Briefing Paper
Meeting with Office of Thrift Supervision
Thursday July 13, 2006

OTS Overview

Discussion Questions

CFC Internal Questions

John Reich, Director

OTS Senior Management

Summary of Capital at OTS Institutions

Summary of CFC's Balance Sheet

Recent Speeches by John Reich

Countrywide
Enterprise Risk Assessment

OTS Overview

The Office of Thrift Supervision (OTS) is the primary regulator of all federally chartered and many state-chartered thrift institutions, which include savings banks and savings and loan associations. OTS was established as a bureau of the U.S. Department of the Treasury in 1989, and has four regional offices located in Jersey City, Atlanta, Dallas, and San Francisco. OTS is funded by assessments and fees levied on the institutions it regulates.

The President, with Senate confirmation, appoints OTS's Director for a 5 year term. The Director serves as a member of the Board of Directors of the FDIC, a member of the Federal Financial Institutions Examination Council (FFIEC), and a director of NeighborWorks America. The current Director of the Office of Thrift Supervision is John M. Reich, who was sworn in on August 9, 2005.

The OTS receives no appropriated funds from Congress; under federal law OTS budget information is provided to the Department of Treasury. The goal of OTS is to supervise saving associations and their holding companies in order to maintain their safety, soundness and compliance with consumer laws and to encourage a competitive industry that meets America's financial services needs.

The OTS supervises approximately 900 savings associations with assets exceeding $1.4 trillion and supervises approximately 500 holding companies with assets exceeding $7.1 trillion. The OTS conducts examinations of associations every 12 to 18 months. The OTS issues two primary examination handbooks-one for holding companies and one for savings associations.

Holding Companies Handbook:
Holding companies are categorized as Category I (noncomplex companies) and Category II (complex companies). Both categories are monitored off-site through regulatory reports, private sector analysis (e.g., stock analysts' reports), and public reports.

On-site holding company examinations are conducted concurrently with the savings association examinations. The examinations are funded through an assessment. The assessment fee scheduled is adjusted periodically. The examinations are designed under a risk-focused approach. This approach considers regulatory filings; affiliate and insider transactions; changes in management, operations, and financial condition; credit ratings of company debt; and stock price.

For Category II companies, examination components are Capital, Organizational structure, Relationship, and Earnings called CORE.

Capital

Evaluation of the capital component involves traditional standards of assessing leverage, the level of short-term debt and liquidity, cash flow, reliance on savings association earnings, interest coverage, quality of earnings, and level of consolidated tangible and equity capital. The conclusion of the evaluation results in an assignment of a rating of 1 through 3. The best rating is a "1" which is assigned to companies that serve as a resource to the entire

corporation. Such companies provide both a basis for growth and access to capital markets as needed.

Organizational structure

Evaluation of organizational structure addresses legal structure including whether the company is a unitary (one savings association) or multiple (multiple savings associations) holding company; diversified (engaged in activities not related to residential lending) or nondiversified (engaged in predominantly residential lending) company; and other legal structures. The structure review also includes a review of the types of activities undertaken by the holding company. The conclusion of the evaluation results in an assignment of a rating of 1 through 3. The best rating is a "1" which is assigned to companies in which there are no control issues and activities are conducted prudently with reasonable risk.

Relationship

Evaluation of relationship between the holding company and its savings association addresses the independence, influence and integration of the savings association, influence and integration of the savings association, and whether the board and management act in the best interest of the association. Examiners consider the following: business plans, budget, intercompany accounts and relationships, quality of board of directors and management, effectiveness of management, and conflicts of interests. The conclusion of the evaluation results in an assignment of a rating of 1 through 3. The best rating is a "1" which is assigned to companies that serve as a resource to the entire corporation. The board of directors and executive management of such companies ensure that control is exercised in the best interests of the savings association. They act with integrity, communicate effectively with the association and the OTS, and oversee the operations of each entity.

Earnings

Evaluation of earnings is conducted in conjunction with a number of other factors. Financial strengths and weaknesses are measured by a variety of ratios and market indicators (i.e., liabilities to assets, return on equity, credit ratings, liquidity analysis).

The conclusion of the evaluation results in an assignment of a rating of 1 through 3. The best rating is a "1" when operating performance and profitability are above average. Cash flow is sufficient, especially relative to the business conducted. Financial indicators equal or exceed forecasted performance.

Large and Complex Enterprises

In a manner similar to other federal financial institution regulators, the OTS applies special examination standards for large complex enterprises. The OTS designs a Supervisory Plan to focus on major areas of risk and to set expectations with respect to reporting requirements. The Plan is communicated to the company's executive management to set expectations about ongoing supervision of the company.

The Plan is designed in coordination with functional regulators with jurisdiction over business functions within the company. In addition the Plan addresses more detailed risk assessment of the components of CORE. The risk assessment is summarized as follows:

- Determine company capital adequacy relative to the needs of each major business sector and the parent.
- Understand the organization-how it is structured, managed and controlled.
- Identify significant intragroup relationships and transactions to assess their impact on the organization's earnings, risk profile, and capital adequacy.
- Assess the organization's major risk exposure and how these risks are impacted by economic changes, legal and tax considerations, how the organization conducts its business and the stability of the financial markets in which they operate.

Examination Handbook:

The OTS supervises savings associations on an integrated basis; safety, soundness and compliance are examined concurrently. The safety and soundness rating system focuses on five components: Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to market risk called CAMELS. The OTS uses the FFIEC 1 through 5 rating system issued in 1997. Financial institutions in the "1" rated group are sound in every respect. Financial institutions in the "2" rated groups are sound and have only moderate weakness that are well within the board of directors' and managements' capabilities. Under this rating system 94 percent of savings associations received the two highest ratings of a "1" or a "2."

An initial and quick review of the OTS exam manuals indicates that they are not noticeably different from the FRB nor OCC approaches to examinations.

Discussion Questions

1. How will the OTS view CFCs growth plans especially given its mortgage centric business model?
2. Can you discuss capital requirements at both the thrift and holding company i.e., assets held outside the bank?
3. Can you discuss the OTS view of and examination procedures surrounding MSRs given the size of this asset for CFC? How might the approach to the examination of this asset differ if the asset is in the bank v. in the holding company?
4. By adopting thrift status what limitations will there be to CFC's business plan – i.e., what broader banking powers exist for a national bank charter? Can you comment on the OTS's examination approach to these type of entities?
   - Insurance
   - Primary Dealer
   - Broker Dealer
   - Other
5. How does the OTS examine and what is their view of non-traditional mortgage products? … "proliferation of these products"
6. How has the OTS applied the guidance regarding appraisal independence?
7. What has been the OTS's approach to examining subprime products and the special features that can accompany subprime products?
8. What has been the OTS's understanding of and approach to examining a thrift with a broad set of loan products and features?
9. What is the OTS's involvement in Basel II? Can you describe your approval approach? How will Basel II be applied to CFC and its Thrift – i.e., the $250 billion threshold? … "While I have testified that I support Basel II, I am cautious about whether we are doing this optimally"
10. Are their special governance requirements for the thrift and again for the holding company?
    - Bank Board
    - Internal Audit
    - Credit
    - Compliance
    - Vendor status of holding company
11. How can the OTS assist/counsel CFC in using national preemption issues over its mortgage production activities?
12. How does the OTS examine and what is their view of Commercial Real Estate? … "expect companies to hold capital higher than regulatory minimums"

13. CFC has a deposit gathering model which does not require CRA for micro-sites within our mortgage locations that has been accepted by the OCC. Is the OTS familiar with such a model in their other OTS regulated institutions?
14. Can you provide an overview of the OTS's exam protocols?
    - Format and rating of your annual inspection report
    - OTS rating system in exam letters
    - Examination of thrift v. examination of holding company - "The Home Owners Loan Act (HOLA) authorizes OTS to examine and supervise the companies that own, directly or indirectly, savings associations. OTS refers to these companies as savings and loan holding companies. OTS has supervisory and enforcement authority over the entire corporate structure."
    - Compliance/file testing approach - or - governance/risk approach
    - CRA, Fair Lending, HMDA
    - What can we expect from the OTS during its first time through exams
    - Target exams v. ongoing supervision
    - Can you explain the OTS's new *Complex and International Organization Program*? How will CFC fit into this program? "similar to FRB program for BHCs"
15. Which OTS office will likely lead the exam efforts at CFC? Potential size of team? Background and expertise of exam team? One exam team or two? Expectation of learning curve?
16. Are there any changes in our need to comply with Reg W – TWA? CFC and Countrywide bank have a well established protocol covering loans produced at CFC to the bank.
17. How will OTS interact with CFC's other functional regulators?
18. How current are publicly available OTS exam protocols – can we rely on these for internal self assessments or are their other standards?
19. Can you describe the OTS's CORE Rating?
20. Can you describe the OTS's PERK system?
21. What will be the OTS's annual assessment?
22. Can you talk about other national banks our size that have converted to Thrift status? What challenges were faced? Length of time to convert?
23. How has the OTS examined deposit gathering strategies? Brokered CDs, hot money issues?
24. CFC's Exam Protocols:
    - All documents provided timely and electronically via CORAD
    - Weekly Thursday update meetings on any exams in process
    - Monthly meetings with EIC to discuss concerns and scheduling
    - Meet with District leadership 4 times per year

- Meet with leadership in DC 2 times per year

25. How will the OTS utilize/rely on CFC governance systems?
    - CORAD
    - Governance Structure
    - Enterprise Risk Map
    - Quarterly Assessments
    - Internal Audit

CFC Internal Questions

1. Can/should we communicate our research of thrift status to Fed and OCC leadership? Regulatory activities appear to be increasing at all financial intuitions – will OTC expand its regulatory focus several years out?
2. Will Fed continue to view CFC as anomalous and higher risk due to MSRs and mono-line status?
3. Depending on expertise of OTS staff the learning curve on CFC could be onerous.
4. With one regulator might the OTS follow compliance issues into the parent and increase examinations within CMD, WLD etc. Thus far, the Fed time in these divisions has been minimal.
5. What are CFC's strategic benefits of a broader use of the bank charter over loan production for preemption?
6. Will OTS significantly reduce Basel II burdens?
7. Will OTS reduce regulatory burden at the parent?
8. Are benefits to having the two leading regulators at CFC (Fed, OCC) measurable?
9. How might investors and rating agencies respond to a change?
10. What will messaging be should change take place?

Bio - John M. Reich, Director
Office of Thrift Supervision

John M. Reich was sworn in August 9, 2005, as Director of the Office of Thrift Supervision (OTS). The President nominated Mr. Reich to be OTS Director on June 7, 2005, and the Senate confirmed his nomination on July 29, 2005. In this capacity, Mr. Reich will continue to serve as a member of the Board of Directors of the FDIC.

Prior to joining OTS, Mr. Reich served as Vice Chairman of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) since November 2002. He has been a member of the FDIC Board since January 2001. He also served as Acting Chairman of the FDIC from July to August 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 (R-FL), before joining the FDIC. From 1998 through 2000, he was Senator Mack's Chief of Staff, directing and overseeing all of the Senator's offices and committee activities, including those at the Senate Banking Committee.

Mr. Reich's community service includes serving as Chairman of the Board of Trustees of a public hospital facility in Ft. Myers, FL, and Chairman of the Board of Directors of the Sarasota Family YMCA. He has also served as a Board member for a number of civic organizations, and was active for many years in youth baseball programs.

Mr. Reich holds a B.S. degree from Southern Illinois University and an M.B.A. from the University of South Florida. He is also a graduate of Louisiana State University's School of Banking of the South.

OTS Senior Management

(All area codes are '202' unless stated otherwise)

DIRECTOR'S OFFICE

Title	Name	Number
Director	John M. Reich	906-6590
Counsel to the Director	Robert W. Russel	906-6579
FDIC Liaison	Claude A. Rollin	906-6634
Associate Director	Bernie (Walter) Mason	906-7236
Manager, Office of Equality & Workplace Principles	Cheryl C. Wright	906-6477

DEPUTY DIRECTOR'S OFFICE

Deputy Director	**Scott M. Polakoff**	**906-6853**
Special Assistant	Joy Burr	906-7428
Special Counsel/Ombudsman	Randy W. Thomas	906-7945
Regional Director, Northeast	Robert C. Albanese	(201) 413-7302
Regional Director, Southeast	John E. Ryan	(404) 888-5619
Regional Director, Midwest	Frederick R. Casteel	(972) 277-9600
Regional Director, West	Michael E. Finn	(650) 746-7010

EXAMINATIONS, SUPERVISION AND CONSUMER PROTECTION

Managing Director	Scott M. Albinson	906-7984
Special Advisor to the Managing Dir.	Michael R. Brickman	906-6062
Special Assist., International Affairs	Kevin Anderson	906-7020
Assistant Managing Director, Complex & International Organizations	CK Lee	906-6035
Assistant Managing Director, Examinations and Supervision Operations	Lori J. Quigley	906-6265
Assistant Managing Director, Examinations and Supervision Policy	Grovetta Gardineer	906-6068
Assistant Managing Director, Compliance, and Consumer Protection	Montrice Yakimov	906-6173

CHIEF COUNSEL

Chief Counsel	John E. Bowman	906-6372
Deputy Chief Counsel, Litigation	Thomas J. Segal	906-7230

Senior Deputy Chief Counsel, Regulations and Legislation	Deborah Dakin	906-6445
Deputy Chief Counsel, Business Transactions	Kevin Corcoran	906-6962
Deputy Chief Counsel Enforcement	Richard C. Stearns	906-7966

EXTERNAL AFFAIRS

Managing Director.....Kevin Petrasic.....906-6288

HUMAN RESOURCES AND ADMINISTRATIVE SERVICES

Managing Director.....Sue A. Rendleman.....906-6050

Assistant Managing Director, HRAS	Diane Cantrell	906-7309
Director, Benefits, Payroll & Travel	Nikki DiPalma	906-6918
Director, Comp./Retirement & Data Sys.	Valerie Waller-Milton	906-7303
Director, Staffing & Outplacement	Marie Janios	906-6070
Director, Professional Development	Matt Amato	906-6254
Director, Procurement Management	Elaine Logan	906-6193
Director, Facilities Management	Terri L. Davidson	906-6234

INFORMATION SYSTEMS & FINANCE

Managing Director/CIO/CFO.....Timothy T. Ward.....906-5666

Special Assistant	Deborah S. Barringer	906-6652
Director, National Systems	Patrick G. Berbakos	906-6720
Director, Quality Assurance and Management Support	Barbara Taylor	906-7510
Director, Financial Operations	Anita Tyndall	906-6458

Summary of Capital at OTS Institutions

Sampling of Institutions Regulated by OTS

Bank	City, ST	Assets	Risk Weighted Assets	Total Risk Based Capital (RBC)	Total RBC Ratio
			in thousands		
AIG Federal Savings Bank	Wilmington, DE	$1,209,886	$576,762	$175,134	**30.37%**
Allstate Bank	Vernon Hills, IL	$1,023,040	$333,723	$83,782	**25.11%**
American Express Bank, FSB	Salt Lake City, UT	$15,154,817	$13,686,932	$1,987,044	**14.52%**
Capital One, FSB	McLean, VA	$15,886,416	$12,320,586	$1,896,062	**15.39%**
Citibank (West) FSB	San Francisco, CA	$129,171,475	$79,454,138	$9,614,234	**12.10%**
Citibank, Federal Savings Bank	Reston, VA	$34,721,856	$27,564,949	$3,507,337	**12.72%**
Citicorp Trust Bank, FSB	Wilmington DE	$38,418,251	$21,775,947	$2,929,099	**13.45%**
E*Trade Bank	Arlington, VA	$33,731,080	$18,764,196	$2,104,021	**11.21%**
Franklin Templeton Bank and Trust, FSB	Salt Lake City, UT	$152,448	$104,839	$31,423	**29.97%**
GE Money Bank	Salt Lake City, UT	$13,045,114	$11,133,991	$3,409,767	**30.62%**
GMAC Bank	Horsham, PA	$11,299,146	$7,772,104	$815,005	**10.49%**
Hudson City Savings Bank	Paramus, NJ	$29,675,499	$10,680,747	$4,169,130	**39.03%**
IndyMac Bank	Pasadena, CA	$23,101,437	$14,077,707	$1,612,581	**11.45%**
ING Bank, FSB	Wilmington, DE	$59,410,941	$17,090,720	$5,122,201	**29.97%**
Lehman Brothers Bank, FSB	Wilmington, DE	$20,621,585	$15,487,008	$1,772,296	**11.44%**
Merrill Lynch Trust Company, FSB	Pennington, NJ	$193,125	$70,966	$60,273	**84.93%**
Prudential Bank & Trust, FSB	Hartford, CT	$549,332	$210,750	$44,906	**21.31%**
Sovereign Bank	Wyomissing, PA	$65,049,365	$50,066,299	$5,492,984	**10.97%**
State Farm Bank, FSB	Bloomington, IL	$12,675,414	$7,704,589	$940,335	**12.20%**
Washington Mutual Bank	Henderson, NV	$347,416,019	$237,880,070	$28,399,882	**11.94%**
World Savings Bank, FSB	Oakland, CA	$126,958,688	$68,239,075	$9,079,166	**13.30%**
Average (unweighted)		**$46,641,187**	**$29,285,528**	**$3,964,127**	**21.55%**

Countrywide Bank	**Alexandria, VA**	**$79,879,571**	**$46,745,424**	**$5,732,138**	**12.26%**
CFC	**Calabasas, CA**	**$177,583,056**	**$114,149,107**	**$14,477,045**	**12.68%**

Definitions and Notes

Equity Capital
Total equity listed on the Balance Sheet

Total RBC Ratio
Total RBC / Risk-Weighted Assets

Total Risk Based Capital=
Tier I Capital
+ Tier II Capital
- Required Deductions

Criteria for Company Selection
Nine of the ten largest institutions regulated by the OTS (Washington Mutual FSB was not included as it is an outlier with an RBC Ratio of 298.82%)
Thrifts and Institutions owned by large and widely-recognized corporations

Sources
All information is from the institution's 3/31/2006 Call Report as posted on the FDIC website

Countrywide
Enterprise Risk Assessment

Summary of CFC's Balance Sheet

		Actual ($ in Mil)					% of Total Equity	
Assets								
1	**Cash (Cap Req: 2%)**	$2,645	$1,031	$1,051	1.5%	0.6%	19.6%	8.0%
2	**Mortgage loans, MBS and ABS Held for Sale (Cap Req: N/A)**	$32,068	$36,808	$33,035	18.1%	21.0%	237.4%	287.2%
2.01	Prime - Held for Sale (Cap Req: 5%)	$20,712	$27,085	$23,433	11.7%	15.5%	153.3%	211.3%
2.02	Non-Prime - Held for Sale (Cap Req: 5%)	$5,275	$6,737	$6,359	3.0%	3.8%	39.1%	52.6%
2.03	Prime Home Equity - Held for Sale (Cap Req: 10%)	$5,027	$1,949	$2,534	2.8%	1.1%	37.2%	15.2%
2.04	Commercial Real Estate (Cap Req: 5%)	$1,052	$1,089	$721	0.6%	0.6%	7.8%	8.5%
3	**Trading Securities Owned or Pledged as Collateral (Cap Req: N/A)**	$12,073	$10,983	$11,985	6.8%	6.3%	89.4%	85.7%
3.01	MBS: Fixed-rate (Cap Req: 0%)	$5,775	$5,638	$6,210	3.3%	3.2%	42.8%	44.0%
3.02	MBS: Adjustable-rate (Cap Req: 0%)	$843	$915	$769	0.5%	0.5%	6.2%	7.1%
3.03	Collateralized Mortgage Obligations (Cap Req: 0%)	$2,526	$2,378	$2,297	1.4%	1.4%	18.7%	18.6%
3.04	US Treasuries (Cap Req: 0%)	$1,418	$1,038	$1,428	0.8%	0.6%	10.5%	8.1%
3.05	Obligations of US GSEs (Cap Req: 0%)	$687	$430	$520	0.4%	0.2%	5.1%	3.4%
3.06	ABS (Cap Req: 0%)	$285	$235	$253	0.2%	0.1%	2.1%	1.8%
3.07	Mark-to-market on TBA Securities (Cap Req: 0%)	$204	$77	$135	0.1%	0.0%	1.5%	0.6%

		Actual ($ in Mil)					% of Total Equity	
Assets								
3.08	IO Stripped Securities (Cap Req: 0.00%)	$329	$255	$302	0.2%	0.1%	2.4%	2.0%
3.09	Negotiable CDs (Cap Req: 0%)	$4	--	--	0.0%	--	0.0%	--
3.10	Corporate Debt Securities (Cap Req: 0%)	--	--	--	--	--	--	--
3.11	Other (Cap Req: 0%)	$2	$17	$8	0.0%	0.0%	0.0%	0.1%
4	**Securities Purchased Under Agreements to Resell (Cap Req: 2%)**	$21,516	$23,317	$22,342	12.1%	13.3%	159.3%	181.9%
5	**Loans Held for Investment, Net (Cap Req: N/A)**	$74,108	$69,865	$61,967	41.7%	39.9%	548.7%	545.1%
5.01	Prime Loans (Cap Req: 5%)	$53,464	$48,617	$40,749	30.1%	27.8%	395.8%	379.4%
5.02	Prime Home Equity (Cap Req: 10%)	$14,963	$14,991	$14,905	8.4%	8.6%	110.8%	117.0%
5.03	Nonprime (Cap Req: 5%)	$324	$158	$209	0.2%	0.1%	2.4%	1.2%
5.04	Warehouse Lending Advances Secured by Mortgage Loans (Cap Req: 10%)	$3,055	$3,943	$4,091	1.7%	2.3%	22.6%	30.8%
5.05	Defaulted Mortgage Loans Repurchased from Securitizations (Cap Req: 10%)	$1,440	$1,370	$1,366	0.8%	0.8%	10.7%	10.7%
5.06	Purchase Premium/ Discount and Deferred Loan Origination Costs (Cap Req: 5%)	$1,034	$938	$809	0.6%	0.5%	7.7%	7.3%
5.07	Allowance for Loan Losses (Cap Req: N/A)	-$172	-$151	-$157	-0.1%	-0.1%	-1.3%	-1.2%
6	**Investments in Other Financial Instruments (Cap Req: N/A)**	$11,112	$11,261	$11,396	6.3%	6.4%	82.3%	87.9%

		Actual ($ in Mil)					% of Total Equity	
Assets								
6.01	Mortgage-backed Securities (Cap Req: 2%)	$6,581	$6,887	$7,089	3.7%	3.9%	48.7%	53.7%
6.02	Obligations of US Gov Sponsored Enterprises (Cap Req: 2%)	$562	$548	$382	0.3%	0.3%	4.2%	4.3%
6.03	Municipal Bonds (Cap Req: 2%)	$379	$370	$325	0.2%	0.2%	2.8%	2.9%
6.04	US Treasury Securities (Cap Req: 0%)	$144	$145	$114	0.1%	0.1%	1.1%	1.1%
6.05	Other (Cap Req: 10%)	$3	$3	$2	0.0%	0.0%	0.0%	0.0%
6.06	Prime Home Equity Residual Securities (Cap Req: 100%)	$791	$882	$821	0.4%	0.5%	5.9%	6.9%
6.07	Prime Home Equity Line of Credit Transferor's Interest (Cap Req: 10%)	$420	$254	$335	0.2%	0.1%	3.1%	2.0%
6.08	Nonprime Residual Securities (Cap Req: 100%)	$416	$547	$558	0.2%	0.3%	3.1%	4.3%
6.09	Prime Interest-only & Principal-only Securities (Cap Req: 10%)	$638	$504	$318	0.4%	0.3%	4.7%	3.9%
6.10	Prepayment Penalty Bonds (Cap Req: 10%)	$110	$112	$101	0.1%	0.1%	0.8%	0.9%
6.11	Nonprime Interest-only Securities (Cap Req: 10%)	$8	$9	$22	0.0%	0.0%	0.1%	0.1%
6.12	Prime Home Equity Interest-only Securities (Cap Req: 100%)	$32	$15	$19	0.0%	0.0%	0.2%	0.1%
6.13	Prime Residual Securities (Cap Req: 100%)	$54	$65	$31	0.0%	0.0%	0.4%	0.5%

		Actual ($ in Mil)					% of Total Equity	
Assets								
6.14	Subordinated Mortgage-Backed Pass-through Securities (Cap Req: 100%)	$2	$2	$2	0.0%	0.0%	0.0%	0.0%
6.15	Hedging Instruments and Mortgage Pipeline Derivatives - Mortgage Servicing (Cap Req: 5%)	$679	$741	$976	0.4%	0.4%	5.0%	5.8%
6.16	Hedging Instruments and Mortgage Pipeline Derivatives - Notes Payable (Cap Req: 5%)	$101	$107	$238	0.1%	0.1%	0.7%	0.8%
6.17	Hedging Instruments and Mortgage Pipeline Derivatives - Mortgage loans held for sale	$181	$89	--	0.1%	0.1%	1.3%	0.7%
6.18	Interest Rate Swaps	$9	$1	--	0.0%	0.0%	0.1%	0.0%
7	**Mortgage Servicing Rights, Net (Cap Req: 17%)**	$14,172	$12,611	$10,788	8.0%	7.2%	104.9%	98.4%
8	**Premises and Equipment, Net (Cap Req: 10%)**	$1,338	$1,280	$1,187	0.8%	0.7%	9.9%	10.0%
9	**Other Assets (Cap Req: N/A)**	$8,561	$7,929	$6,757	4.8%	4.5%	63.4%	61.9%
9.01	Reimbursable Servicing Advances (Cap Req: 10%)	$1,674	$1,947	$1,180	0.9%	1.1%	12.4%	15.2%
9.02	Securities Broker-dealer Receivables (Cap Req: 10%)	$1,416	$393	$781	0.8%	0.2%	10.5%	3.1%
9.03	Investments in FRB and FHLB Stock (Cap Req: 2%)	$1,364	$1,334	$1,191	0.8%	0.8%	10.1%	10.4%

		Actual ($ in Mil)					% of Total Equity	
Assets								
9.04	Receivables from Custodial Accounts (Cap Req: 10%)	$613	$629	$570	0.3%	0.4%	4.5%	4.9%
9.05	Interest Receivable (Cap Req: 10%)	$863	$778	$666	0.5%	0.4%	6.4%	6.1%
9.06	Capital Software, Net (Cap Req: 10%)	$314	$331	$318	0.2%	0.2%	2.3%	2.6%
9.07	Federal Funds Sold (Cap Req: 2%)	$0	$0	$137	0.0%	0.0%	0.0%	0.0%
9.08	Prepaid Expenses (Cap Req: 10%)	$224	$187	$198	0.1%	0.1%	1.7%	1.5%
9.09	Cash Surrender Value of Assets Held in Trust for Deferred Compensation Plan (Cap Req: 10%)	$231	$225	$212	0.1%	0.1%	1.7%	1.8%
9.10	Restricted Cash (Cap Req: 2%)	$439	$430	$242	0.2%	0.2%	3.3%	3.4%
9.11	Receivables from Sale of Securities (Cap Req: 10%)	$145	$325	$181	0.1%	0.2%	1.1%	2.5%
9.12	Derivative Margin Accounts (Cap Req: 10%)	$69	$296	$184	0.0%	0.2%	0.5%	2.3%
9.13	Real estate acquired in settlement of loans	$153	$110	--	0.1%	0.1%	1.1%	0.9%
9.14	Other Assets (Cap Req: N/A)	$1,057	$943	$869	0.6%	0.5%	7.8%	7.4%
10	**Total Assets**	$177,592	$175,085	$160,507	100.0%	100.0%	--	--

		Actual ($ in Mil)					% of Total Liabilities	
Liabilities								
11	**Notes Payable**	$72,554	$76,188	$68,246	40.9%	43.5%	44.2%	47.0%
11.01	Medium term notes: Fixed rate (WAV Rate: 4.50%)	$11,609	$11,504	$12,183	6.5%	6.6%	7.1%	7.1%
11.02	Medium term notes: Floating rate (WAV Rate: 4.71%)	$14,453	$14,467	$12,182	8.1%	8.3%	8.8%	8.9%
11.03	FHLB advances (WAV Rate: 4.22%)	$27,000	$26,350	$23,644	15.2%	15.0%	16.5%	16.2%
11.04	Asset-backed commercial paper (WAV Rate: 4.76%)	$10,049	$12,367	$11,146	5.7%	7.1%	6.1%	7.6%
11.05	Unsecured commercial paper (WAV Rate: 4.85%)	$3,434	$6,249	$5,018	1.9%	3.6%	2.1%	3.9%
11.06	Asset-backed secured financings (WAV Rate: N/A)	$3,246	$23	--	1.8%	0.0%	2.0%	0.0%
11.07	Junior subordinated debentures (WAV Rate: 7.39%)	$1,052	$1,085	$1,042	0.6%	0.6%	0.6%	0.7%
11.08	Convertible securities (WAV Rate: N/A)	--	$11	$29	--	0.0%	--	0.0%
11.09	LYONs convertible debentures (WAV Rate: N/A)	--	$2	$7	--	0.0%	--	0.0%
11.10	Secured revolving line of credit (WAV Rate: 4.65%)	$724	$2,865	--	0.4%	1.6%	0.4%	1.8%
11.11	Unsecured bank loans (WAV Rate: 4.55%)	$450	$730	--	0.3%	0.4%	0.3%	0.4%

		Actual ($ in Mil)					% of Total Liabilities	
Liabilities								
11.12	Subordinated debt (WAV Rate: 5.26%)	$500	$500	--	0.3%	0.3%	0.3%	0.3%
11.13	Other (WAV Rate: N/A)	$37	$36	--	0.0%	0.0%	0.0%	0.0%
12	**Securities sold under agreements to repurchase**	$32,600	$34,153	$34,687	18.4%	19.5%	19.9%	21.0%
13	**Deposit liabilities**	$45,378	$39,439	$33,383	25.6%	22.5%	27.7%	24.3%
13.01	Time deposits (WAV Rate: 4.21%)	$24,847	$20,876	$17,551	14.0%	11.9%	15.1%	12.9%
13.02	Company controlled custodial deposit accounts (WAV Rate: 4.39%)	$14,435	$13,201	$12,130	8.1%	7.5%	8.8%	8.1%
13.03	Money Market Accounts (WAV Rate: 4.32%)	$4,908	$4,466	$3,083	2.8%	2.6%	3.0%	2.8%
13.04	Non-interest-bearing checking accounts (WAV Rate: 0.00%)	$1,243	$927	$626	0.7%	0.5%	0.8%	0.6%
13.05	Savings accounts (WAV Rate: 0.82%)	$1	$1	$1	0.0%	0.0%	0.0%	0.0%
13.06	Basis adjustment through application of hedge accounting	-$56	-$32	--	0.0%	0.0%	0.0%	0.0%
14	**Accounts payable and accrued liabilities**	$5,920	$6,358	$8,302	3.3%	3.6%	3.6%	3.9%
15	**Income taxes payable**	$4,241	$3,846	$3,403	2.4%	2.2%	2.6%	2.4%

		Actual ($ in Mil)					% of Total Liabilities	
Liabilities								
16	**Trading securities sold, not yet purchased at fair value**	$3,393	$2,285	--	1.9%	1.3%	2.1%	1.4%
17	**Total Liabilities**	$164,086	$162,270	$148,592	--	--	100.0%	100.0%

Arnold's & Porter Memo
April 21, 2006

(Note – highlights added)

Countrywide
Enterprise Risk Assessment

ARNOLD & PORTER LLP

**PRIVILEGED AND CONFIDENTIAL
ATTORNEY-CLIENT COMMUNICATION**

To: General Counsel
XYZ Corporation

From: Arnold & Porter LLP

Date: April 21, 2006

Re: Summary of Advantages and Disadvantages of XYZ Corporation Converting to a Savings and Loan Holding Company

You have asked us to summarize certain advantages and disadvantages for XYZ Corporation ("XYZ") to convert from a financial holding company regulated by the Federal Reserve to a savings and loan holding company regulated by the Office of Thrift Supervision ("OTS"), by converting its four state chartered banks to federal savings banks.

Overall Observations

1. If XYZ were to pursue this option and announced a plan to convert to a savings and loan holding company, XYZ would need to explain to the market the reasons for the conversion. Thus, XYZ would need to consider the business reasons why this could be an advantageous change. XYZ also should consider how its relationships with its regulators may be impacted by a conversion or an announcement it was considering such action. Currently, XYZ is regulated by the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC") and the Commissioner of Banks, with whom XYZ maintains an excellent relationship. If it were to convert to a savings and loan holding company with either one or multiple federal savings banks, XYZ's only bank regulator would be the OTS.[1] It is difficult to foresee what type of relationship XYZ would have with the OTS although the conversion of a bank the size of XYZ would result in one of the largest entities regulated by the OTS and given the level of assessments paid by such entities, would likely be welcomed by the agency. On the other hand, the size and complexity of the converted banks may present the OTS with issues which could retard -- at least in the short term -- some of the more sophisticated activities currently conducted by the XYZ Banks. It also is not clear how XYZ's current regulators would react to XYZ leaving their supervision.[2] Although it is not clear what theory they would employ to prevent such a conversion, the Federal Reserve, the FDIC or the state could try to prevent XYZ from leaving its jurisdiction, which could create a turf battle between regulators.

[1] XYZ could choose to have one or more state-chartered savings and loan associations or savings banks and be regulated on the state level as well.
[2] XYZ would need to have a conversation with the OTS regarding its conversion authority before it converted its state-chartered commercial banks to federal savings banks, in what would be an unprecedented transaction.

2. As the regulators become more coordinated in their approach to supervision and regulation, the issues we understand were raised in XYZ's last examination, relating to corporate governance, could be raised as well by other federal banking agencies, including the OTS. In this connection, we have seen corporate governance, as part of a supervisory evaluation of overall enterprise risk management, increasingly becoming a focus of examinations by the Federal Reserve and the Office of the Comptroller of the Currency ("OCC"). However, the OTS regulates its holding companies differently than the Federal Reserve, and, therefore, the OTS may take a slightly different view on corporate governance matters than either the Federal Reserve or the FDIC. Nevertheless, we assume that because of the importance of corporate governance issues in corporate America today, this is likely an issue that the OTS would also focus on in some manner during its examinations of institutions it regulates. Furthermore, XYZ would be one of the largest institutions regulated by the OTS and therefore may receive closer scrutiny from the OTS.

3. We believe there is a some risk-albeit a small one - that the OTS will be merged into another agency in the next 5- 10 years. If that were to occur, the XYZ Banks would be subject to a new regulator. The OTS has had many of its regulated entities convert or be acquired in the last fifteen years, and if one of the few large remaining federal savings banks such as Washington Mutual were to convert its charter to a commercial bank, the OTS, which derives most of its funding from examination fees, may not have sufficient funding to continue as an independent entity. If this were the case, the OTS could be merged into another federal banking agency, with the OCC as the most logical choice. If this merger were to occur, the OCC would regulate the savings banks and it is highly likely that the OCC would regulate the holding company as well. The political firestorm that would erupt if the Federal Reserve were to be given regulatory control over savings and loan holding companies--particularly "grandfathered savings and loan holding companies-- is such that it is extremely doubtful that Congress would take such action.

With these observations in mind, the advantages and disadvantages of converting to a savings and loan holding company are discussed below.

Advantages:

- A non-grandfathered savings and loan holding company may undertake all of the powers of a financial holding company, so XYZ should be able to continue all of its current activities conducted as a financial holding company under the Bank Holding Company Act ("BHC Act").[3] Moreover, because the Home Owners Loan Act ("HOLA") does not link the activities of the holding company to the financial or managerial status of the banking subsidiaries as does the BHC Act, the XYZ Banks would not need to maintain being well-capitalized, well-managed, or a satisfactory or better CRA rating for the holding company to retain its financial holding company powers. Nevertheless, realistically, the OTS would monitor these requirements and may impose restrictions on XYZ if the XYZ Banks were not well-capitalized or well-managed.

[3] We note that the OTS has never concluded that a savings and loan holding company can exercise all of the powers of a bank holding company under Section 4 of the BHC Act, so there may be activities currently conducted by XYZ that the OTS may question if XYZ were to become a savings and loan holding company. This is in all likelihood more of a theoretical than a real issue.

- The OTS regulation of holding companies is not as intrusive as that of the Federal Reserve. In particular, the OTS rarely conducts extensive onsite examinations and when they do conduct an onsite examination they are generally not considered intrusive to the holding company.

- XYZ would not be subject to consolidated capital requirements at the holding company level, although any depository institutions controlled by it would continue to be subject to applicable regulatory capital requirements.

- Because of the lack of a consolidated capital requirement for savings and loan holding companies, XYZ should have more flexibility in its capital structure and thus, for example, it could issue subordinated debt and use the proceeds to make other investments or to invest in its banks to meet their capital requirements.

- XYZ as a unitary savings and loan holding company, would not have to apply to or notify the OTS prior to directly commencing a new activity or directly acquiring a company that may engage in a new non-banking (but financially related) activity (although aproval requirements would apply to any XYZ Bank acquisition or activity).

- The XYZ Banks, as federal savings banks, could branch de novo in any state as long as the qualified thrift lender ("QTL") test is met on both a consolidated level for each bank and under current law on a state-wide level for the state in which the branch is proposed to be located.[4]

- As a savings and loan holding company, XYZ could undertake real estate development activities, which are not currently permissible for financial holding companies unless the merchant banking powers are used.

- Operating a federal savings bank would allow XYZ to take advantage of the authority under the HOLA and OTS regulations to operate under one uniform law nationwide and preempt state consumer and other laws that may conflict with the federal law.

Disadvantages:

- To become a savings and loan holding company, the XYZ Banks would have to become either federal savings banks or state savings banks. We note that most savings and loan holding companies are unitary savings and loan holding companies and do not own multiple savings banks. Thus, a multiple savings and loan holding company is very rare, although if XYZ would want to continue its credit card operations in State Z without any changes in its operations, it may need to be a

[4] The Financial Services Regulatory Relief Act of 2006, which was recently passed by the House of Representatives, would eliminate the state-by-state application of the QTL test. It is not clear whether this legislation will be considered by the Senate this year, although the better view is that it will not be considered.

multiple savings and loan holding company. Such status could impact the need for prior approval for non-bank acquisitions.

- Each XYZ Bank would be subject to the basket provisions and the QTL provisions applicable to federal savings banks, which place limitations on the amount of commercial lending a savings bank does or the type of assets a savings bank can hold. This could create issues for banks such as the XYZ Banks that generate significant commercial loan assets. The QTL test, as a general matter, requires federal savings banks to maintain at least 65% of its "portfolio assets" (which excludes liquid assets, goodwill and the value of premises) in "qualified thrift investments," such as mortgage related assets, credit card loans, and to a certain extent, other consumer loans. In addition, the basket limitations place limitations on the types of assets a federal savings bank may acquire or generate and continue to hold in its portfolio, such as commercial loans, certain consumer loans, and unsecured construction loans.[5] Under current law, the QTL test would need to be met at the bank level in each state where XYZ maintained branches.[6]

    - Only a small percentage of commercial loan assets (10 percent generally or 20 percent for small business loans) could be retained at the bank level for the XYZ Banks to meet the QTL test and basket limitations. There are alternatives available to the XYZ Banks to manage their asset mix to comply with these tests, including periodically selling assets to holding company affiliates or to third parties, but this can be awkward. These transactions also would be subject to the affiliate transaction limitations under Sections 23A and 23B and Section 11 of the HOLA.

    - As an alternative, XYZ could move the commercial lending operations of the XYZ Banks to a new non-banking subsidiary to conduct its commercial lending operations. This subsidiary would likely be a state-chartered company that would be subject to state licensing requirements in the states in which it operates. In addition, this entity could not be funded with deposits, so XYZ would need to look into other alternatives to fund the entity such as the issuance of debt at the holding company level.

    - XYZ also could establish an industrial loan company ("ILC") in Utah to run its commercial lending operations. ILCs are currently very controversial in Congress, but XYZ may be interested in this idea since undertaking commercial lending through the ILC may allow the lending to be funded with deposits.

[5] We note that the Regulatory Relief Act, described in Footnote 4, would increase the limit on commercial real estate loans from 400 percent of capital to 500 percent of capital and would remove the restrictions related to auto loans (currently the amount of auto loans federal savings associations can make is limited to 35 percent of assets).
[6] See Footnote 4.

- Bank acquisitions could become more difficult because of a provision in the Savings and Loan Company Act which provides that if a savings and loan holding company wants to acquire a state bank in a state other than its home state, that state's laws need to specifically allow savings and loan holding companies to acquire a state bank. While this type of provision (called the now repealed Douglas Amendment in the BHC Act) used to apply to bank acquisitions, because there is virtually no state law guidance on this issue under state laws applicable to thrifts, the OTS tends to raise issues about such acquisitions, with the result that most interstate acquisitions are done as mergers at both the subsidiary level as well as at the holding company level. This can present issues if the target institution needs to be merged into the XYZ Banks at the time of the acquisition.

- The OTS generally is considered a less sophisticated regulator than the Federal Reserve, and usually needs to be educated on proposed new activities or acquisitions to be undertaken by the federal savings bank, and often is suspicious of, and takes a long time to approve, new activities for a federal savings bank. Because the OTS is viewed generally as a less sophisticated regulator, there also could be a market perception that XYZ as a savings and loan holding company, is not as strictly regulated as a bank holding company by the Federal Reserve. This perception might weaken XYZ's financial standing in the market.

Recent Speeches by John Reich

Countrywide
Enterprise Risk Assessment

REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE EXCHEQUER CLUB

FEBRUARY 15, 2006

Good afternoon. It is indeed an honor to be with you again. My previous opportunity to be here was in November 2004, when I was Vice Chairman of the FDIC and spoke to you regarding my concerns about accumulated regulatory burden and its impact on industry consolidation.

Presently, I am concluding my first six months at the Office of Thrift Supervision (OTS), and I appreciate this timely opportunity to spend a few minutes updating you on my impressions of the agency and the institutions we supervise. I will also discuss the regulatory burden relief project, which I am managing for the FFIEC, as it enters a particularly critical phase on Capitol Hill. Finally, I will update you on three supervisory issues. Before concluding, I will make a few comments on the situation in the Gulf Coast and our efforts there.

I must begin by telling you that I came to this job with the perspective of a 23-year national banker – and wasn't sure quite what to expect. Any new Director of the OTS has to deal with threshold questions about the future of the agency and its charter – and my experience has been no different. But after six months on the job, learning about the agency and meeting its capable staff, I come to you with the impression that OTS and the charter we administer have inherent strengths that will ensure its continued viability and relevance well into the future.

I will tell you what these are.

First, our charter is primarily a retail charter and I see no evidence that this part of the financial services world is in decline. Rather, the opposite is true. Today, OTS is reporting that for 2005 industry assets are up 12.0 percent from the prior year to a record $1.46 trillion. In the past five years, industry assets have grown 57.7 percent, representing a robust average annual five-year growth rate of 9.5 percent. Similarly, earnings for 2005 are up 17.6 percent from 2004, and industry earnings have more than doubled in the past five years, climbing from $8.0 billion in 2000 to a record $16.4 billion in 2005.

As this sector grows, I believe our charter is well positioned to provide a structural and regulatory alternative to both established financial services

businesses and to new entrants that are working to grow market share in this area.

Second, the statutory framework and regulatory structure around savings banks allow for a degree of regulatory consistency not found elsewhere. Our charter's well-established and well-recognized powers of branching and preemption ensure savings institutions are able to follow their customer base and the growth of their business from one end of the country to the other – all with minimal regulatory burden. Further, the seamless supervision of at all levels of the organization – both savings banks and savings and loan holding companies are supervised by the OTS – ensures both a comprehensive supervisory regime and minimal regulatory overlap.

Finally, the record shows that our charter is remarkably flexible in adapting to the many products and structures present in today's financial services marketplace. We operate with a minimum of overhead, and with a skilled staff with tremendous experience in nearly every sector of modern banking, and both our charter and our agency are remarkably able to adapt to market demands.

The savings bank charter is deployed in neighborhood community banks all across America. It is used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerates involved in a wide array of diverse businesses – to name just a few. These organizations have all come to the savings bank charter at different times and for reasons as diverse as their underlying businesses and the markets they serve. And the facts seem to show that it has been a profitable decision.

That is not to say we don't have our challenges. We do. A significant challenge involves human capital. Like all the banking agencies, we are competing with Wall Street and the industry for similar talent. A growing portion of our workforce will be retiring in the next few years and we must replace these seasoned regulators with new hires. Just this year, we will hire 60 new examiners. We are boosting our resources on training and hiring the critical areas of modern banking – capital markets, economic analysis, and compliance management. We are re-establishing here in Washington, DC a centralized direction for compliance, CRA, community affairs, and consumer protection – all functions that were delegated to the regions in recent years.

A key staffing decision I made recently is the hiring of Scott Polakoff as the agency's new Chief Operating Officer and Deputy Director. Scott is an exceptional individual, a terrific career regulator with outstanding credentials and

leadership skills. Scott will truly be an invaluable asset for OTS, and we are very fortunate to have him.

In addition to resolving our human resources needs, we have also requested four statutory changes from Capitol Hill. These are part of the interagency regulatory burden legislation, and will help us build on the flexibility inherent in our charter and ensure long-term competitiveness and vitality.

First, we need parity for savings banks under the federal securities laws. This fix will ensure that savings associations and banks are on an even footing with respect to investment advisor and broker-dealer activities.

Second, we should permit unlimited small business lending for federal savings associations and raise the cap on commercial lending from 10 percent to 20 percent of assets.

Third, we should amend the Home Owners' Loan Act (HOLA) to eliminate the artificial 35 percent limitation on secured consumer lending. This will align that authority with the fact that there is no corresponding limitation on unsecured credit card lending.

Finally, we should provide parity for federal savings associations on federal court jurisdiction by clarifying that the savings association is a citizen of only the state in which its main office is located for purposes of determining federal court jurisdiction.

These are all common sense changes in our statute that will help us continue to provide a flexible and streamlined alternative for established financial services businesses and new entrants into the market.

The challenges I have outlined are not unique to OTS, and our plan for meeting them will, in my view, put our agency on solid footing for the long term – and allow us to meet the growing and increasingly diverse demands of a complex financial marketplace.

I also think there is a good chance to get our priorities, and those of the other agencies and the industry, enacted as part of our broader regulatory relief effort – the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) project. As you may recall from my last visit here, this is a subject near and dear to my heart. Both as a regulator and as a former community banker, I am concerned that the accumulated weight of regulatory burden

threatens the competitiveness of the banking industry and falls particularly hard on community banks. This is not idle speculation – it is a fact.

We have tried over the last 2 ½ years to increase awareness of the burden issues facing both large and small banks. My counterparts in the other banking agencies and I have put hundreds of agency regulations out for comment – receiving more than 1,000 suggestions in the process. We have held 16 banker and consumer outreach sessions around the country, given numerous speeches, and have offered Congressional testimony on the subject to both houses of Congress. We appear again before a Senate Banking Committee Hearing tentatively set for March 1st.

In addition to building awareness in the marketplace and in Congress, we have worked to reduce burden where we can – and where we already have the authority to act. Along with the other federal banking agencies, we have increased the small bank threshold under the Community Reinvestment Act (CRA) from $250 million to $1 billion, simplified some of our application and reporting requirements, streamlined examination processes, and made other changes to our regulations and internal procedures to reduce burden. I have noticed, also, that almost every new regulation, process, or procedure now includes a discussion about burden and how to accomplish the objectives while minimizing the regulatory burden on the industry.

Now we must ensure that our recommendations pass Congress. I know there are skeptics here. Unfortunately there are skeptics even among some of the industry associations that a regulatory relief bill will ever get enacted. But the House Financial Services Committee recently acted on a 67-0 vote to send a comprehensive regulatory relief bill to the House floor. The Senate Banking Committee is poised to take up a similar bill this spring. Make no mistake about it, this is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of recommendations before Congress is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. I hope I can count on many of you here to encourage Congress to make it happen.

In addition to our Congressional agenda on regulatory burden, we have been working on the policy around three supervisory issues that have evoked both interest and controversy. All three are particularly important and relevant to the universe of OTS-supervised institutions and holding companies.

The first of these involves interagency guidance, issued in December, on non-traditional mortgage products. Not unexpectedly, the guidance generated

considerable attention due to the popularity of two products in particular, "interest-only" and "pay option" adjustable rate mortgages, or "ARMs".

The features of interest-only and pay option ARMs can temporarily protect borrowers from payment increases resulting from rising interest rates. The experience with these instruments has, so far, been favorable. However, these new products share a common, potentially substantial additional risk element—a payment shock when the loan terms are eventually recast. For pay option ARMs, in particular, this shock can be quite dramatic—under reasonable assumptions about interest rates, as much as a 100 percent increase or more in the monthly payment.

Products much like these have long been offered by the thrift industry. Savings institutions have offered ARMs for more than thirty years. Some institutions have offered and successfully managed ARMs with negative amortization features for more than twenty years. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks associated with these types of loans.

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

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them to set concentration limits as a percentage of capital and, as a result, manage them successfully. As a regulator, that is our recommendation as well as our expectation.

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

Another initiative receiving some attention lately is the proposed guidance we issued last month on commercial real estate (CRE) lending by insured institutions.

The proposed guidance sets out thresholds for assessing whether an institution has a CRE concentration requiring heightened risk management practices. It focuses particularly on concentrations in those types of CRE loans that are vulnerable to cyclical commercial real estate markets. Institutions with these types of concentrations are expected to hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios.

While savings banks' CRE lending exposure is generally limited, 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 remain a concern.

If you have an interest in commenting on the proposed CRE lending guidance, the comment period closes March 14.

Finally, I will spend a minute or two on the perennial topic of the proposed Basel II capital standards. There has been considerable debate in the U.S. about the need for Basel II, the proposed revised capital framework for our largest and internationally active financial institutions. Some believe that we simply need to update our existing capital rules to accommodate advances and changes in the banking system since the original Basel I Accord was adopted and implemented in 1988. Others argue that implementation of Basel II is imperative to ensure the continued international competitiveness of our largest institutions.

While a Basel II-type approach may be best for our largest internationally active banks – about 24 in number, for most institutions, either the current Basel I rules or a modified Basel I framework is likely more appropriate. The challenge is how to proceed on these parallel tracks.

This past October, the federal banking agencies issued an Advanced Notice of Proposed Rulemaking, or ANPR, seeking comment on modernizing Basel I. The comment period on the so-called Basel IA ANPR closed a few weeks ago. We are currently reviewing comments and will soon be developing a

formal rulemaking on the subject. We anticipate the Basel II rulemaking will be available to the public at the end of March and published in the Federal Register in May for an extended comment period. Our goal is to issue the Basel IA rulemaking some time this summer, providing a meaningful overlap between the Basel IA and Basel II comment periods.

I am aware of significant sentiment from a number of community bankers that they are perfectly content to continue operating under the existing Basel I framework. In my view, a good case can be made that requiring institutions to move to a new set of capital rules will increase regulatory burden. At the same time, many believe that we need to modernize our risk-based capital system to make it truly more risk-based. The challenge is to do this without creating undue burden and complexity for our community institutions - certainly nothing approaching the complexity of Basel II.

Before concluding, I want to say a few words about the crisis in the Gulf Coast following the hurricanes last year. In late November, I decided to visit the hurricane-devastated areas of New Orleans. I am traveling there again this afternoon after this meeting, and again at the end of the month for an interagency forum with the industry.

To put it mildly, during my first visit I was unprepared for the devastation I witnessed there, and my impression is that little has changed in the intervening weeks. The scene defies description. It is truly unnerving – even for a former resident of Florida familiar with the damage that a hurricane can inflict – to witness block after block, mile after mile of standing empty structures and no signs of human activity.

The challenges facing the hurricane victims are daunting and unprecedented. While most local financial institutions are back on line, they still must deal with many of the issues directly affecting their customers. These challenges are overwhelming. I will give you a few examples of what individuals, businesses and financial institutions are facing:

FEMA flood maps may not be redrafted until later this year, and until that task is completed, government decisions on building codes and locations are on hold;
Levee reconstruction standards and timing are uncertain, yet are critical to those people who evacuated the city and are uncertain whether they will ever return;
Insurance companies are reluctant to write new policies;
Over 100,000 homes are estimated to need electrical rewiring, but

there is a shortage of qualified electricians in the region;
Homes modestly damaged are deteriorating rapidly due to mold problems;
Costs to rebuild have increased dramatically due to tightness in the supply of labor and materials;
There are an inadequate number of contractors and subcontractors;
Soil contamination will require multi-government review and timing is uncertain;
Many properties have yet to be reviewed by an insurance adjuster;
Debate continues among insurance companies over flood versus wind damage; and
Communication remains poor and postal service is sporadic.

It is one thing to face the huge task of rebuilding a storm-damaged dwelling, it is quite another to face that challenge when there is no public infrastructure in place and no assurance your neighborhood will ever re-emerge.

The banking regulators are doing everything we can to assist institutions and victims. The Federal Financial Institutions Examination Council (FFIEC) website contains questions and answers for institutions attempting to deal with issues such as extensions of loan payments and related accounting and disclosure issues. We have an "800" number to receive and address inquiries from victims. The banking agencies have clarified that favorable CRA consideration will be given to activities by financial institutions nationwide that provide lending, investment, or service activities in the devastated area.

In December, OTS sponsored a forum, jointly with Operation HOPE, to solicit support and assistance from the business community to identify, address and resolve the financial challenges faced by hurricane victims. Tomorrow, I will again be visiting with our institutions in the hurricane-affected areas. In addition, on March 2nd and 3rd, the banking agencies are sponsoring a banking forum in New Orleans to focus attention on the short- and long-term challenges facing institutions operating in the areas affected by the hurricanes.

The short-term prospects for the OTS-supervised institutions in the Gulf Coast region seem favorable; however, I am concerned about the long-term effect of the hurricanes. A favorable economic outlook and a recovering job-creation picture are critical to the area's recovery, but there first must be a stable and viable foundation on which businesses and communities can rebuild. How these issues are addressed will define the future of New Orleans and the Gulf Coast – and we must continue our efforts to assist them in this effort.

Let me conclude today by reiterating that our core mission is maintaining the safety and soundness of savings institutions, and ensuring their compliance with the laws and regulations we administer, including consumer protection laws. In addition to hiring new examiners, we will improve our training for existing examiners and enhance our supervisory, policy, and legal staff – both in Washington and throughout our regional structure. My goal is to provide our staff every opportunity to succeed in improving our oversight of, and responsiveness to, the industry we regulate.

We will continue our efforts to pass a significant regulatory relief bill. Congress needs to address this important problem this year and I believe, with your help, it will happen.

A final and critically important priority is capitalizing on the vibrancy of our charter to ensure we remain a viable alternative for both established retail banking businesses and new entrants into the financial marketplace. We will continue our efforts to ensure that OTS and the institutions we regulate are safe, sound, and well positioned to meet the challenges and seize the opportunities ahead.

Thank you. I will be happy to answer your questions.

REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

MARCH 8, 2006

Good morning. It is always an honor and a pleasure to talk to the Independent Community Bankers of America. As I stand here before this wonderfully large assembly of community bankers from around the country, I am fondly reminded of my 23 years as a community banker in Illinois and Florida, ten of those years as President and CEO of the National Bank of Sarasota, in Sarasota, Florida.

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

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

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

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

proposed interagency guidance, one dealing with non-traditional mortgage products, and the other with commercial real estate lending.

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

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

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

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

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

supervision at all levels of an organization — at the bank level as well as at savings and loan holding companies — ensures a comprehensive supervisory regime with minimal regulatory overlap.

The charter we oversee is remarkably flexible in adapting to the many products and structures present in today's financial services marketplace. It is deployed in neighborhood community banks all across America. It is also used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerates involved in a wide array of diverse businesses — to name just a few. These organizations have all come to the savings bank charter at different times and for reasons as diverse as their underlying businesses and the markets they serve. And the facts bear out that it has been a profitable decision.

Notwithstanding a great staff and a dynamic charter, there is always room for improvement. We have requested several statutory changes from Capitol Hill to better align our charter with the realities of the legitimate business activities of modern retail community banking. These are included in the proposals for interagency regulatory burden legislation, and will help us maintain the vitality and competitiveness of our retail community banking charter. Notwithstanding suggestions to the contrary, I think there remains a good opportunity to get these priorities, and those that your organization has articulated, enacted as part of our broader regulatory relief effort – the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) project.

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

Many of you know that regulatory burden relief is a subject near and dear to my heart. Both as a regulator and as a former community banker, I am concerned that the accumulated weight of regulatory burden threatens the competitiveness of the banking industry and falls particularly hard on community banks. This is not idle speculation — it is a fact.

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

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

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

To those who say let market forces determine the future of community banking, my response is that our industry is not a free market. It is a highly regulated market and this fact is having great influence on the bottom line and market behavior of many smaller community banks. Regulatory forces that unduly impact industry competitiveness are not good for institutions of any size when they skew market forces; and that is what we are faced with today.

I am deeply concerned that community banks will continue to disappear from our landscape, with local communities and consumers across the country being the ultimate losers. When independent community banks are absorbed by larger non-local competitors, I've seen firsthand what usually results. The absorbed banks lose their personal touch and their communities lose the leadership previously provided by senior bank officers and their directors who are business owners with vested interests in their communities. I will also tell you that I am concerned about the future of community institutions led by the current generation of community bank CEO's approaching retirement. What is the exit plan? Is it to remain independent and to pass the gavel along to a successor, thereby retaining the unique quality of your institution? Or is it to merge with another institution?

The loss of these community human resources not only impacts local banking relationships with small businesses and individuals, it reduces human resources available for leadership of community service organizations on which senior bank officers and their directors serve. There is an unquantified social cost to industry consolidation that is attributable to the weight of accumulated regulatory burden. This is a growing problem in communities across the country, with implications that are largely ignored by policymakers.

Ten years ago, Congress enacted EGRPRA, which required the federal regulators to review all of their regulations in an effort to reduce regulatory burden on the industry. We have taken this mandate seriously and are approaching the conclusion of our effort in the next few months.

When this project began in June of 2003, we began to increase awareness of the burden issues facing both large and small banks. We worked with the other banking agencies to publish more than 125 regulations for comment, and received more than 1,000 comment letters with suggestions for change. We held 16 banker and consumer group outreach sessions around the country, have given numerous speeches, offered Congressional testimony on the subject to both houses of Congress, and, like your staff in Washington, we have met with many Members of Congress to discuss the importance of this issue.

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

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

This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of recommendations before

Congress is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. I believe we have a limited window of opportunity this year to move forward on regulatory relief legislation. There is much greater visibility and recognition of the problem now than in the past. Again, it is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

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

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

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

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

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

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

The features of interest-only and pay option ARMs, as you know, can temporarily protect borrowers from payment increases resulting from rising interest rates. The experience with these instruments has, so far, been favorable. However, these new products share a common, potentially substantial additional risk element — a payment shock when the loan terms are eventually recast. For pay option ARMs, in particular, this shock can be quite dramatic — under reasonable assumptions about interest rates, as much as a 100 percent increase or more in the monthly payment.

Products much like these have long been offered by institutions regulated by OTS, with the agency's interest rate risk model helping guide us and the institutions we regulate to manage the risks inherent in these programs. Savings institutions have offered ARMs for more than thirty years. Some institutions have offered and successfully managed ARMs with negative amortization features for more than twenty years. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks associated with these types of loans.

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

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them to know the characteristics, strengths and weaknesses of the products they offer and to let experience and sound management practices guide them in knowing

their markets and customers, determining appropriate concentration limits, and successfully managing their risks. As a regulator, that is our recommendation as well as our expectation.

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

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

While CRE lending exposure is generally limited in the institutions regulated by OTS, I support the principle of robust risk management and commensurate capital in the presence of higher risk loan concentrations. In the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system. While underwriting standards are generally stronger now than in the past, higher concentrations in CRE loans at some institutions located particularly in high growth regions of the country remain a concern.

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

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

REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO AMERICA'S COMMUNITY BANKERS GOVERNMENT AFFAIRS CONFERENCE
WASHINGTON, DC

MARCH 14, 2006

Good morning. This marks my second formal appearance as Director of the Office of Thrift Supervision (OTS) before America's Community Bankers (ACB). I am pleased to be here today at ACB's Government Affairs Conference to discuss some issues currently pending in Washington that I think are important to everyone in this room.

ACB is a strong and dynamic organization that has carried the voice of America's community bankers to Capitol Hill, the Administration, the federal banking agencies, and to other policymakers both inside and outside the beltway. Most importantly to OTS, ACB has been a solid partner supporting our efforts effectively to supervise and oversee the institutions and holding companies we regulate while also ensuring that we maintain the proper focus and perspective in carrying out our statutory duties and responsibilities. This is a delicate balance that ACB has admirably preserved in its efforts on behalf of America's community bankers.

Diane Casey-Landry and her staff serve you well. Diane is an effective leader and a worthy advocate for America's community bankers. Most recently, Diane, Bob Davis and the ACB staff have taken a prominent and visible role on an issue near and dear to my heart - regulatory burden relief, which I will discuss with you today.

I have also enjoyed my conversations with your Chairman, Weller Meyer. Weller is a man I can identify with—a community banker fed up with the accumulated weight of regulatory burden who is willing to do something about it. There are plenty of people who "talk the talk" in Washington, but Weller is also "walking the walk." At a regulatory burden relief hearing before the Senate Banking Committee two weeks ago, Weller told me that regulatory burden relief is his personal mission and a top legislative priority for ACB and he then testified to that before the Committee. That is the kind of commitment needed to push regulatory burden relief through the Congress, and I applaud Weller for his dedication, enthusiasm and, most importantly, his follow-through.

As many of you know, regulatory burden relief is a subject near and dear to my heart. 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.

Two weeks ago, I testified before the Senate Banking Committee that 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. Investment bankers at recent M&A conferences confirm this fact.

To those who say let market forces determine the future of community banking, my response is that our industry is not a free market. It is a highly regulated market and this fact is having great influence on the bottom line and market behavior of many 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've seen firsthand what usually results. The absorbed banks lose their personal touch and their communities lose the leadership previously provided by senior bank officers and their directors who are business owners with vested interests in their communities. I will also tell you that I am concerned about the future of community institutions led by the current generation of community bank CEO's approaching retirement. What is the exit plan? Is it to remain independent and to pass the gavel along to a successor, thereby retaining the unique quality of your institution? Or is it to merge with, or sell out to, another institution?

The loss of these community human resources not only impacts local banking relationships with small businesses and individuals, it reduces human resources available for leadership of community service organizations on which senior bank officers and their directors serve. There is an unquantified social cost to industry consolidation that is attributable to the weight of accumulated

regulatory burden. This is a growing problem in communities across the country, with implications that are largely ignored by policymakers.

> Ten years ago, Congress enacted EGRPRA, which required the federal regulators to review all of their regulations in an effort to reduce regulatory burden on the industry. We have taken this mandate seriously and are approaching the conclusion of our effort in the next few months. I fear all of this work may be for naught if a regulatory relief bill is not enacted this year. And there has been a lot of work done!

When this project began in June of 2003, we began to increase awareness of the burden issues facing both large and small banks. We worked with the other banking agencies to publish more than 125 regulations for comment, and received more than 1,000 comment letters with suggestions for change. We held 16 banker and consumer group outreach sessions around the country, have given numerous speeches, offered Congressional testimony on the subject to both houses of Congress and, like your staff in Washington, we have met with many Members of Congress to discuss the importance of this issue.

In addition to building awareness in the marketplace and in Congress, we have worked to reduce burden where we can; that is, where we already have the authority to act. Along with the other federal banking agencies, we have increased the small bank threshold under the CRA from $250 million to $1 billion, simplified application and reporting requirements, streamlined examination processes, and made other changes to our regulations and internal procedures to reduce burden. It will probably surprise you to hear that almost every new regulation, process, or procedure today includes a discussion among the FFIEC principals about burden and how to accomplish the objectives while minimizing the regulatory burden on the industry.

Now we must ensure that our recommendations lead to fruition with the passage of a significant bill in the Congress. There are skeptics - even with some people within the industry in Washington, DC who have the greatest ability and influence to get a regulatory relief bill enacted. But the House recently passed H.R. 3505, a comprehensive regulatory relief bill, by an overwhelming vote of 415 to 2. And the Senate Banking Committee is poised to take up a similar bill very soon. Thus, regulatory burden relief is very much in play.

> This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. The list of recommendations before Congress is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. I believe we have a limited window of opportunity this year to move forward on regulatory relief legislation. There is much greater visibility and recognition of the

problem now than in the past. Again, it is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

I will talk more about the importance of regulatory burden relief to the institutions we regulate in a few minutes, but I would like to take a few moments now to share with you some observations about my first six months at OTS.

When I came over to the OTS from the Federal Deposit Insurance Corporation (FDIC) last August, I wasn't sure what to expect. After a little more than six months on the job, I have learned much about OTS and its staff, and I have also learned a lot about you, the industry, and in many cases, the individual institutions, we regulate. I come to you with the impression that OTS and the charter we administer have unique and inherent strengths I have not fully appreciated heretofore.

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

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

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

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

The charter we oversee is deployed in neighborhood community banks all across America. It is also used by leading nationwide lenders, by investment banks offering a full array of financial services, and by global conglomerates involved in a wide array of diverse businesses – to name just a few. These organizations have all come to the savings institution 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.

As you know, the charter has adapted remarkably well to today's financial services marketplace. But there is always room for improvement, particularly to address historical constraints that no longer serve a useful purpose or, more importantly, that frustrate legitimate business activities and operations of the charter as it and the marketplace have evolved. This is what a number of the items on the list of pending regulatory burden proposals are about. And the federal savings institution charter is among the greatest beneficiaries of regulatory relief under the proposals currently being considered by Congress.

But what will happen if nothing happens this year? After all, in the eyes of some, this is only regulatory burden—does it really matter that much? And how important is it in the big scheme of things? Let's talk about this thought for a few minutes—specifically, what happens to OTS-regulated community savings institutions without regulatory relief legislation?

First and most obvious, savings associations will continue to operate under a duplicative set of regulations and oversight with respect to their investment advisor and broker-dealer activities that bank competitors are not subject to. Moreover, this additional layer of regulation and review by the Securities and Exchange Commission (SEC) yields no additional supervisory or consumer benefit since the activities are already subject to supervision by the banking agencies that is more rigorous than that imposed by the SEC.

Failing to enact regulatory relief legislation will also miss an opportunity to update statutory limits on the ability of federal savings associations to make small business and other commercial loans. We are aware of a number of institutions that are currently constrained or bumping up against the statutory 20 percent of assets commercial/small business lending limit, as well as the 10 percent of assets sub-limit on commercial (other than small business) lending imposed on federal savings associations.

Legislation removing the current limit on small business lending and increasing the cap on other commercial lending will provide savings associations 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. But, again, these important benefits require legislation.

Another lost opportunity would be eliminating a statutory anomaly that subjects the consumer lending authority of federal savings associations to a 35 percent of assets limitation, but permits unlimited credit card lending. This exists even though both types of credit may be extended for the same purpose. Removing the 35 percent cap on consumer lending will permit savings associations to engage in secured consumer lending activities to the same extent as unsecured credit card lending. This makes sense for regulatory burden reduction and for reasons of safety and soundness. Absent regulatory relief, savings associations will continue to be able to make all of the same loans that they can currently make, except some savings associations may make loans that are unsecured because of the current statutory anomaly.

An issue that has garnered recent attention is the so-called "federal diversity jurisdiction" amendment. Currently, a federal savings association may sue or be sued in federal court if the claim exceeds $75,000 and the parties are citizens of different states. Whether a case may be transferred to federal court based on the diversity of the parties, i.e., their different state citizenships, hinges on the determination of the citizenship of the federal savings association. Some courts have determined that if a savings association conducts a substantial amount of business in more than one state, it is not a citizen of any state and, therefore, may not sue or be sued in federal court under diversity jurisdiction.

Failing to enact regulatory relief legislation misses the opportunity to implement a uniform rule governing federal jurisdiction when a savings association is involved, thereby reducing confusion and uncertainty. Absent legislation, federal savings associations will not have the same access to the

federal courts as national banks were accorded in the Supreme Court's recent decision holding that a national bank is a citizen of only its home state.

There are a couple of additional popular issues that I want to mention that will remain unresolved for all insured institutions in the absence of regulatory relief legislation. First, all institutions struggle with the existing requirements of the Bank Secrecy Act (BSA). While this issue is at the top of every banker's list – and without a doubt BSA is problematic for larger institutions - the impact of BSA is often most acute for smaller, community-based institutions that do not have the resources and wherewithal to implement the type of cost-effective program required to address the monitoring of activities under the law. This, in turn, imposes greater competitive stresses on community banks relative to their larger competitors.

Absent regulatory relief legislation, a provision such as that proposed in H.R. 3505, the regulatory relief bill passed by the House last week, to provide relief for certain currency transaction reports (CTRs) will fall by the wayside.

Finally, also lost will be an opportunity to provide relief to institutions, as proposed in H.R. 3505, under the annual privacy notice requirements. While some suggest that a number of items such as this are marginal, I believe the contrary is true. In the aggregate, H.R. 3505 and a similar Senate bill provide a tremendous opportunity to reduce the cumulative effect of regulatory burden on all depository institutions, but particularly on community banks and, especially, OTS-regulated institutions. Absent regulatory burden relief, nothing will be gained, and much would be lost.

Before concluding there is one "housekeeping" issue that I want to highlight. I believe my Deputy Director and OTS Chief Operating Officer, Scott Polakoff, may have addressed this yesterday but I think that it is important to raise again. Ironically, this is a problem that is not helped by the prospects of regulatory burden relief legislation, but rather is an issue that may be created by it.

Within the last several months, OTS has been asked to opine on several occasions regarding a proposal to amend the statutory and regulatory requirements applicable to mutual holding companies (MHCs). In particular, a request was made to alter the corporate governance rules for these types of entities in order to permit the minority shareholders of a savings association to override the interests of a controlling, majority MHC shareholder.

The proposal we were asked to review would provide the minority shareholders in a MHC structure greater control over the underlying depository institution than a majority and controlling MHC. In our view, this is inconsistent with U.S. corporate governance standards, and would undermine the interests of the underlying institution's depositors. I believe that any proposal that overrides the controlling interest of a majority MHC shareholder in favor of the institution's minority shareholders is inconsistent with good corporate governance and prevailing U.S. rules related to the rights of minority shareholders vis-à-vis majority shareholders in public companies. More fundamentally, 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. Accordingly, we oppose inclusion of this proposal in any legislation considered by the Congress.

> I am quite aware that a substantial portion of the thrift industry wants to retain the mutual form of ownership. We do not favor one form of ownership over another. Conversion to the stock form of ownership has raised considerable capital for the industry. But it has also heightened our resolve that depositors get fair treatment in the conversion process and that management not be unduly enriched. The mutual form of ownership continues to play an important role in many communities as evidenced by the fact we still have approximately 340 mutual institutions under supervision, as well as approximately 80 OTS-regulated MHC structures in place

In conclusion, I encourage you to take advantage of your time in Washington this week not only to enjoy our beautiful weather, but also to get involved and have your voices heard in the regulatory burden relief effort. I have said many times that my twelve years working for Senator Connie Mack were tremendously enlightening in understanding how important it is for community banks to get involved in the political process. You are the best ones to do this.

Thank you for the opportunity to speak to you, today. Again, I am honored to be here and I look forward to a continued, strong relationship with ACB. I will be happy to answer your questions.

REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION

TO WOMEN IN HOUSING FINANCE
WASHINGTON, DC

MARCH 22, 2006

Good afternoon. This marks my first appearance before Women in Housing Finance, and I am pleased to be here. I understand that your organization has been around since 1979 and not only has a focus on policy and professional development, networking and education, but also has an outstanding record of good works through the WHF Foundation. You have an outstanding model of service and commitment combined with your primary mission as a professional organization focused on housing and financial services issues. I applaud your accomplishments and efforts in all of these areas.

I want to spend a few moments with you today talking about two areas that are on my mind as Director of the Office of Thrift Supervision (OTS) — housing issues and my favorite topic, regulatory burden reduction. But first, let me tell you a little about myself so you can perhaps understand a little better my focus on the issues I will address today.

I came to OTS with significant experience as a regulator, policymaker, and community banker. My five years at the Federal Deposit Insurance Corporation (FDIC), including three and half years as the FDIC Vice Chairman, taught me much about the kinds of things that are important from a supervisory and regulatory perspective. And my 12 years on Capitol Hill working alongside Senator Connie Mack were tremendously beneficial in understanding how Washington works, how policy is developed, and how things get done inside the beltway. It was informative and enlightening to say the least, particularly for someone coming to Washington with a background as a community banker.

I was a community banker for 23 years in Illinois and Florida, including ten years as President and CEO of the National Bank of Sarasota, in Sarasota, Florida. And I continue to identify most closely with that part of my professional experience. It is a frame of reference that I still call upon in making and evaluating policy decisions that affect the institutions we regulate. And it provides a foundation for my professional experiences since coming to Washington.

During my brief tenure at OTS, I have learned much about the agency and its staff, and I have also learned a lot about the industry we regulate. OTS and the charter we administer have unique and inherent strengths, including a specialized role in housing finance and the mortgage markets, as well as a unique supervisory structure that provides for a unified regulator for both the institutions we regulate and their holding companies. However, these multiple disciplines require a uniquely qualified and effective staff.

While OTS operates with a minimum of overhead, we have a skilled staff with tremendous experience in nearly every sector of modern banking. And we are continually striving to improve our staff. This year, we will hire 60 new examiners, bolstering our exam staff by 11.5 percent. We are also boosting training and hiring in certain critical areas, including capital markets, economic analysis, and compliance management.

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

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

While mortgage lending activities account for a significant portion of these numbers, other areas of retail banking are emerging as significant growth areas for the charter. This is a natural progression that we want to encourage for the continued health and vitality of the charter, as well as its diversification. As the retail community banking sector grows, I believe our charter is well positioned to provide a structural and regulatory alternative both to established financial services businesses and to new entrants that are working to grow market share in this area. Well-established and well-recognized powers of branching and preemption ensure savings institutions are able to follow their customer base and the growth of their business from one end of the country to the other — all with minimal regulatory burden. And OTS's seamless supervision at all levels of an organization — at the bank level as well as at savings and loan holding

companies — ensures a comprehensive supervisory regime with minimal regulatory overlap.

The charter has adapted remarkably well to today's financial services marketplace, but what about the core housing mission of the industry? How are savings institutions faring in the mortgage markets? And what about recent concerns with the mortgage markets, including the proliferation of alternative mortgage products, concentrations in commercial real estate lending, concerns with a "housing bubble," and the current interest rate environment under a flat yield curve?

OTS-regulated institutions account for a sizeable portion of aggregate mortgage originations nationwide. Although the industry we regulate is less than one-sixth the size of the commercial banking industry, last year OTS-regulated thrifts accounted for 26 percent of total one-to-four family mortgage originations nationwide. And that does not include taking into account the size of the mortgage banking industry that operates outside the context of a depository institution charter. Thus, more than one quarter of all one-to-four family mortgage loans last year was originated by an industry substantially smaller than the aggregate size of its market competitors.

So what are some of the housing-related issues the industry is facing? Let's start with the proliferation of alternative or non-traditional mortgage lending products. The popularity of two products in particular, "interest-only" and "pay option" adjustable rate mortgages (ARMs) has 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 non-traditional lending products such as interest-only and pay option ARMs.

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. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks, particularly the inherent credit risks, associated with these types of loans.

Do we want to halt the use of these products or impose limits on the amount or usage by particular institutions that have a proven and sustained track record in managing the risks associated with these products? The answer, of course, is no. There is clearly a market for this product in situations where the loan is properly structured, appropriately marketed, well underwritten, safely managed, and the terms are fully disclosed. That said, given the structural complexities and possible payment increases when the loan terms are reset, this product is not appropriate for unsophisticated borrowers or those with weaker credit capacities.

Appropriately structured negative amortization products may offer qualified borrowers who are capable of understanding and managing the possible risks attendant to this product greater financial flexibility than traditional products. While it is not a product that should be offered to all borrowers, I would not want to deprive qualified candidates from a homeownership opportunity by declaring this product off limits. Nor would I want to limit the use of these products by institutions that understand and are managing the risks.

We expect the institutions we regulate to approach innovations in the mortgage market with caution and with thorough due diligence. We expect them to know the characteristics, strengths and weaknesses of the products they offer and to let experience and sound management practices guide them in knowing their markets and customers, determining appropriate concentration limits, and successfully managing their risks. As a regulator, that is our recommendation as well as our expectation.

In December, the federal banking agencies issued guidance on non-traditional mortgage loan products. For anyone interested in commenting on the proposed guidance, the comment period will close one week from today, on March 29th.

Another issue prompting interagency guidance is the concentration in commercial real estate (CRE) lending by some insured institutions. The proposed guidance sets out thresholds for assessing whether an institution has

a CRE concentration requiring heightened risk management practices. It focuses particularly on concentrations in CRE loans that are vulnerable to cyclical commercial real estate markets. Institutions with these types of concentrations are expected to hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. The guidance sets forth concentration ratios based on loan type. While the concept of capital allocation based on concentration ratios is not novel, the proposed guidance establishes new thresholds.

While CRE lending exposure is generally limited in the institutions we regulate, I support the principle of robust risk management and commensurate capital in the presence of higher risk loan concentrations. In the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system. While underwriting standards are generally stronger now than in the past, higher concentrations in CRE loans at some institutions located particularly in high growth regions of the country remain a concern.

Legitimate concerns are being expressed about the proposed guidance. It is, in my view, not cast in concrete, and I encourage interested parties to comment. The comment period has been extended until April 13th.

Next, I want to focus briefly on the current interest rate environment under a flat yield curve. What does this mean for the institutions we regulate? The immediate impact for depository institutions generally is higher funding costs, which can mean a narrowing of the spread between what institutions pay for money and what they lend it out at, also known as their net interest margin. A narrowing of net interest margin will squeeze profits, which is obviously a concern, but I want to focus on a different phenomenon. That is the impact of a flat yield curve on mortgage lending and, specifically, a potential migration from shorter term ARMs to fixed rate mortgage products.

As short term borrowing costs increase for institutions so do the rates that they charge for shorter-term loan products, specifically ARMs. At the same time, longer term fixed rate products do not move up as quickly simply because longer term mortgage rates are not as sensitive to increases in short term funding costs. The effect is a narrowing of rates offered for ARM and fixed rate loans, with more borrowers willing to pay slightly higher interest rates to lock in a fixed rate for the life of a mortgage loan.

What this means for the institutions we regulate is potentially greater interest rate risk associated with increased fixed rate mortgage lending.

However, this is an area where we believe our interest rate risk model will benefit the institutions we regulate by providing information on their interest rate risk sensitivity in their market and within their peer group. We will continue to monitor interest rate risk closely in the months ahead.

Similar to the concerns of a flat yield curve are continuing commentaries about a housing bubble in certain markets across the country. While I believe much of the hype about a housing bubble has subsided with recognition that housing costs have generally stabilized and/or slowed down significantly, this is an area we continue to monitor closely. While a multitude of economic pressures can influence housing costs, it is important to bear in mind that mortgage lenders, particularly many of the institutions we regulate, have significant experience in dealing with a housing slow down. In California, for example, several of our largest lenders were able to weather a significant housing slump in the late 1980s and early 1990s. Sound risk management and aggressive, but prudent lending strategies enabled these institutions to come out of that difficult period stronger and more able to compete in California's unique and volatile mortgage market.

For now, we are continuing to monitor the interest rate risk exposure of our institutions, and we are paying close attention to markets and regions that have experienced inordinate increases in housing costs. And, again, our interest rate risk model is a tool that will assist us in keeping a close eye on any areas of concern.

The final housing issue that I want to discuss with you is actually much more than a housing issue — it is a social issue. It is something that I struggle with and, I fear, we will all have to deal with it for a long time to come. The situation in the Gulf Coast is an ongoing crisis of monumental proportions. I have visited the hurricane-devastated areas of New Orleans three times in the past five months. During my first visit I was unprepared for the devastation I witnessed there, and little has changed in the intervening months. The scene defies description. It is truly unnerving — even for a former resident of Florida familiar with the damage that a hurricane can inflict — to witness block after block, mile after mile of standing empty structures and no signs of human activity.

The challenges facing the displaced hurricane victims are daunting and unprecedented; they strike at the bare essentials of food, clothing and shelter. While there is a high labor demand related in part to recovery efforts, there is little available housing to support the existing workforce. Everyday starting early in the afternoon, traffic backs up for miles on Interstate 10 as commuters head

back to their temporary and for many, perhaps permanent, homes in Baton Rouge, Lafayette, and surrounding communities. For these Katrina commuters a typical one and a half hour drive is now a nightmare marathon of bumper-to-bumper traffic that seems never to end. It is not uncommon for many of these people to spend three hours in traffic every afternoon, and that is for just half of their daily commute back and forth between their new homes and their jobs in New Orleans.

> While most local financial institutions are back on line, they still must deal with many of the issues directly affecting their customers. These challenges are overwhelming. Individuals, businesses and financial institutions are facing issues ranging from uncertainty regarding levee reconstruction standards and timing to poor communications and mail delivery service. More than 100,000 homes require electrical rewiring, and there is a shortage of qualified electricians in the region. Modestly damaged homes are deteriorating rapidly due to mold problems, cleanup and rebuilding costs are escalating, and there are too few qualified contractors and subcontractors. There are also a multitude of unresolved insurance issues, and insurance companies are reluctant to write new policies in the area. And the list goes on and on.

It is one thing to face the huge task of rebuilding a storm-damaged dwelling, it is quite another to face that challenge when there is no public infrastructure in place, no available affordable housing, and no assurance your neighborhood will ever re-emerge.

The short-term prospects for OTS-supervised institutions in the Gulf Coast region seem favorable; however, I am concerned about the long-term effect of the hurricanes. A favorable economic outlook and a recovering job-creation picture are critical to the area's recovery, but there first must be a stable and viable foundation on which businesses and communities can rebuild. Again, affordable housing is at the core of a viable recovery for New Orleans. How these issues are addressed will define the future of New Orleans and the Gulf Coast — and we must continue to find creative ways to assist in the recovery.

My final topic for today is a subject near and dear to my heart. Regulatory burden reduction 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.

Several weeks ago, I testified before the Senate Banking Committee that accumulated regulatory burden is suffocating the banking industry despite the fact the industry seems to be doing so well. While regulatory burden impacts all institutions, I believe it has a significantly greater competitive impact on smaller community-based institutions. There is considerable anecdotal evidence

supporting the notion that regulatory burden has risen to 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 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've seen firsthand what usually results. The absorbed banks lose their personal touch and their communities lose the leadership previously provided by senior bank officers and their directors who are business owners with vested interests in their communities.

The loss of these community human resources not only impacts local banking relationships with small businesses and individuals, it reduces human resources available for leadership of community service organizations on which senior bank officers and their directors serve. There is an unquantified social cost to industry consolidation that is attributable to the weight of accumulated regulatory burden. This is a growing problem in communities across the country, with implications largely ignored by policymakers.

> Ten years ago, Congress enacted EGRPRA, which required the federal regulators to review all of their regulations in an effort to reduce regulatory burden on the industry. We have taken this mandate seriously and are approaching the conclusion of our effort in the next few months. I fear all of this work may be for naught if a regulatory relief bill is not enacted this year. And there has been a lot of work done!

When this project began in June of 2003, we began to increase awareness of the burden issues facing both large and small banks. In addition, we have worked to reduce burden where we can; that is, where we already have the authority to act. And at every opportunity with my colleagues on the FFIEC, I raise the issue of regulatory burden with almost every new regulation, process, or procedure and how to accomplish the objectives while minimizing the regulatory burden on the industry.

The EGRPRA process has generated an extensive list of recommendations before Congress that is sensible, balanced, and will help address the problem of accumulated regulatory burden in this country. Now we must ensure that these recommendations lead to fruition with the passage of a

significant bill in the Congress. There are skeptics. But the House recently passed H.R. 3505, a comprehensive regulatory relief bill, by an overwhelming vote of 415 to 2. And the Senate Banking Committee is poised to take up a similar bill very soon. Thus, regulatory burden relief is very much in play.

> This is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. I believe we have a limited window of opportunity this year to move forward on regulatory relief legislation. There is much greater visibility and recognition of the problem now than in the past. It is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

Thank you for the opportunity to speak to you, today. Again, I am honored to be here and I look forward to visiting with you again some time in the future. I will be happy to answer your questions.

REMARKS OF JOHN M. REICH, DIRECTOR
OFFICE OF THRIFT SUPERVISION
TO THE NEW YORK BANKERS ASSOCIATION
NEW YORK, NY

APRIL 6, 2006

Good morning. It is a pleasure to be here today and I thank you, Michael Smith, for the invitation. In a sense, this marks my second appearance before you as Director of the Office of Thrift Supervision (OTS). This past November 18, I spoke to the Community Bankers Association of New York State (CBANYS). As I recall, immediately prior to my speech, it was announced that CBANYS was merging with the New York Bankers Association. Given the clear impact that the announcement had on everybody in the room that morning, I considered whether I should simply give the same speech again today. But, for those who were able to pay attention the first time, I will spare you a repeat of my words that day. Instead, I will concentrate on a different topic for the majority of my remarks today — credit quality.

In addition to credit quality, I want to touch on two issues very much entwined in that topic — recent proposed guidance issued by the Federal Banking Agencies (FBAs) covering two areas, nontraditional mortgage lending products and commercial real estate lending. And I will also highlight a topic that has not received much domestic attention to date, but that has become a very significant and internationally recognized part of our operations — OTS's Complex and International Organizations program. Finally, I will briefly conclude with some observations on Basel II, and my favorite topic — regulatory burden relief.

During the last several years, the banking industry has demonstrated remarkable success and adaptability to relatively fluid economic conditions. I believe one of the mainstays to the success of our banking system is our supervisory structure. The United States bank regulatory system is considered to be among the most comprehensive and admired in the world. Our supervisory system is grounded in a regular program of on-site examinations complemented by comprehensive and frequent reporting and off-site monitoring — a level of supervisory review that, in the aggregate, provides tremendous insights into industry developments and trends, and that assists us in our overall supervisory strategy going forward.

The trends we review include both lagging and leading indicators of what we are seeing in the industry. Lagging indicators tell us where the industry has been, and include things such as loan classifications and past due ratios. Leading indicators suggest where the industry may be heading, and include factors such as loan documentation, loan pricing, and underwriting standards. To some analysts, it may appear that the banking industry has never been healthier and, to a certain extent, a good case can be made to support this notion. The industry continues to grow and has experienced record profitability the last several years. Loan originations have been high, but are stabilizing, and, despite somewhat thinning margins, loan classifications and past-due ratios are at all time lows. And industry capital has never been better. So why raise the issue now?

As every good banker knows, now is precisely the time to pay attention. My 23 years as a community banker, plus nearly a dozen years on Capitol Hill, supplemented by more than five years as a bank regulator, have taught me to pay particularly close attention to leading indicators of change. While lagging indicators provide a good snapshot of where we are now based on what we know from the immediate past, leading indicators help us to identify what is on the horizon based on information that is generally predictive of longer term trends. Leading indicators enliven the lagging indicators snapshot and sometimes produce a very different picture — and the perspective of experience helps us to see that picture for what it really is, not for what it appears to be at the moment.

What are the leading indicators that concern us? First, let us take a look at the obvious issues. Despite record profitability, we are beginning to see declining profits in a number of institutions, particularly at smaller community-based institutions. This results from declining margins due, in part, to a recent decline in mortgage originations, particularly in certain market areas. 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 the responses we are seeing to this phenomenon.

For example, in an effort to continue feeding their current loan volume, some institutions are purchasing loan participations. The concern that I have, however, is that some of these purchases are occurring despite the fact that the packages lack complete documentation. Moreover, I am told that some sellers are telling buyers that if they insist on complete documentation then other buyers will take their place. This practice is unacceptable and will be scrutinized by our examiners. We expect any banker who purchases a loan participation to analyze it as if the bank originated the credit. 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, I am concerned that there has been an overall slippage in underwriting due to increased competition in certain markets segments and areas. Specifically, my 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 an 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.

A final, but very important concern is greater reliance on wholesale funding by a number of institutions. Excessive dependence on wholesale funding creates greater risks. The combination of greater dependence on a more volatile funding stream coupled with greater risk exposure in the underwriting and pricing of loan products will likely squeeze some institutions, if it has not done so already. And yield curve pressures continue to cause institutions to increase their risk profile and/or leverage their capital to maintain and/or increase their return on equity (ROE).

All of these factors give us good reason for concern. How are we responding? We are increasing our vigilance, both from a supervisory perspective and a policy perspective. On the supervisory side, we our asking our examiners to dig deeper into loan portfolios to understand the risks individual institutions are assuming. We are paying close attention to the fundamentals, including loan documentation, pricing, loan-to-value ratios, and overall underwriting standards.

We are also closely monitoring how institutions are funding their ongoing operations, particularly their mortgage originations. And we continue to monitor overall operational costs, again, with close attention paid to costs attributable to prior build-ups in mortgage lending operations. In addition to our ongoing monitoring of interest rate risk, we are looking at credit risks, particularly with respect to nontraditional mortgage lending products.

From a policy perspective, one of the risks we are closely monitoring involves the proliferation of alternative or nontraditional mortgage lending products. The popularity of two products in particular, "interest-only" and "pay option" adjustable rate mortgages (ARMs) has 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. The 'news' here is that these products are now being offered in some markets across the country by institutions with limited experience in managing the risks, particularly the inherent credit risks associated with these types of loans. And pricing is a particular concern.

Do we want to halt the use of these products or impose limits on the amount or usage by particular institutions that have a proven and sustained track record in managing the risks associated with these products? No. There is clearly a market for this product in situations where the loan is properly structured, appropriately marketed, well underwritten, safely managed, and the terms are fully disclosed. That said, given the structural complexities and possible payment increases when the loan terms are reset, this product is not appropriate for unsophisticated borrowers or those with weaker credit capacities.

Appropriately structured negative amortization products may offer qualified borrowers who are capable of understanding and managing the possible risks attendant to this product greater financial flexibility than traditional products. While it is not a product that should be offered to all borrowers, I would not want to deprive qualified candidates from a homeownership opportunity by declaring this product off limits. Nor would I want to limit the use of these products by institutions that understand and are managing the risks.

In December, the FBAs issued proposed guidance on nontraditional mortgage loan products. The comment period on the proposed guidance closed last week. Among the comments we received, one experienced mortgage lender suggests significant regulatory attention should be directed at the practice of deep payment discounts, or promotional loan rates that get a borrower in the door. As that commenter noted, offering deep payment discounts to borrowers who do not otherwise qualify at the fully indexed rate is not only risky to the institution, but wrong for the borrower. At the same time, that commenter took exception to the notion that only a certain strata of borrowers are appropriate for nontraditional mortgage product offerings. We will work with the other FBAs over the next several months to review these and the other comments received on the proposed guidance to make certain that we get this right.

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 expect them to know the characteristics, strengths and weaknesses of the products they offer and to let experience and sound management practices guide them in knowing their markets and customers, determining appropriate concentration limits, and successfully managing their risks. As a regulator, that is our recommendation as well as our expectation.

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

I support the principle of robust risk management and commensurate capital in the presence of higher risk loan concentrations. In the past, weak CRE loan underwriting and depressed CRE markets have contributed to

significant bank failures and instability in the banking system. While underwriting standards are generally stronger now than in the past, higher concentrations in CRE loans at some institutions located particularly in high growth regions of the country remain a concern.

Legitimate concerns are being expressed about the proposed guidance. It is, in my view, not cast in concrete, and I encourage interested parties to comment. The comment period has been extended until April 13th.

The other major topic I want to address today is OTS's Complex and International Organizations (CIO) program.

As you know, OTS has a well-established program for discharging its statutory responsibilities with respect to thrift holding companies. OTS's holding company examination program is designed to understand the structure of the parent and identify the effect, if any, that the holding company enterprise has on the subsidiary savings institutions.

The holding companies we regulate range from non-complex shell companies to 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.

Conglomerate supervision poses unique challenges for supervisors, and OTS has specialized procedures for this subset of our holding company population. These procedures are designed to assess the conglomerate on a consolidated basis and perform full-time, continuous reviews of the capital structure, corporate governance, and risk management functions — as well as other areas where there is a concentration of risk. We also review the work of other functional supervisors, both foreign and domestic, in order to identify trends and avoid duplicative and overlapping supervision.

Supervising these firms requires multi-industry and international expertise. It requires extensive interaction with foreign and domestic supervisors heightening the need for OTS to maintain consistency in its policies and communications. Our examiners must understand the governance and risk management practices of large and complex enterprises, as well as the economic and regulatory environment for many diverse lines of business. They must also be able to make sound judgments and conduct supervisory conversations with high-level company executives and supervisors around the world.

Our conglomerate supervisory structure is designed to guide our examiners and their efforts. Our supervisory procedures are intended to keep us focused on the activities, functions, and processes most critical to each conglomerate's consolidated operations and ongoing viability. We start with an understanding of a conglomerate's organizational structure, its capital underpinnings, and how it manages the various businesses under the corporate umbrella. We then develop customized supervisory plans for each conglomerate and these plans guide the examiners in their work. We augment the information we receive through regular holding company reporting with information from the marketplace, from the companies' own internal risk management and internal audit process, and from regular specialized reports we receive from conglomerates on risk concentrations and intra-group transactions. This information is used continually to adjust and refine our supervisory strategy and our onsite examination work stream. And we typically meet on a regular basis with other interested supervisors in the United States and around the world who have an interest in our consolidated view of a given conglomerate's operations.

This cross-sector consolidated supervision discipline is relatively new. And supervisors around the world who face the challenge of understanding and supervising these complex companies are still refining it. We are also fine-tuning our own approach to discharging our responsibilities with respect to financial conglomerates, but are pleased with the progress we have made in this area over the past two years and look forward to more success.

I would like to move briefly now to the recent release of the Basel II notice of proposed rulemaking (NPR) by the Federal Reserve Board (FRB). Given the attention prior to its release, I think it is good that the NPR is out. This is the work product of the four FBAs. OTS and the OCC, as part of the Treasury Department, have submitted the draft NPR to the Office of Management and Budget (OMB) for its review. OMB clearance is required before the NPR can be published in the Federal Register. At that time, there will be a 120-day comment period. In effect, the FRB's release of the NPR provides extra time for review of the proposal, which, given the breadth and complexity of the document, can only help the process.

I want to reiterate what I have said about Basel II since joining OTS, namely that nothing in this initiative is etched in stone. It is a proposal, culminating a number of years of hard work and research. While I have testified before Congress in support of Basel II generally, I am cautious about whether we are doing this optimally. I do 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 into the structured phase-in implementation period. Basel II warrants close scrutiny by all interested parties. My hope is that the notice and comment process will further improve Basel II where needed.

Finally, I want to briefly mention regulatory burden relief. As some of you know, this is a subject near and dear to my heart. 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.

A little over a month ago, I testified before the Senate Banking Committee that 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.

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. The loss of these community human resources not only impacts local banking relationships with small businesses and individuals, it reduces human resources available for leadership of community service organizations on which senior bank officers and their directors serve. There is an unquantified social cost to industry consolidation that is attributable to the weight of accumulated regulatory burden. This is a growing problem in communities across the country, with implications that are largely ignored by policymakers.

I believe this is the best opportunity in years to enact meaningful, balanced, regulatory burden reduction legislation. I also believe we have a limited window of opportunity this year to move forward on regulatory relief legislation before Congressional elections this fall and the currently

planned October adjournment. There exists today a much greater visibility and recognition of the problem than ever in the past. It is my hope that you will work with your representatives in Congress to respond positively with a solution to this significant problem before too many more of our community banks disappear from the landscape.

Thank you again for the opportunity to speak to you, today. The "new" New York Bankers Association is an outstanding organization and I look forward to continuing an excellent working relationship with you.