



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

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

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

Strong Regulator for a Strong Charter

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

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

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

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

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

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

Development of an Efficient Risk-Based Examination Process

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

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

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

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

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

Mortgage Lending Focus

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

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

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

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

Charter Choice

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

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

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

Holding Companies

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

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

Challenges of Industry Consolidation

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

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

Credit Union Conversions

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

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

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

Federal Housing Finance Board Proposal on Retained Earnings

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

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

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

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

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

Recommendations for the Future

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

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

Hurricanes Katrina and Rita

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

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

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

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

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

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

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

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

Conclusion

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

Thank you.