT SAVINGS BANK, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. NOLAN. Good morning, Chairman Garrett, Ranking Member Gutierrez, and members of the committee. I am Michael Nolan, chairman, president and CEO of Fifth District Savings Bank in New Orleans. We are a mutual savings bank, with approximately $400 million in assets and 6 offices in the New Orleans area. We have been an OTS-regulated institution since 1989.

Last year, we converted our charter from a Louisiana savings association to an OTS charter, because we believe the OTS has a strong commitment to mutual institutions.

I am testifying today on behalf of America's Community Bankers. I am a member of the board of directors of America's Community Bankers. Two-thirds of ACB members are OTS-regulated savings associations. ACB strongly supports the continued operation of OTS as an independent regulator. The efficiency and professional regulatory oversight that OTS provides is critical to the continued vibrancy of financial institutions that have a special focus on home lending, retail banking, and a commitment to the communities.

In the years since its creation, OTS has undergone a successful evolution that mirrors that changes in the industry it regulates. The Agency supervises a wide range of institutions with different operating strategies, business needs, sizes, and charters. Over the years, the industry has become more complex and diverse, and the OTS has kept pace with the change.

OTS has developed a strong expertise in the business conducted by savings associations, mutual institutions, and their holding com-

panies. OTS has developed a more risk-focused way of looking at supervision, rather than the prescriptive regulations of the past.

For example, OTS uses its examination force efficiently to examine savings associations simultaneously for safety and soundness and compliance. Although every institution is unique and every examination is different, many institutions appreciate having examiners in-house at one time, rather than having multiple examinations.

In addition to implementing stringent safety and soundness operational flexibility and relief for community banks from our increasing regulatory burden—and the Agency has taken a leadership role in that regard—we commend Director Reich for his efforts in this area, and we urge Congress to pass meaningful regulatory relief legislation this year.

Finally, let me add a brief personal note. As a New Orleans banker, I want to acknowledge the OTS's response and assistance to the industry after Hurricanes Katrina and Rita. Both Washington and in our region, the OTS provided valuable assistance to me and to my colleagues and our competitors.

My written testimony provides the details, but it's important to note that within 24 to 36 hours after the flooding began in New Orleans, the OTS Midwest regional office in Dallas was in touch with me, personally. For a period of time after that, I was in almost daily contact with the OTS officials in Dallas and in Washington. OTS Director Reich has journeyed to New Orleans several times since Katrina, to speak with bankers, and to gain firsthand knowledge of the destruction.

One of the biggest challenges facing financial institutions in the hurricane zone was a quality of the pre-hurricane assets. OTS worked with each institution, allowing us to use our own judgement in helping to determine the quality of these assets.

OTS also recognized that compliance with many regulations, when our institutions were under severe stress, would be almost impossible. And without flexibility, we would not have been able to help our customers when they needed our help the most. The lesson that we take away from this disaster is simply this. When banks are relieved of unnecessary regulatory burdens, they are better able to serve the needs of their customers.

Mr. GARRETT. You just want to briefly close?

Mr. NOLAN. Sure. ACB commends the OTS for balancing strong safety and soundness oversight with an understanding and appreciation of the businesses and the institution it supervises.

Thank you, sir, and I will be happy to try to answer your questions.

[The prepared statement of Mr. Nolan can be found on page 37 of the appendix.]

Mr. GARRETT. Thank you, Mr. Nolan. And I realize I failed to do something that Ms. Kelly always does when she is here running the meetings, and that is for the witnesses to always indicate that they are to push the little button for speaking, that the little green light comes on when you're okay to speak, the yellow is a 1-minute warning, and then the red light is the conclusion.

She always does that; I apologize for not leading off with that. Thank you, Mr. Nolan. Mr. Gurzynski?

STATEMENT OF THEODORE GURZYNSKI, VICE PRESIDENT AND CHIEF CREDIT OFFICER, PYRAMAX BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. GURZYNSKI. Mr. Chairman, Ranking Member Gutierrez, and members of the subcommittee, my name is Ted Gurzynski, and I am vice president and chief credit officer of Pyramax Bank, a Federal savings bank located in Greenfield, Wisconsin. It is my pleasure to speak to you today about the OTS on behalf of the Independent Community Bankers of America, which represent approximately 5,000 community banks across the Nation, many of whom, like Pyramax, are Federal or State savings associations or thrifts, regulated by the OTS.

Established by Congress as a bureau of the Department of the Treasury in August of 1989, the OTS charters, examines, supervises, and regulates Federal savings associations, thrifts insured by the FDIC.

With a skilled staff of 900 employees, most of whom work in 4 regional offices, the OTS has done an excellent job of supervising and examining thrifts under HOLA. The ICBA notes that, just recently, the OTS announced plans to hire 60 new examiners, bolstering its exam staff by 11.5 percent. In addition, OTS has stated that it will reestablish at its Washington headquarters a centralized direction for compliance, Community Reinvestment Act, and consumer protection, a function that was formerly delegated to the regional offices.

ICBA commends the OTS for taking these actions to improve its ability to supervise the Nation's savings associations.

The thrift industry has never been healthier. You have already heard the statistics from Director Reich; I need not repeat them. ICBA believes that the excellent health of the thrift industry and its remarkable recovery since the enactment of FIRREA can be attributed to the supervision and regulation of the OTS, as well as to the vitality of the thrift charter.

OTS has fulfilled its mission well, as the Nation's primary regulator of thrift institutions, and has the expertise in supervising institutions whose business focus is housing finance.

The ICBA opposes eliminating the OTS and merging or shifting its duties to another agency. The OTS has done an excellent job in supervising the industry and assisting it through some very difficult times. As long as the institutions it regulates prefer a separate regulator, and support the OTS through assessments, the OTS should remain a separate regulator.

Furthermore, having a separate regulator for thrifts can help focus that industry on the Nation's housing market and housing finance. The ICBA commends OTS Director Reich for his efforts to reduce unnecessary regulatory burden on banks and thrifts, and the leadership that he has assumed under the Economic Growth and Regulatory Paperwork Reduction Act.

Director Reich's competent leadership of the project, and his passionate belief that unnecessary regulation must be reduced were critical to achieving the goals of EGRPRA project of identifying outdated, unnecessary, or unduly burdensome regulatory requirements. The ICBA recommends the OTS, and commends them and

that—the other banking industries, for their support of a comprehensive regulatory relief bill.

Agency support for H.R. 3505, the Financial Services Regulatory Relief Act of 2005, was critical to successful passage of that legislation in the House by an overwhelming majority. Similarly, Agency support for the Financial Service Regulatory Relief Act of 2006, Senate Bill 2856, will be critical for the success of that bill in the Senate. Both bills include provisions from the ICBA-backed communities bank serving their communities first, or Communities First Act.

ICBA supports the savings association provisions in the regulatory relief bills, H.R. 3505 and title 4, Senate Bill 2856. These include updating the statutory limits on the ability of Federal savings associations to make small business and other commercial loans, and two, providing parity for thrifts with banks under the Securities Exchange Act of 1934, and the Investment Advisors Act.

All of these provisions would provide thrifts with greater flexibility to promote safety and soundness through diversification, more opportunities to counter the cyclical nature of the mortgage market, and additional resources to manage their operations safely and soundly.

ICBA recommends the leadership role taken by the OTS in helping to reduce examination burden under the Community Reinvestment Act rules. Prior to the OTS taking action on the CRA rules, extended discussions among the agencies about increasing the asset size limit, for eligibility, for streamlined small banks, CRA examinations did not result in consensus. With the OTS's action—in part due to their definitive action, the other Federal banking agencies were able to reach consensus, and also increase the asset limit for streamlined examination.

Recently, the OTS has been asked to support a proposal to amend statutory and regulatory requirements applicable to mutual holding companies, or MHC's. We understand that a request was made of the OTS to alter the corporate governance rules for MHC's, in order to promote minority shareholders of savings associations to override the interest of a controlling majority. This would provide minority shareholders in an MHC structure greater control over the underlying depository institution, more than the majority and the controlling MHC.

Mr. GARRETT. I'm sorry, sir, if you can just come to a conclusion?

Mr. GURZYNSKI. Contrary to prevailing law regarding the rights of minority shareholders, vis a vis majority shareholders in public companies.

When it comes to—we also applaud the OTS for recent testimony as it relates to credit union conversions.

And at this point, I would just like to say that we believe and support the Deputy Director's comments when he said, "Minimize regulatory obstacles, reduce burden, and facilitate legitimate business decisions regarding charter choice made by institutions we regulate."

And the credit unions should not be allowed to allow their members not to switch. Thank you for the opportunity to testify.

[The prepared statement of Mr. Gurzynski can be found on page 30 of the appendix.]

Mr. GARRETT. And I thank you, sir, for your testimony.
Mr. Smith?

STATEMENT OF GEOFF SMITH, PROJECT DIRECTOR, WOODSTOCK INSTITUTE

Mr. SMITH. Good morning, and thank you for the invitation to testify at today's hearing. My name is Geoff Smith, and I am project director at the Woodstock Institute. The Woodstock Institute is a Chicago-based nonprofit research and policy organization that, for over 30 years, has worked locally and nationally to promote reinvestment and economic development in lower income and minority communities.

Woodstock Institute also convenes the Chicago CRA Coalition, a group of nearly 70 community organizations with a mutual interest in increasing access to bank and thrift lending, investments, and services in underserved areas in the Chicago region and across the State of Illinois. The Woodstock Institute is also a member of the National Community Reinvestment Coalition.

My testimony today largely echoes Congressman Gutierrez's pointed and very insightful questions on the Office of Thrift Supervision, and the Agency's recent actions to potentially weaken its regulation of the Community Reinvestment Act.

CRA was born in 1977 out of grass roots organizing efforts that brought to light the devastating impact of redlining on inner city urban neighborhoods, and it requires the depository financial institutions, monitored for their ability to meet the credit needs of the communities in which they do business, including low and moderate-income neighborhoods and households.

In its early years, CRA had limited effectiveness, despite some significant advocacy efforts. And it wasn't until the CRA regulation was made more rigorous in the late 1980's, particularly in the 1990's, that CRA became truly effective in meeting its legislative intent.

One of the most critical changes was instituting a three-part exam for banks and thrifts with assets over $250 billion. This examination evaluated large institutions' CRA performance through separate tests that systematically assessed an institution's lending, services, and investments to low- and moderate-income markets. These changes served to standardize the way large banks were examined under CRA, and added transparency that made both financial institutions and regulators publicly accountable for community reinvestment performance.

Evidence of the effectiveness of CRA can be seen in increased mortgage loan levels and CRA-regulated institutions to low and moderate-income mortgage markets; the development of flexible and affordable deposit accounts for underbanked markets; and increased investments in affordable housing, small business development, and financial literacy training.

Despite the effectiveness of CRA in encouraging banks and thrifts to have a presence in lower income communities, there recently have been a number of regulatory actions that have weakened CRA, put forward under the banner of reducing regulatory burden for financial institutions.

The Office of Thrift Supervision was the lead agency in enacting the most extreme of these proposals. In many instances, the OTS acted unilaterally, breaking away from the traditional unity of the bank regulatory agencies, and making decisions in the face of very strong public opposition. In the summer of 2004, the Office of Thrift Supervision broke away from other regulatory agencies, and unilaterally raised the asset limit for institutions it considered small under CRA to $1 billion.

This action created an uneven regulatory playing field, and significantly reduced the number of thrifts covered by a comprehensive, large institution CRA exams who were, therefore, subject to review of their provision of community development lending, services, and investments, and threatened significant development resources in low and moderate income markets everywhere, but most significantly in rural communities and small cities, who are predominantly served by mid-sized institutions.

The three other regulatory agencies, after extensive review and public comment, adopted a more modest revision of the CRA regulation, which created an intermediate small bank category for institutions between $250 million and $1 billion in assets. Unlike thrifts of similar size, intermediate small banks are examined under a streamlined two-part CRA exam, which includes a community development test that continues to assess an institution's provision of community development lending, services, and investments.

In 2005, OTS acted unilaterally again, and against overwhelming public opposition, by adopting a proposal that dramatically weakened CRA by changing the way that large thrifts' CRA ratings are assessed. Other bank regulatory agencies continue to require large banks are regularly reviewed for their provision of lending, investments, and services. The OTS altered this framework by allowing large thrifts to opt out of providing services and investments to low and moderate-income markets.

The OTS regulations set up a circumstance where a large thrift could have a large branch network with few or no branches in low and moderate-income communities, offer no flexible or affordable services or products, make no investment in affordable housing or business development, or refuse to make grants or investments to organizations who promote economic development in lower-income communities. The thrift could make few or no direct loans to low and moderate-income communities or borrowers, but purchase these loans from third parties.

Yet, a thrift could still receive an outstanding rating or satisfactory rating on a CRA evaluation with virtually no direct presence in a low or moderate-income community. In fact, an analysis of results of recent OTS large bank exams show examples of institutions receiving outstanding CRA ratings with no consideration of their provision of services to low and moderate-income consumers.

It was good to hear from Director Reich that the OTS is considering changing its CRA regulation to conform with other regulatory agencies, and we look forward to working with the OTS in this regard. Thank you.

[The prepared statement of Mr. Smith can be found on page 96 of the appendix.]

Mr. GARRETT. Thank you very much. And again, I appreciate all of your testimony. I just have initial opening questions for anyone who wishes to address them.

It would appear that the general consensus from the industry perspective is that OTS is—has performed in an admiral fashion, an adequate fashion. And taking into consideration the comments that you have made in the testimony today, are there any other weak areas that we should be, as a committee, looking at OTS and its overall structure?

One of the comments was made as to how it responds from works here, and then back out into the region, and I guess it's something of a hub and spoke sort of arrangement. Your testimony seems to be that it seems to be working, but is that hub and spoke regional aspect with the four regions that it has, is that the best mechanization or methodology for setting it up? And if there is any changes in that structure, should we be looking at it?

And just one last question, and then you can go into these, is would it be helpful to establish an advisory—an OTS advisory group, similar to the financial crimes enforcement network, for the OTS?

Mr. NOLAN. The experience of our institution is that the existing structure of the OTS is effective. And I use, again, the example of Hurricane Katrina to point that out most emphatically.

Institutions deal directly with their regional offices, and very indirectly with the Washington office. In a circumstance that we found ourselves in, in an unprecedented disaster such as that, the communication level was open, and positive, and swift, and responsive from not only the regional but also the national, the Washington, level.

So, my estimation is that the structure works. The lines of communication are accurate and are open. And I see no difficulty with its current structure.

Mr. GURZYNSKI. I would concur with that. I live by the principle that if it isn't broke, don't fix it. And our experience with the OTS, management-wise, has been excellent.

As far as weaknesses, I wouldn't call this a weakness, but certainly—and they are working at this—and that is that as the thrift industry moves more towards other types of lending, commercial lending in particular—and they are doing that, strengthening their staff as it relates to commercial lending, and they have already done that.

Mr. NOLAN. If I may, just to add an additional comment, that the OTS does establish outreach meetings regularly in their regions, and so we feel the communication issue and the connectivity is very positive.

I don't think any banker enjoys dealing with regulators. But we have a very open and honest dialogue, and they are very interested in what is happening with us, and are open to the realities that we deal with, and we appreciate that.

Mr. GARRETT. Mr. Smith?

Mr. SMITH. I don't know that I can really add anything on that.

Mr. GARRETT. Then I will start with you on the next question in the minute I have left—and you have commented on this a little bit—with regard to the changing of the—through—without formal

rulemaking, changing from the $250 million to $1 billion for capitalization that was done in that matter—I think I know—if you want to elaborate on that, and your opinion on that, and then I would like also the industry's perspective, if that is the best procedure to be going through.

Is it good public policy to move in that direction, or is it better to have these changes be made in a formal rulemaking process so outside voices can be heard?

Mr. SMITH. In that particular instance, and in many of the actions around—at least around CRA that the OTS has taken—or has been limited consideration of public comments, during public comment periods, the action to raise—to change the way large institutions are assessed under the OTS's CRA exam received overwhelming public opposition, in fact. Yet the action was taken, regardless.

So, I think the formal rulemaking perhaps would be a more effective way to vet that.

Mr. GARRETT. Thank you. Mr. Gurzynski?

Mr. GURZYNSKI. We have two branches in areas that heavily serve this area, both of them Hispanic areas. And I am going to tell you, from my perspective, who determines whether we are doing the job as it relates to meeting the needs of our community in those areas, and that is the customer.

And if we're not providing the services that they want, and the mortgages, and at the pricing they can afford, then they don't bank with us. And that's our main market there, and we try to do the best job we can.

So, I think that structure as proposed, from our standpoint, makes a lot of sense. We are already doing that. Now, I realize that there was a comment made by one of the members here that, "Well, if you are meeting those rules, then you wouldn't mind the regulations." If we are following the rules, then why do we need to be regulated to the extent that we have been?

So, I think we're doing the job. If we're doing the job, I think these new proposed size limitations should not affect negatively the markets we serve.

Mr. GARRETT. And if you could just briefly answer that, Mr. Nolan.

Mr. NOLAN. Thank you for that. I think ACB's position, and certainly that of our own institution, would be to recognize and support the existing structure of $1 billion and below having a small bank test to be the appropriate level.

I think the real issue here is that CRA recognizes that there is some exemption level, if you will, and I don't mean that in the sense that you don't abide by CRA; you do, you're subject to it. But at certain asset levels, there are different tests for a reason. And the reason is the amount of assets and the amount of resources that institutions have to devote to the activity.

The three areas of testing, which are lending, service, and development, are all very valid and important areas. However, if an institution can focus its resources and pick one of those areas—perhaps they're very strong in lending—then it seems unreasonable for a smaller institution to divert resources away from that which they are very good at meeting the community needs into other

areas where they don't have any expertise at that moment in meeting those needs.

So, it's really a concentration of the resources, and having regulation recognize that if the resources and the business plan of the institution is good in certain areas, that should be sufficient enough for CRA evaluation.

Mr. GARRETT. Thank you. Mr. Cleaver?

Mr. CLEAVER. Thank you, Mr. Chairman. Mr. Gurzynski, can we go back to the regulation issue that you touched on just a moment ago?

Do you think that the thrifts are adequately regulated? Do you think that the—or do you think they are under-regulated?

Mr. GURZYNSKI. We certainly are not under-regulated.

Mr. CLEAVER. Yes, I didn't think you were going to go there.

[Laughter]

Mr. CLEAVER. Well, do you think that you are over-regulated?

Mr. GURZYNSKI. I actually believe that we are over-regulated, because our business is to be in, to be active in, and to provide services to the community. If we weren't doing what the community needs are, we wouldn't be in that community, and our customers would tell us that we weren't meeting their needs by walking away.

Mr. CLEAVER. The—with all of the issues that poor people face, and you're suggesting, I think, that you would do those things even if you were not regulated.

Mr. GURZYNSKI. We would certainly do them—to the extent, I don't know what we would—but we certainly would, because, in reality, a community bank exists to provide services that the local community that it serves is in.

We're not a multi-national bank. We are there to meet the needs of its community, just as have—for example, if I might digress—in our two branches in the Hispanic area, we offer products there that we don't offer in other markets, because the needs were brought forth by the community, and we provided those products to meet those needs.

Mr. CLEAVER. Is there a particular segment of the population to whom thrifts direct their service, or from which population do you hope to get the greatest response?

Mr. GURZYNSKI. We try to get, in our marketplace, and I can only speak for ours, we try to really relate to the customers who live locally around where our branches are, and who wants to build a relationship with an organization that gets to know them, and then provides the products to meet their needs.

We don't mass market, we only go to our local community needs. Because, in all honesty, the larger organizations really don't meet those needs on a very selective basis. We have developed programs in mortgage lending that go way beyond what even the CRA would ask us to do, to meet the particular needs in a particular location.

Mr. CLEAVER. Of course, you know, the large banks would disagree with you. They come into my office, and I'm sure in all of our offices, to express their disagreement.

Mr. GURZYNSKI. And I can only tell you, sir, what we do in our organization.

Mr. CLEAVER. Well, and I tend to be a little closer to where you are. But I am just, you know, it—you're dealing with people in reality that most of the big banks would turn down, anyway.

Mr. GURZYNSKI. In many cases, that is correct.

Mr. CLEAVER. And so—but I am—I mean, how do you market? Who do you go after?

Mr. GURZYNSKI. Well, it depends on our marketplace. But let's say, for example—what we go after is we go after the local individuals—on a lesser extent, the small businesses—but basically the individuals, the homeowners, those who want to be homeowners, those who want to get loans for their children to go to school, via home equity loans, or what have you it is.

And what we do is we hold meetings locally and ask the people in the community, "What kind of products do you want from a financial institution? How do you want things structured?" And then, based on the regulations, we try to meet those needs as best we can, and at the same time, not to get the OTS's wrath, because maybe we have done some things that are beyond policy.

Mr. CLEAVER. One final question, and I will go to Mr. Nolan. But being down in New Orleans, you are, I mean, at the epicenter, I think, for the needs.

First of all, can you share—if you can do it briefly—the problems that you see right now? I don't want to get into insurance, but what are the major problems right now in New Orleans, with regard to what—I mean, I'm not speaking about the universe, I'm speaking more specifically about thrifts.

Mr. NOLAN. Thank you for that. We—that's a topic we could speak a lot about. In narrowing it perhaps to our bank and thrifts, some of the major issues we are dealing with is a community that is anxious about its future, people who are uncertain about the stability of the levee system that is under the supervision of the United States Corps of Engineers.

They are uncertain about the speed with which the city can recover—70 percent of it was flooded. And as far as banks, I think banks are—simply reflect the vision of the community. We can do no greater and no less than the citizens wish to do.

And while our asset quality is fine, I know the insurance issues are very important issues in the future, as to whether we will have adequate insurance availability for homeowners, as well as businesses. So our challenges are bringing our small businesses up and running, and keeping our citizens housed and employed, so that the recovery can take place in a reasonable way.

Mr. CLEAVER. One final—if—I don't think anybody knows it at this moment, exactly what kind of insurance will be put in place for people who live actually in the flood plain. Do you foresee difficulty financing or refinancing any of the families in those areas, if we cannot come up with a level of coverage that would make lenders at least somewhat comfortable?

Mr. NOLAN. I think you are speaking, Congressman, I believe, about the Federal Flood Insurance Program.

Mr. CLEAVER. Yes.

Mr. NOLAN. Yes, the level of insurance is important. It's capped at $250,000, is my understanding, at the moment. Certainly, many

homes exceed that. Even though New Orleans is not a very wealthy community, many homes exceed that.

That's a very important issue for flood insurance. Equally as important, it has to be affordable homeowners and casualty coverage for businesses, as well as homes. And the current circumstance seems to indicate the premiums will be extremely high, the coverage will be limited, and I do anticipate that will have a negative effect on the ability of people to finance the type of mortgage that they would like to have for the type of home they would like to live in, because it's simply a matter of economics. How much can you afford, then, if the insurance has increased to a significant amount?

Mr. CLEAVER. You gave the answer I was hoping you would give, but unfortunately I would like for the world to have heard your response. Thank you.

Mr. NOLAN. Thank you, sir.

Mr. GARRETT. And of course, his response is in the record, so you can disseminate.

Again, I would like to thank the members of the panel—Mr. Nolan, Mr. Gurzynski, and Mr. Smith—for your testimony and your time today. The record will remain open for another 30 days, for members to submit questions to the panels and place their response on the record.

Again, I thank you, and the meeting is adjourned.

[Whereupon, at 11:50 a.m., the subcommittee was adjourned.]

A P P E N D I X

May 25, 2006

Testimony
by
Mr. Theodore Gurzynski
Vice President &
Senior Credit Officer
PyraMax Bank, FSB
Greendale, Wisconsin

On behalf of

Independent Community Bankers of America
Washington, DC

"Oversight of the Office of Thrift Supervision"

United States House of Representatives
Financial Services Committee, Subcommittee on
Oversight and Investigations

May 25, 2006

Mr. Chairman, Ranking Member Gutierrez and members of the Subcommittee, my name is Ted Gurzynski and I am Vice President and Chief Credit Officer of PyraMax Bank, FSB, located in Greendale, Wisconsin. It is my pleasure to speak to you about today about the Office of Thrift Supervision (OTS) on behalf of the Independent Community Bankers of America, which represents approximately 5,000 community banks across the nation, many of whom like PyraMax Bank are federal or state savings associations or thrifts regulated by the OTS.[1]

Summary of ICBA Views

ICBA believes that the excellent health of the thrift industry and its remarkable recovery since the enactment of FIRREA can be attributed to the supervision and regulation of the OTS as well as to the vitality of the thrift charter. OTS has fulfilled its mission well as the nation's primary regulator of thrift institutions and has expertise in supervising institutions whose business focus is housing finance. ICBA opposes eliminating the OTS and merging or shifting its duties to another agency. As long as the institutions it regulates prefer a separate regulator and support the agency through assessments, the OTS should remain a separate regulator.

ICBA commends OTS Director John Reich for his efforts to reduce unnecessary regulatory burden on banks and thrifts and the leadership that he has assumed under the Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") project. The support of the OTS and the other banking agencies has been critical for the successful passage of H.R. 3505, the Financial Services Regulatory Relief Act of 2005, in the House and will be critical for passage of S.2856, the Financial Service Regulatory Relief Act of 2006, in the Senate. ICBA generally supports the savings association provisions in H.R. 3505 and S. 2856.

In its role as an advocate for all community banks, ICBA promotes mutuality as a viable charter alternative that should be accorded parity in all respects with other charter forms. We agree with the OTS that regulators should be neutral when it comes to charter choice and charter conversions. The National Credit Union Administration attempts to thwart the conversions of credit unions to mutual savings banks violate this principle.

Mission of the Office of Thrift Supervision

Established by Congress as a bureau of the Department of Treasury on August 9, 1989, OTS charters, examines, supervises, and regulates federal savings associations (thrifts) insured by the Federal Deposit Insurance Corporation (FDIC). OTS's primary statutory authority is the Home Owner's Loan Act or HOLA originally enacted in 1933. OTS also examines, supervises and regulates state-chartered thrifts insured by the FDIC and provides for the registration, examination, and regulation of savings and loan holding companies and other affiliates.

[1] Throughout this statement, the terms "thrifts" or "savings associations" will be used interchangeably.

With a skilled staff of 900 employees most of whom work in four regional offices, OTS has done an excellent job of supervising and examining thrifts under HOLA. ICBA notes that just recently the OTS announced plans to hire 60 new examiners, bolstering its exam staff by 11.5 percent. In addition, OTS has stated that it will re-establish at its Washington headquarters a centralized direction for compliance, Community Reinvestment Act and consumer protection—a function that was formerly delegated to the regional offices. ICBA commends the OTS for taking these actions to improve its ability to supervise the nation's savings associations.

Health of the Thrift Industry

Today's thrift industry has never been healthier. For 2005, assets for institutions regulated by OTS were up 12 percent from the prior year to a record $1.46 trillion. In the past five years, industry assets grew 57.7 percent, representing a robust average annual five-year growth rate of 9.5 percent.

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

The industry equity capital ratio improved to a record 9.45 percent at the end of 2005—well in excess of minimum requirements—and the amount of equity capital held by thrifts reached a new record. Over 99 percent of the industry currently exceeds well-capitalized standards and no thrift was less than adequately capitalized at year-end. Of the 863 savings associations regulated by the OTS, over 94 percent achieved an overall composite CAMELS rating of 1 or 2 last year.

ICBA believes that the excellent health of the thrift industry and its remarkable recovery since the enactment of FIRREA can be attributed to the supervision and regulation of OTS as well as to the vitality of the thrift charter. OTS has provided effective regulation that has allowed this industry to both thrive and operate in a safe and sound manner. With its ability to operate nationally under uniform standards and its flexibility to engage in a wide variety of activities, many view the federal thrift charter as the preeminent retail banking charter.

ICBA opposes eliminating the OTS and merging or shifting its duties to another agency. The OTS has done an excellent job in supervising the thrift industry and assisting it through some very troubled times. As long as the institutions it regulates prefer a separate regulator and support the OTS through assessments, the OTS should remain a separate regulator.

Furthermore, having a separate regulator for thrifts can help focus that industry on the nation's housing market and housing finance. Housing is one of the principal drivers of the American economy, accounting for more than 20 percent of the annual gross domestic product (GDP). Thrifts are major players in this arena and therefore make a significant contribution to the nation's GDP. Total thrift mortgage originations for

2005 were $744.1 billion and accounted for 26 percent of total 1-4 family originations in the fourth quarter.

The business focus for most thrifts remains residential mortgages and supporting the nation's housing market. Thrift investments related to residential mortgages still account for more than 65 percent of total industry assets. Although thrifts have been expanding into consumer and commercial lending, single-family mortgage loans account for nearly half of thrift assets. The OTS has demonstrated that it has the expertise and competence to regulate all aspects of this important industry.

Reducing Regulatory Burden

ICBA commends Director Reich for his efforts to reduce unnecessary regulatory burden on banks and thrifts and for the leadership that he has assumed under the EGRPRA[2] project. Through the public comment process, banker outreach meetings and the EGRPRA website, the project has generated a large number of recommendations for reducing the regulatory burden on banks. Changes to the Community Reinvestment Act regulations to extend eligibility for streamlined CRA exams to more community banks, and the amendments by the FDIC to the Annual Audit and Reporting Requirements (Part 363) to eliminate costly internal control attestations for privately held banks with up to $1 billion in assets, are examples of burden reduction measures recently adopted by the banking agencies that were due, in whole or in part, to the efforts of the EGRPRA project.

However, Director Reich's competent leadership of the project, and his passionate belief that unnecessary regulation must be reduced, were critical to achieving the goals of the EGRPRA project of identifying outdated, unnecessary, or unduly burdensome regulatory requirements. The universal message from the EGRPRA banker outreach meetings is that community banks are struggling under the burden and costs of regulatory compliance. This burden is eroding the ability of community banks to compete effectively. Even though the last three years have been very profitable for the banking industry as a whole, there is a gap between community banks' profitability and the rest of the industry, in part due to the disproportionate impact of regulations on community banks, causing many community banks to consider selling or merging. As Director Reich stated in Congressional testimony, "I believe that in looking to the future, regulatory burden will play an increasingly significant role in shaping the industry and the number and viability of community banks....if we do not do something to stem the tide of ever increasing regulation, America's community banks will disappear from many of the communities that need them most." [3]

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[2] Mandated by Congress in the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the EGRPRA project is an overall review of agency rules to identify outdated, unnecessary, or unduly burdensome regulatory requirements.

[3] Statement of John M. Reich, Vice Chairman, Federal Deposit Insurance Corporation on Consideration of Regulatory Reform Proposals before the Committee on Banking, Housing and Urban Affairs, United States Senate, June 22, 2004

ICBA commends the OTS and the other banking agencies for their support of a comprehensive regulatory relief bill in Congress. Agency support for H.R. 3505, the Financial Services Regulatory Relief Act of 2005, introduced by Reps. Jeb Hensarling (R-Texas) and Dennis Moore (D-Kansas) was critical to successful passage of that legislation in the House by an overwhelming margin. Similarly, agency support for the Financial Service Regulatory Relief Act of 2006 (S. 2856) authored by Senator Mike Crapo (R-Idaho) will be critical for the success of that bill in the Senate.

Both bills include provisions from the ICBA-backed Communities Banks Serving Their Communities First Act or "Communities First Act" (H.R. 2061 and S.1568) introduced by Rep. Jim Ryun (R-Kansas) and co-sponsored by more than eighty members of the House, and introduced by Sen. Sam Brownback (R-Kansas) and co-sponsored by four members of the Senate. These provisions include: (1) directing the federal banking agencies to review the call report every five years to delete items that are no longer needed; (2) increasing the asset-size eligibility for an 18-month exam cycle for well-rated, well-capitalized banks from $250 million to $1 billion (S. 2856 would raise eligibility to $500 million); and (3) increasing the $20 million in assets limitation for exemption from the management interlocks restriction (H.R. 3505 would raise it to $100 million, S.2856 would raise it to $50 million).

In addition, H.R. 3505 includes two additional provisions from the Communities First Act: allowing well-managed, well-capitalized banks under $250 million to submit short form quarterly call reports in two out of four quarters each year; and eliminating annual Gramm-Leach-Bliley Act customer privacy notices for banks that have not changed their privacy policies and do not share information with third parties.

ICBA also supports the savings association provisions in the regulatory relief bills (Title II in H.R. 3505 and Title IV in S. 2856). These include (1) updating the statutory limits on the ability of federal savings associations to make small business and other commercial loans, and (2) providing parity for thrifts with banks under the Securities Exchange Act of 1934 and the Investment Advisors Act. All of these provisions would provide thrifts with greater flexibility to promote safety and soundness through diversification, more opportunities to counter the cyclical nature of the mortgage market, and additional resources to manage their operations safely and soundly.

ICBA commends the leadership role taken by the OTS in helping to reduce examination burden under the Community Reinvestment Act rules. Prior to OTS taking action on CRA rules, extended discussions among the agencies about increasing the asset size limit for eligibility for streamlined small bank CRA examinations did not result in consensus. Believing that the increased asset limit would both reduce burden and help thrifts serve their communities, the OTS acted unilaterally in August 2004 to increase the asset limit for the streamlined exam from $250 million to $1 billion. In part due to the OTS's definitive action, the other federal banking agencies were able to reach consensus and also increased the asset limit for a streamlined examination.

In addition, OTS is the only agency that has considered increased flexibility for assessing the CRA compliance of larger institutions with more than $1 billion in assets. Larger thrifts are assessed on a combination of their community lending, services and investments. Generally, a bank's rating is based 50% on lending and 25% each on investments and services. However, in November 2004, the OTS proposed reducing burden by granting larger thrifts the option to realign these weightings to allow them to offers loans, investments and services in a way that best meets the needs of the thrift's community and the thrift's own strategic goals and strengths.

Mutual Holding Companies

Recently, OTS has been asked to opine on and support a proposal to amend the statutory and regulatory requirements applicable to mutual holding companies or MHCs. ICBA understands that a request was made that OTS alter the corporate governance rules for MHCs in order to permit the minority shareholders of a savings association to override the interest of a controlling, majority MHC shareholder. This would provide the minority shareholders in a MHC structure greater control over the underlying depository institution than a majority and controlling MHC, contrary to prevailing law regarding the rights of minority shareholders vis-à-vis majority shareholders in public companies.

ICBA agrees with the OTS that this proposal is inconsistent with U.S. corporate governance standards and would undermine the interests of the underlying institution's depositors who are represented by the majority or the controlling MHC. Furthermore, the proposal poses significant safety and soundness risks in the operation of MHCs, and also risks the retention and future use of the MHC structure. Furthermore, ICBA opposes its inclusion in any of the regulatory relief bills being considered by Congress and commends the OTS for also taking that stand.

In its role as an advocate for all community banks, ICBA promotes mutuality as a viable charter alternative that should be accorded parity in all respects with other charter forms. The banking agencies should not favor one form of ownership—stock or mutual—over another form. The OTS is correct in its position that supporting the minority shareholders in a MHC structure would not only pose safety and soundness risks but would indirectly favor one form of ownership over another. With approximately 340 mutual institutions and 80 MHCs under its supervision, the OTS should maintain its neutrality on this issue. **The mutual charter remains a vigorous, competitive, and innovative option for hundreds of banks in the United States who are very content with their choice of charter and have no desire to change it.**

Credit Union Conversions and the NCUA

ICBA also applauds the OTS for its recent testimony before the House Subcommittee on Financial Institutions concerning credit union conversions and H.R. 3206, Credit Union Charter Choice Act. We agree with the Deputy Director of OTS who testified that it should be the regulator's role to "minimize regulatory

obstacles, reduce burden and facilitate legitimate business decisions regarding charter choice made by the institutions we regulate." [4]

When it comes to credit union conversions, the National Credit Union Administration (NCUA) has not followed that advice. Instead, the NCUA has attempted to obstruct the right of a credit union to convert to a mutual savings bank rather than supporting the right of a financial institution to choose the type of charter under which it operates.

ICBA believes that the NCUA should follow the lead of the OTS and other banking agencies and cease thwarting credit union conversions. As the Deputy Director of OTS testified, "charter flips" are a normal course of business at the OTS and among the banking agencies." The ability of financial institutions to choose their charter is one of the key strengths of our nation's diverse economy. Unlike other countries, we do not have a one-size-fits-all financial system. Our depository institutions have the ability to choose a national or state charter, as well as the ability to choose the type of charter. Each of these charters has their advantages and limitations, though all must meet safety and soundness and consumer protection standards.

We also agree that for the NCUA to require converting credit unions to provide detailed descriptions of potential future business plans serves no meaningful purpose. Requiring detailed information on the downsides of converting and barring any information of the upsides as the NCUA requires with its "boxed" disclosures is misleading to the members of the credit union. The NCUA should revise its conversion regulations so that they are consistent with those of the other banking agencies.

Conclusion

ICBA very much appreciates the opportunity to testify at this oversight hearing regarding the OTS. The OTS is successfully fulfilling its mission as the primary regulator of thrift institutions. Today's thrift industry is healthier than ever and the OTS has done an excellent job in supervising the industry, including through some troubled times. As long as the institutions the OTS regulates prefer a separate regulator and support the OTS through assessments, the OTS should remain a separate. Having a separate regulator for thrifts can help focus that industry on the nation's housing market and housing finance, and the OTS has demonstrated that it has the expertise and competence to regulate all aspects of this important industry.

[4] See the testimony of Scott Polakoff, Deputy Director of OTS, before the House Subcommittee on Financial Institutions and Consumer Credit dated May 11, 2006.

Testimony of

America's Community Bankers

on

"Oversight of the Office of Thrift Supervision"

before the

Subcommittee on Oversight and Investigations

of the

Financial Services Committee

of the

United States House of Representatives

on

May 25, 2006

Michael E. Nolan
Chairman, President & CEO
Fifth District Savings Bank
New Orleans, Louisian

and

Member, Board of Directors
America's Community Bankers
Washington, DC

Good Morning Chairman Kelly and Ranking Member Gutierrez. I am Michael Nolan, Chairman, President and CEO of Fifth District Savings Bank in New Orleans, Louisiana. Fifth District has almost $400 million in assets and is a mutual savings bank founded in 1926. We have six offices in the New Orleans area. While Fifth District has been subject to OTS examination since 1989, last year, we converted our charter from a Louisiana savings and loan association to an OTS charter. We made a choice to be an OTS-chartered institution because we believe that the OTS has a strong commitment to the mutual charter and a deep understanding of traditional community lending. Fifth District serves consumers through mortgage lending for homes and supports its local community through numerous activities involving education, healthcare and housing.

I am pleased to testify today on behalf of America's Community Bankers. I am a member of its Board of Directors. ACB is the national trade organization that represents the vast majority of OTS chartered and supervised savings associations and their holding companies. Approximately two thirds of ACB's members are OTS-regulated savings associations.

ACB strongly supports the continued operation of the OTS as an independent regulator. The efficient and professional regulatory oversight provided by OTS is critical to the continued vibrancy of a segment of the financial institutions industry with a special focus on home lending, retail banking and a commitment to communities.

Strong Regulator for a Strong Charter

The savings association charter of today is a strong, vital charter that provides the tools for community institutions to meet the needs of their customers and their communities. There is

no better platform for the provision of retail and consumer financial services. We have listened to what our customers want in a community bank and have worked to provide those services, whether it is small business lending, investment products, an array of mortgage products or other retail services. As the OTS reported last week, industry earnings and profitability are strong. Asset quality is also strong.

The savings association industry and its regulator were created to meet a specialized financial services need -- to provide financing for homeownership. For many years, savings associations had the authority to engage in only a limited number and type of products. The predecessor of OTS, the Federal Home Loan Bank Board, regulated this industry with prescriptive regulations that did not envision many variations in operating strategy. Although the powers of these institutions have over the years been broadened in response to market forces and the financial services needs of consumers, savings associations continue to be required to maintain 65 percent of their assets in housing-related and retail banking assets.

In the years since its creation, the OTS has undergone a successful evolution that mirrors the evolution of the industry it regulates. The agency currently supervises a wide range of institutions, with different operating strategies, business needs, sizes and charters. Over the years, the industry has become more complex and diverse, and the OTS has kept pace with the change.

The ability of the agency to evolve and change in the past 17 years is at least in part attributable to the quality and commitment of the individuals appointed to head OTS and the staff they assembled. In addition to implementing stringent safety and soundness regulation, the agency has taken a leadership role in providing operational flexibility and relief for community banks from an increasing regulatory burden. We believe the agency has struck an appropriate

balance between its need to provide strong and appropriate supervisory oversight with the realities facing community banks in the marketplace. Some of the actions taken to streamline supervision without diminishing the oversight of safety and soundness will provide needed efficiencies as the agency looks to the future.

Development of an Efficient Risk-Based Examination Process

The OTS has developed a more risk focused way of looking at supervision rather than the prescriptive regulations of the past. For example, the OTS has worked to use its examination force more efficiently to examine savings associations for both safety and soundness and compliance. The OTS began a pilot program five years ago to meld safety and soundness examinations with examinations for compliance regulations for some institutions. Eventually, the combined examination approach was rolled out for all examinations. Although every institution is unique, and every examination is different, many institutions appreciate having examiners in house at one time rather than having multiple examinations. The agency also is revising and streamlining the pre-examination questionnaire for institutions that do not have complex operations and made it less time consuming and burdensome for management to complete. The ability of the supervisory staff to access and review information off-site is a welcome addition to the process.

Finally, the staffing of examinations reflects the OTS's recognition of the diversity of the institutions the agency supervises. For those institutions that do not present risks in particular areas, the exam team does not include specialists; if the operations are more complex in one or more areas, examiners with specialized expertise can be involved. For example, if the institution has a trust department or a need for an information technology, capital markets or interest rate

risk expert, an examiner with that particular expertise can be on site. Every region may not have certain specialists available at a particular time, but examiners can travel to the institution from elsewhere. This process permits a greater efficiency in allocation of resources as well as greater expertise where needed.

The inclusion of examiner guidance and handbooks on the OTS website is helpful. The documents provide valuable insights to associations preparing for examinations or considering offering additional products or services.

OTS has an unusually experienced staff, but the aging of the examination force is something that each of the federal banking agencies must monitor. The OTS, like the other agencies, may be faced with a number of retirements in the upcoming years. The agency has been successful in recruiting new examiners who can work side-by-side with experienced examiners over several years to gain the experience necessary to provide a seamless transition of examination staff.

Mortgage Lending Focus

While the universe of savings associations has evolved and OTS-supervised institutions offer an array of products, many OTS institutions continue to be primarily home mortgage lenders. As a result, the OTS continues to have specialized expertise in this substantive area at the policy and the examination staff levels.

The 2006 ACB Real Estate Lending Survey illustrates how important traditional mortgage lending continues to be to savings institutions. The survey shows that savings institutions continue to originate mortgages very successfully in a rising rate environment. These

institutions also continue to originate 30-year fixed-rate loans and continue to hold them in portfolio.

OTS understands the importance of mortgage lending to the segment of the industry it supervises. The supervisory expertise of OTS includes understanding interest rate risk and Federal Home Loan Bank advances as a funding source. The OTS has been a leader among the agencies in looking at underwriting standards and risk management at those institutions that offer alternative mortgage products. We appreciate the role played by the OTS in the development of recent proposed interagency guidance.

Charter Choice

When the Home Owners' Loan Act was enacted, Congress contemplated that the institutions chartered under that statute would be in mutual form. One half of all OTS-supervised institutions remain in mutual form, either as mutual holding companies or mutual institutions. As a mutual institution, I can confirm that the OTS understands the unique nature of the mutual form of organization in today's marketplace. The agency regularly reviews its regulations and guidance to ensure that nothing in its policies has the unintended consequence of hampering the operation of mutual institutions. In addition, several years ago, the agency issued guidance to examiners that highlighted areas in which examiners should look at mutual institutions in different ways. For example, peer group comparisons should not be made up of one mutual institution and the rest stock institutions. Compensation issues were also addressed.

While the OTS recognizes the importance of the mutual institution charter and the value of these institutions to their communities, the agency also realizes that it is not in the best interest of every institution to be a mutual. The choice to convert is the institution's, not the regulator's.

Indeed the agency does not promote one charter type over any other. If a mutual institution wishes to convert to stock form, the agency has worked to ensure that the rules and regulations relating to the conversion are as rational as possible. The rules are intended to be fair to the depositors of the institution while ensuring a safe and sound deployment of the conversion proceeds.

Holding Companies

For over 30 years, the OTS has also had the authority to charter holding companies. The regulatory regime found in the Savings and Loan Holding Company Act is different from the Bank Holding Company Act administered by the Board of Governors of the Federal Reserve System. OTS holding companies could be other types of financial services companies and the permitted affiliations were not limited generally so long as there was only one association in the structure, although certain changes occurred as part of the enactment of the Gramm-Leach-Bliley Act. As a result, the OTS has had years of experience working with holding companies that are insurance companies and other financial services providers as well as other types of entities. The agency has worked with other functional regulators, where any exist, and entered into Memoranda of Understanding with them addressing supervisory and other matters.

Recognizing that some of the companies that own savings associations are engaged in business outside the United States, the OTS revised its holding company regulation with a view to seeking a designation as a consolidated holding company regulator for purposes of the European Union. This designation has been granted in at least one instance.

Challenges of Industry Consolidation

Although ACB does not generally comment on specific transactions involving individual financial institutions, we have observed that the OTS continues to adapt to the challenges presented by industry consolidation and changes in the broader financial services marketplace. This is not an issue unique to the OTS. The federal banking agencies and the state bank supervisory agencies are all affected by consolidation, and all regulators must be flexible and adapt to trends in the industry. The OTS has demonstrated that it is a flexible and effective regulator.

The U.S. banking system provides charter choice for all financial institutions and ACB fully supports charter choice, including the dual banking system. In choosing a particular charter, an institution also selects its primary regulator. For these reasons, we strongly believe that the OTS must remain as an independent regulator with special expertise in the business conducted by savings associations, mutual institutions and their holding companies.

Credit Union Conversions

The Subcommittee's invitation asks that I address the issue of credit union conversions. ACB recently testified before the House Subcommittee on Financial Institutions and Consumer Credit on this issue. Recent actions of the NCUA have obstructed the ability of credit unions to convert to a mutual bank charter. Therefore, ACB strongly supports H.R. 3206, the Credit Union Charter Choice Act, introduced by Congressman McHenry and several cosponsors. H.R. 3206 would require the NCUA to conform to the intent of Congress that the NCUA's rules for credit union conversions be no more or less restrictive than the rules applicable to charter conversions by other financial institutions. Unfortunately, the NCUA has

promulgated rules that are not only more restrictive than those of other financial regulators, but actually conflict with OTS conversion rules.

The issue of credit union conversions is important to the overall structure of our nation's financial services sector. As one of its fundamental policy positions, ACB believes in charter choice for all financial institutions, banks, thrifts, and credit unions alike. When an institution and its members are able to change charters to the one that best fits the needs of members and their communities, our financial system will be stronger and healthier. Institutions and their communities change over time. The charter that was best for an institution 50 years ago may not be the best choice now. By allowing charter conversions we allow our financial system to evolve and grow stronger.

Federal Housing Finance Board Proposal on Retained Earnings

On March 15, 2006, the Federal Housing Finance Board (FHFB) issued a proposed rule for public comment that would require each of the Federal Home Loan Banks to hold a minimum level of retained earnings equal to $50 million plus 1 percent of the Bank's non-advance assets. During an initial transition period, if a Bank fails to meet the retained earnings requirement, the Bank could not pay a dividend in excess of 50% of net earnings to its cooperative owner-members without Finance Board approval. Once a Bank has reached the retained earnings target, a Bank would be prohibited from paying dividends during any period that it fails to meet the retained earnings target. The proposal also would limit the amount of excess stock that any Federal Home Loan Bank could have outstanding to 1 percent of total assets, and it would prohibit a Bank from paying stock dividends.

First, we cannot understand why the Finance Board has undertaken this proposal. By the FHFB's own admission, the Federal Home Loan Bank System as a whole is well-capitalized. Moreover, there is no System-wide safety and soundness problem. The Banks overall are sound and stable, with a strong record of earnings. Second, all but one of the twelve Federal Home Loan Banks has recently completed the painstaking and expensive transition to the new capital regime prescribed by Congress in 1999 in the Gramm-Leach-Bliley Act. Gramm-Leach-Bliley established two forms of permanent capital for the System: Class B stock redeemable in 5 years and retained earnings. The mix of retained earnings and Class B stock was determined in each Bank's capital plan with Finance Board approval. We believe that there are serious concerns about the validity of the Finance Board's retained earnings and excess stock proposal in light of the capital regime established in Gramm-Leach-Bliley.

ACB is very concerned about the impact that this proposal, if adopted, would have on all members of the FHLB system. The Federal Home Loan Bank System is critical to the funding needs of community banks. As just one example of the potential concerns, if funding becomes more expensive as a result of this rule and if members do not receive dividends on their investment, it is possible that larger members with alternate sources of funding could exit the System. We are very concerned that this would drive up the cost of advances and other services from the Federal Home Loan Bank System and could threaten the viability of this important liquidity source for community banks.

ACB is seeking documentation of the Finance Board's underlying methodology used in the development of this proposal through a Freedom of Information Act (FOIA) request to the agency. We believe further documentation is necessary to enable the public to comment

meaningfully on the proposal under the Administrative Procedures Act. ACB will work over the coming months to develop our comments on the Finance Board's proposal.

Recommendations for the Future

For several years, the agency has worked with Members of Congress to have legislation passed that would include the OTS as one of the regulators with a voice on the debate over Basel II. Agency staff have been attending meetings and have provided valuable input in the U.S. rulemaking process. ACB believes that it is vital that the OTS have a seat at any future Basel discussions. The agency has unique insights regarding the risks of mortgage and consumer finance and how to measure them. Given that the capital rules are drafted on an interagency basis, the input of the OTS staff is necessary.

ACB also notes that H.R. 3505, the Financial Services Regulatory Relief Act, recently passed by the House, contains important provisions for OTS-regulated institutions. I would like to highlight three of the many important reforms for savings associations found in HR 3505. The legislation would establish for thrift trust activities the same functional regulatory scheme that currently applies to bank trust activities. Another provision would provide federal savings associations the same access to federal courts as national banks and other businesses. H.R. 3505 also increases the capacity of federal savings associations to engage in small business and agricultural lending, so that associations can expand their role as community lenders to businesses, farmers and ranchers. S. 2856, recently adopted by the Senate Banking Committee, includes some of the savings association provisions found in H.R. 3505.

Hurricanes Katrina and Rita

Now I would like to turn to another topic that is very important to me - the OTS's response and assistance to the industry after Hurricanes Katrina and Rita. The agency, both in Washington and in the region, provided invaluable assistance to me, my colleagues and competitors.

Within 24 to 36 hours after the flooding began in New Orleans, the OTS Midwest Regional Office in Dallas was in touch with me. For a period of time after that, I was in almost daily contact with OTS officials in Dallas and Washington. OTS Director Reich has journeyed to New Orleans on several occasions since Katrina to speak to bankers affected by Katrina and to gain first hand knowledge of the destruction experienced by New Orleans and other hurricane-ravaged communities. The FDIC has also been very responsive to the banks and communities in that region. The response of the banking regulators to the country's biggest disaster has been commendable.

In the early days after the storms, we needed advice and technical assistance to ensure that we would be able to meet the needs of our customers. We also needed to know that there would be some flexibility in the application of some of the regulations when examiners first came in after the storms. The guidance that was issued in the early days after the storms was very helpful in providing comfort that there would be a more flexible approach. We received assurances from the OTS that such flexibility would be forthcoming.

One of the biggest challenges facing financial institutions in the hurricane zone was the quality of the pre-hurricane assets. The banks in the region had given their customers payment deferrals for 60 to 120 days. Our customers were displaced. Some of the customers continued to make payments. Others could not. The concentration of collateral affected by Katrina differed

from bank to bank. Each bank's circumstance was different. OTS worked with the institutions and allowed the institutions to use their own judgment, in the first instance, to determine the quality of their assets.

All banks in the region have significant vacancies on their staffs, with some banks losing as much as one-third of their employees. Staff shortages make it difficult for banks to undergo a full-scale examination. OTS responded by delaying full-scale examinations for institutions with severe staff shortages. My own institution was fortunate to lose only ten percent of our staff. We underwent a full examination in March.

We appreciate particularly the recognition by OTS that compliance with many regulations, when our institutions were under severe stress, would have been almost impossible. OTS relieved our banks of many of the regulatory burdens that normally accompany the transaction of routine banking business, such as the transfer of funds, on behalf of our customers. Without this flexibility, we would not have been able to help our customers when they needed our help the most. I believe that this is a lesson that we can take away from this disaster, namely, that when banks are relieved of unnecessary regulatory burdens, they are better able to serve the needs of their customers.

The number one challenge now facing banks in New Orleans and other communities in the hurricane zone is how to rebuild. One of the principal issues that must be resolved is whether insurance companies will write policies for families and businesses in the areas affected by Katrina and Rita. If the insurance industry is too restrictive in its approach to the region, banks will have difficulties meeting the credit needs of the families and businesses. The insurability of the region must be maintained if the region is to prosper again.

Conclusion

The challenges to every regulator are numerous in today's financial services world. ACB appreciates the role that OTS has been able to fill as the industry segment it regulates looks to the future. The savings association charter is a strong charter that serves a very important role in the provision of financial services to communities and consumers. We commend the OTS for balancing strong safety and soundness oversight with an understanding and appreciation of the businesses of the institutions it supervises.

Thank you.

EMBARGOED
Until May 25, 2006 at 10 a.m.

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

May 25, 2006

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Statement required by 12 U.S.C. § 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

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

May 25, 2006

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

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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.

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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 vain, 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 increases 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, yet aggregate FHLBank income has decreased recently.

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, only five 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.

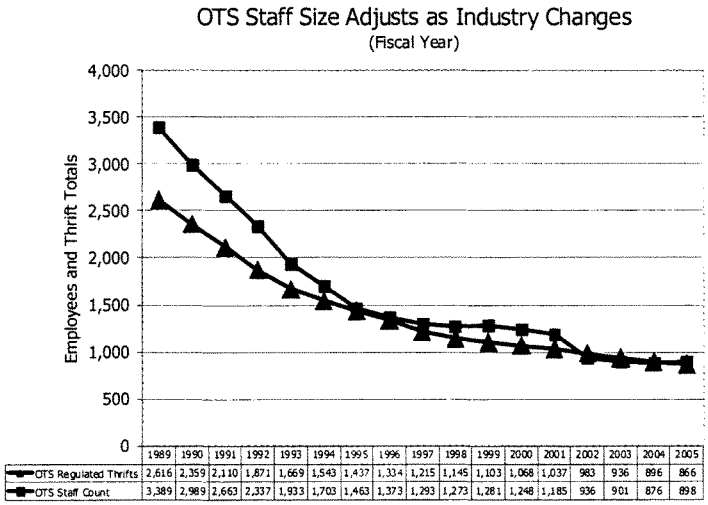
The OTS mission is to supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with

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.



	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
OTS Regulated Thrifts	2,616	2,359	2,110	1,871	1,669	1,543	1,437	1,334	1,215	1,145	1,103	1,068	1,037	983	936	896	866
OTS Staff Count	3,389	2,989	2,663	2,337	1,933	1,703	1,463	1,373	1,293	1,273	1,281	1,248	1,185	936	901	876	898

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

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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:

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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.

Testimony of

Geoff Smith
Project Director
Woodstock Institute

Before the
Subcommittee on Oversight and Investigations

U.S. House of Representatives

Regarding
Oversight of the Office of Thrift Supervision

Thursday, May 25, 2006

Good morning. Thank you for the invitation to testify at today's hearing. My name is Geoff Smith, and I am Project Director at the Woodstock Institute. Woodstock Institute is a Chicago-based non-profit research and policy organization that for over 31 years has worked locally and nationally to promote reinvestment and economic development in lower-income and minority communities. Woodstock Institute also convenes the Chicago CRA Coalition, a group of nearly 70 community organizations with a mutual interest in increasing access to bank and thrift lending, investments, and services in Illinois' underserved communities. Woodstock Institute is a member of the National Community Reinvestment Coalition, the Illinois Coalition Against Predatory Home Loans, the Monsignor John Egan Campaign for High Cost Consumer Loan Reform, and Americans for Fairness in Lending.

My testimony today focuses on the Office of Thrift Supervision and the agency's recent actions to substantially weaken its regulation of the Community Reinvestment Act. In many ways Chicago is considered the birth place of CRA. Starting in the late 1960s and early 1970s, Chicagoan Gail Cincotta led a grassroots organizing efforts that brought national attention to the crisis of redlining and its impact on inner city neighborhoods. This organizing effort ultimately helped lead to the passage of the Home Mortgage Disclosure Act in 1975 and the Community Reinvestment Act in 1977. Both pieces of federal legislation were aimed at ending geographic discrimination in access to financial services. With HMDA, the focus was mortgage lending. With CRA, the focus was ensuring that depository institutions meet the credit needs of low- and moderate-income neighborhoods and households within the communities in which they are chartered do business.

In it early years, however, CRA was a little used and largely ineffective piece of legislation, and it wasn't until the CRA regulation was made more rigorous in the late 80s, but particularly in the mid 1990s, that CRA truly began to become effective at meeting this legislative intent. Changes implemented over this period include:

- Requiring public disclosure of bank exam results and performance evaluations;
- Shifting the emphasis of CRA exams to focus on analysis of an institution's actual performance as opposed to its processes;
- Public availability of small business lending data;
- Most importantly the instituting the three test system for banks with over $250 billion in assets. This large bank exam evaluated an institution's CRA performance through separate tests that systematically examined an institution's lending, services, and investment to underserved markets.

These changes served to standardize the way large banks were examined under CRA and made both financial institutions and regulators publicly accountable for community reinvestment performance. It was this increased rigor introduced into CRA examinations that made the regulation effective. Evidence of this effectiveness can be seen in the active role CRA-regulated institutions have in the community development process.

- Research has shown, for example, that during the 1990s CRA-regulated mortgage lenders substantially increased their lending presence to low- and moderate-income communities and borrowers.
- Investments and loans from CRA-regulated institutions have facilitated the rapid growth of the Community Development Financial Institution industry. With the help of mainstream financial institutions, CDFIs participate in affordable housing, small businesses, and other types of economic development projects in lower-income communities that might otherwise be too risky for banks and thrifts to take on alone.
- CRA also encouraged banks to develop flexible and affordable deposit accounts and financial services available for under-banked markets.
- Encouraged banks to work closely with local community development organizations. In Chicago, CRA Coalition, has successfully negotiated and monitored CRA agreements and partnerships with financial institutions including Charter One, Fifth Third Bank, and most recently Bank One/JP Morgan. These agreements have led to increased mortgage lending in underserved markets, new

bank branches in low- and moderate-income and minority communities, and increased investment in affordable housing, small business development, and financial literacy in the region.

Despite the relative effectiveness of CRA in encouraging banks to have a presence in lower-income communities, there recently have been a number of regulatory actions that have weakened CRA put forward under the banner of reducing regulatory burden for financial institutions. The Office of Thrift Supervision was the lead agency in enacting the most extreme of these proposals. In many instances the OTS acted unilaterally, breaking away from the traditional unity of the bank regulatory agencies and making decisions in the faced of very strong public opposition.

In the summer of 2004, the Office of Thrift Supervision broke away from other regulatory agencies and unilaterally raised the asset limit for institutions it considered "small" under CRA to $1 billion. This action was taken without the opportunity for public comment. This created an uneven regulatory playing field, significantly reduced the number thrifts covered by comprehensive, large bank CRA exams; threatened significant community development resources in rural communities and small cities predominantly served by these mid-sized thrifts; and eliminated the reporting of critical small business lending data. The three other regulatory agencies, after extensive review and public comment, adopted a more modest revision of their CRA regulation which created an "intermediate small bank" category for institutions between $250 million and $1 billion dollars. Unlike with the OTS, Intermediate small banks are examined under a two part CRA exam which includes a community development test that assesses an institutions provision of community development lending, services, and investments.

In 2005, the Office of Thrift Supervision acted unilaterally again and against overwhelming public opposition adopted a proposal that dramatically weakened CRA by changing the way that "large" thrifts' (now those over $1 billion in assets) CRA ratings are assessed. The other bank regulatory agencies continue to assess a large institution's final CRA rating based on weighted consideration of its performance in providing

lending, investments and services to low- and moderate-income households and communities. An institution's performance on the lending portion of its CRA exam is 50 percent of its final score, while services and investments are each given 25 percent weight in the final grade. The OTS action altered this framework by allowing large thrifts to essentially opt out of providing services and investments to LMI markets. These institutions can now choose to have lending count for between 50 and 100 percent of their final CRA rating thus minimizing or completely excluding consideration of community development investments and services.

This OTS regulation sets up a circumstance where a large thrift could receive an "outstanding" or "satisfactory" on a CRA evaluation with virtually no direct presence in LMI communities. A thrift could have a large branch network with few or no branches in LMI communities, but choose not to have its level of community development services considered on a CRA exam. The thrift could make no investments in affordable housing or business development or refuse to make grants or investments to organizations that promote economic development in LMI communities, yet not have their community development investments considered on their CRA exam. The thrift could make few or no direct loans to LMI communities or borrowers, but purchase LMI loans from a third party. These loans could be years old, contain abusive prepayment penalties, or have large yield-spread premiums. This thrift could also provide a "community development" loan for a golf course that "revitalizes" a "rural" community on the fringe of a large metropolitan area. Despite virtually no presence in LMI markets, this institution could be considered "outstanding" under the current OTS large bank exam. In fact, an examination of recent OTS large bank CRA exams shows examples of institutions receiving outstanding CRA ratings with no consideration of their provision of services to low- and moderate-income consumers.

The Community Reinvestment Act has been shown to be the most effective tool available for promoting lending, investment, and services in low- and moderate-income communities. We have consistently opposed the OTS's actions to weaken CRA and continue to promote improvements to CRA that would increase access to lending,

investments, and services in low- and moderate-income markets such as the requiring the continued reporting of small business lending data for mid-sized banks and thrifts, colleting data new retail accounts opened for low- and moderate-income households; and promoting investment in declining and underserved rural markets.

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