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Statement of

John M. Reich

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Director, Office of Thrift Supervision

concerning

**The Condition of the Thrift Industry, Part II**

before the

Committee on Banking, Housing and Urban Affairs  
United States Senate

June 5, 2008

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Department of the Treasury

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**STATEMENT OF JOHN M. REICH  
DIRECTOR, OFFICE OF THRIFT SUPERVISION  
ON THE CONDITION OF THE THRIFT INDUSTRY, PART II  
BEFORE THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE**

**June 5, 2008**

**I. Introduction**

Good morning, Chairman Dodd, Senator Shelby and members of the Committee. Thank you for the invitation to return today to provide you with an update on the financial condition and performance of the thrift industry.

Thrift institutions continue to face significant challenges from the downturn in the housing sector and general economic weakness, but their capital remains solid and the managers of our institutions are continuing to prepare for potential charge-offs by adding significantly to loan loss provisions. Thrifts' capital and loan loss provisions keep them well-positioned to withstand further pressures. The overall safety and soundness of the industry is perhaps best illuminated by noting that there were only a dozen problem thrifts in the first quarter of this year, compared with more than 200 during the height of the thrift crisis in the early 1990s. Although the number of problem thrifts will probably increase slightly in coming months and a handful of failures could occur, we expect these seriously troubled institutions to remain few in number and small in asset size.

This testimony will provide an update on conditions in the markets and broader economy, review the performance of the thrift industry in the first quarter of 2008 and disclose some of the supervisory concerns that are surfacing from our examinations. Then, I will respond to several questions that the Chairman posed when I appeared before this Committee in March and describe initiatives by OTS to prevent foreclosures and protect consumers.

**II. Conditions in the Housing Market and Broader Economy**

The U.S. economy grew at a 0.9 percent pace in the first three months of 2008, due in part to a 25.5 percent contraction in residential investment and slower growth in consumer spending.<sup>1</sup> The first quarter of 2008 marked the second consecutive quarter of GDP growth below 1.0 percent as the protracted slowdown in the housing market caused overall economic output to remain sluggish. Consumer spending grew at a 1.0 percent

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<sup>1</sup> Bureau of Economic Analysis



pace during the period, a significant drop from a 3.0 percent rate a year ago. Declines in job growth and consumer confidence, coupled with sharp increases in prices for food and energy, dampened overall consumption, which comprises two-thirds of growth in this country.<sup>2</sup> Positive trends include an increase in net exports and inventory investment, both of which added to economic output, although not enough to offset the deceleration in spending by consumers and businesses.

As housing stock rose to a 10-month supply, loan data continue to show an increase in mortgage loan delinquencies, but at a slower pace. In the first two months of this year, late payments by subprime and alt-A borrowers rose at 20-plus percent and 12-plus percent, respectively, driven primarily by ARM loans. Option ARM delinquencies have soared since 2007, rising from less than 1 percent in February of 2007 to 3.42 percent in February 2008.<sup>3</sup> Home prices have fallen in response to the contraction in sales and rise in delinquencies and foreclosures. The most severe home price declines occurred in areas where investor activity was prevalent, such as Las Vegas, Phoenix and Miami.<sup>4</sup> The once-rapid rise in home prices in Los Angeles, San Francisco and Washington, D.C., followed by a lack of affordable housing and a decline in demand, pushed home prices lower, while weak economic conditions drove prices down in Cleveland and Detroit.<sup>5</sup> In summary, the elevated supply of housing inventory—the highest since 1991—indicates that home prices may continue to trend lower in coming months.

### **III. Thrift Industry Performance in the First Quarter of 2008**

#### **Summary**

First quarter results for the nation's thrift industry improved from the results of the fourth quarter of 2007, but remained weak as the thrift industry set aside a record level of provisions for anticipated loan losses. The continued housing market distress resulted in declines in earnings during the quarter, and a decline in asset quality measures.

During the quarter, thrifts set aside a record \$7.6 billion in loan loss provisions, or 2.01 percent of average assets. That was up from 1.44 percent (\$5.5 billion) in the previous quarter and 0.33 percent (\$1.2 billion) in the first quarter one year ago.

Capital measures for the industry continue to be strong, stable and well in excess of minimum requirements. The industry's equity capital ratio was 9.05 percent in the first quarter, down from 9.26 percent in the prior quarter and 10.70 percent in the first quarter one year ago.

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<sup>2</sup> Ibid.

<sup>3</sup> LoanPerformance February 2008.

<sup>4</sup> S&P/Case-Shiller Home Price Index, February 2008.

<sup>5</sup> Ibid.



Total mortgage origination volume in the first quarter was down 20 percent from the fourth quarter and 21 percent from the first quarter a year ago because of declines in refinancings and sales of new and existing homes. Delinquencies for most types of loans increased over the past year and continued to rise in the first quarter. The largest increases in delinquency rates were in 1-4 family mortgages and construction loans, reflecting the weakness in the housing sector.

OTS supervised 831 thrift institutions with assets of \$1.52 trillion at the end of the first quarter. That's about 12 percent of the total assets of all commercial banks and savings institutions nationwide. In addition, OTS supervised 479 holding company enterprises with approximately \$8.4 trillion in U.S. domiciled consolidated assets. These enterprises owned 445 thrifts with total assets of \$1.32 trillion, or 87 percent of total thrift industry assets.

### **Earnings and Profitability**

Net losses in the first quarter of 2008 were \$617 million, an improvement from net losses of \$8.75 billion in the fourth quarter of 2007, but down from net income of \$3.61 billion in the first quarter one year ago. The fourth quarter was the first quarterly loss reported by the thrift industry since a special assessment was collected in the third quarter of 1996 for the Savings Association Insurance Fund.

Profitability, as measured by return on average assets (ROA), was a negative 0.16 percent in the first quarter, an improvement from a negative 2.31 percent in the fourth quarter, but down from 0.97 percent in the comparable quarter a year ago. The median ROA increased to 0.43 percent in the first quarter from 0.39 percent in the prior quarter, but was down from 0.51 percent in the first quarter a year ago.

Return on average equity was a negative 1.80 percent in the first quarter, up from a negative 23.48 percent in the fourth quarter, but down from 9.35 percent in the first quarter a year ago.

### **Analysis of ROA**

Higher loan loss provisions (2.01 percent of average assets) drove the losses in the first quarter, reflecting the increase in noncurrent loans stemming from the slower housing market and the deterioration of loans originated in the past several years. Loan loss provisions averaged 0.26 percent of average assets between 2001 and 2003, and generally trended lower from the beginning of 2003 through the first half of 2006, reflecting historically low levels of problem assets.

Net interest margin increased to 276 basis points (or 2.76 percent of average assets) from 261 basis points in the fourth quarter, and approximates the 277 basis points in the comparable quarter a year ago.



Total fee income, including mortgage loan servicing fee income and other fee income, was unchanged in the first quarter from the comparable quarter a year ago at 1.11 percent of average assets, but was down from 1.15 percent in the fourth quarter.

Other noninterest income was 0.60 percent of average assets in the first quarter, up from a negative 0.51 percent in the fourth quarter and from 0.39 percent in the first quarter a year ago. Other noninterest income is typically volatile because it includes realized gains or losses on assets held for sale and the results of balance sheet restructuring activities.

Noninterest expense increased to 2.77 percent of average assets in the first quarter from 2.46 percent in the first quarter a year ago, but was down from 4.59 percent in the fourth quarter. Noninterest expense in the fourth quarter of 2007 was higher due to write-downs of goodwill by several large thrifts. General and administrative expense, the largest component of noninterest expense, increased 26 basis points to 2.66 percent of average assets in the first quarter from 2.40 percent in the comparable quarter a year ago.

### **Mortgage Originations**

Total thrift industry mortgage originations (which include multifamily and nonresidential mortgages) were \$133.7 billion in the first quarter, down 21 percent from \$169.2 billion in the first quarter a year ago and down 20 percent from \$166.6 billion in the prior quarter.

An estimated 10 percent of thrift originations were ARMs in the first quarter, down from 12 percent in the comparable quarter a year ago, but up from nine percent in the previous quarter. The ARM share for all lenders was estimated at eight percent in the first quarter, eight percent in the prior quarter and 11 percent in the first quarter one year ago.<sup>6</sup>

The volume of mortgage refinancing, as a percentage of total originations, remained strong in the first quarter as borrowers converted adjustable-rate mortgages to fixed-rate mortgages. Refinancing activity accounted for 50 percent of thrift originations in the first quarter, up from 48 percent in the previous quarter, but down from 52 percent in the first quarter a year ago.

### **Asset Quality**

Troubled assets, which consist of noncurrent loans and repossessed assets, were up 40 basis points from the prior quarter at 2.06 percent of assets, and were up from 0.80 percent one year ago. Repossessed assets were up seven basis points from the prior quarter at 0.27 percent of assets, and were up from 0.10 percent one year ago.

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<sup>6</sup> Data are from the Federal Housing Finance Board's monthly *Mortgage Interest Rate Survey*.



Noncurrent loan rates (loans more than 89 days past due or in nonaccrual status) increased by 32 basis points from the prior quarter to 1.78 percent of assets at the end of the first quarter, and were up from 0.70 percent one year ago. Noncurrent 1-4 family loans were 2.85 percent of all such loans, up 182 basis points from one year ago and 50 basis points from the prior quarter. Noncurrent multifamily loans increased to 0.50 percent of all such loans from 0.25 percent one year ago. Noncurrent consumer loans increased from 0.82 percent of all such loans one year ago to 1.11 percent at the end of the first quarter. Noncurrent nonresidential mortgages increased to 0.81 percent of all such mortgages from 0.65 percent one year ago. Noncurrent construction and land loans were 6.00 percent of all such loans at the end of the first quarter, up from 1.23 percent one year ago. Noncurrent commercial loans increased to 1.14 percent of all such loans at the end of the first quarter from 0.97 percent a year ago.

Loans past due by 30 to 89 days were higher over the year. Total loans past due by 30 to 89 days at the end of the first quarter were \$20.2 billion (1.33 percent of assets), compared with \$12.1 billion (0.81 percent of assets) one year ago, but were down from \$20.6 billion (1.37 percent of assets) in the prior quarter.

#### **Assets, Liabilities and Capital**

Industry assets increased by two percent over the year to \$1.52 trillion from \$1.49 trillion. Thrifts remain focused on residential mortgage lending, with 49.4 percent of assets invested in 1-4 family mortgage loans at the end of the first quarter, down from 51.8 percent one year ago. Of these 1-4 family mortgage loans, 7.8 percent are home equity lines of credit, up from 6.2 percent one year ago. Holdings of consumer loans decreased to 5.6 percent of assets from 5.9 percent a year ago, and multifamily mortgages decreased over the year from 4.3 percent of assets to 4.2 percent at the end of the first quarter. Commercial loans increased to 4.0 percent of assets at the end of the first quarter from 3.5 percent one year ago.

Deposits and escrows fell by four percent over the year to \$913 billion from \$953 billion. As a percentage of total assets, deposits and escrows decreased to 60.3 percent from 64.0 percent one year ago. Federal Home Loan Bank advances were up from 14.2 percent one year ago to 20.4 percent of total assets.

At the end of the first quarter, 98 percent of the industry exceeded well-capitalized standards and only three thrifts were less than adequately capitalized.

#### **Problem Thrifts**

The number of problem thrifts—those with composite examination ratings of 4 or 5—was 12 at the end of the first quarter, up from six thrifts one year ago and 11 at the end of the fourth quarter of 2007. As of June 1 of this year, the number of problem thrifts was 17.



## **Structural Changes**

During the first quarter, three “de novo” institutions and three state-chartered institutions came into OTS regulation. In addition, six state-chartered savings banks were brought into OTS supervision as a result of an acquisition by an OTS-regulated institution. Two thrifts converted to state savings bank charters during the quarter. Also, two OTS-regulated thrifts merged with other OTS-regulated thrifts during the quarter and non-OTS-regulated institutions acquired two thrifts. There was one voluntary dissolution during the quarter.

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## **IV. Supervisory Concerns**

The thrift industry is facing challenging times. In many parts of the country, we are seeing reductions in home prices and real estate values, and increases in inventories of unsold homes, delinquencies, non-performing assets and real estate owned by the institution because the borrower was unable to repay the loan. These factors all contribute to declining performance measures for a number of thrift institutions.

Demand for housing continues to decline and this may continue in the coming months. Thrifts with business lines of mortgage banking (i.e., originate to sell) or jumbo loan products have been negatively affected more significantly and many of them have adjusted their entire business models to accommodate the current economic environment. Even thrifts that were able to change quickly are affected by reduced profits from alternative lines of business. As a result, earnings have been adversely affected for many of these companies and they continue to experience credit quality problems.

Assessing credit quality is always an integral part of an OTS examination. As credit risks increase, significant additions are required to loan loss provisions and these additional provisions reduce earnings with a potential future impact on capital for some institutions. Delinquencies are increasing significantly among thrift lenders with option ARM loans, even before payment resets. This is especially true in markets where values have declined significantly, such as California and Florida.

Although construction and land portfolios represent only 3.5 percent of the thrift industry’s total assets, institutions engaged in this type of lending are also feeling market pressures. The over-building that has occurred in certain markets has caused many developers to abandon projects or file for bankruptcy protection, resulting in significant increases in delinquencies, extended periods of time for sales and further reductions in earnings.

Liquidity is a critical component in the current economic environment and remains a key supervisory concern. Several of our institutions have experienced liquidity pressures in their daily operations in the current market conditions. The deposit structure or perhaps a deposit outflow due to market events has resulted in a weak liquidity



position at some institutions. We are also assessing capital needs and requiring institutions to maintain their capital levels, or raise capital, when necessary.

Overall downgrades of composite examination ratings reflect our supervisory concerns about the thrift industry. From May 2007 to May 2008, we downgraded the overall composite ratings of 78 institutions. As of June 1, 2008, there were 17 institutions that had ratings of "4" or "5". Although our experience shows that many of these institutions will work their way back to financial health, there is a likely possibility that a few institutions may fail in the next few quarters.

## **V. Underwriting Standards**

During Part I of this Committee hearing March 4 on the Condition of the Industry, Chairman Dodd asked questions about the oversight of underwriting standards, the assumptions underlying Basel II, and the changes expected in supervision of bank risk management.

Regarding underwriting standards, there were clearly relaxations in loan underwriting that contributed to the significant challenges we are facing today in the financial markets. Part of the problem was a lack of transparency for borrowers about the terms and conditions of their mortgages. Borrowers must receive an honest, simple and clear explanation of the terms and conditions of their mortgage contracts. In some cases, there was also inadequate assessment of the borrowers' ability to repay their mortgages. Relying on stated income, basing a borrower's ability to repay on a starter or teaser rate, assuming never-ending home price appreciation, or assuming that all risk was being transferred to the secondary market were flawed approaches.

Borrowers were also offered mortgage products that may not have been appropriate. For example, "interest only" and "pay-option ARM" loans are perfectly acceptable for some borrowers, but they are certainly not for everyone. When they were used primarily as affordability tools and people ended up in homes they could not otherwise afford, rather than as financial management tools as originally intended, the results were disastrous for borrowers and lenders alike.

The OTS, along with the other federal banking agencies, issued guidance that specifically addresses the underwriting standards used by the financial institutions we supervise. Specifically, in 2006, the agencies issued the Interagency Guidance on Nontraditional Mortgage Product Risks to all insured financial depositories. In that guidance, the federal regulators reiterated the long-standing underwriting policy that underscored the importance of making sure the borrower has the ability to repay the loan. All regulated lenders are expected to follow this guidance and our examination teams review institutions' portfolios to determine whether they are implementing the guidance as expected. The federal guidance was also a model for state action. By mid-February of this year, 44 states and the District of Columbia had adopted the guidance.





The interagency Statement on Subprime Mortgage Lending, which described standards for banks and thrifts to follow to ensure that borrowers obtain loans they can afford to repay, was also embraced at the state level. By the middle of last month, 38 states and D.C. had adopted it.

However, such guidance and the accompanying oversight of federal examiners do not extend to all corners of the home mortgage sector. Perhaps the most important lesson from today's housing crisis is that all mortgage originators should be subject to the same rules and regulatory scrutiny. Mortgage brokers and mortgage companies are largely regulated at the state level and are generally subject to less, and certainly more inconsistent, regulation than banks and thrifts.

In short, a level playing field does not exist and, in this environment, even well-regulated banks and thrifts felt pressure to compete with the products offered by their less regulated mortgage competitors.

Looking ahead, we should establish a level playing field with the same supervision and rules for all players, so the standards of the under-regulated segments of the market are raised to the level followed by the federally regulated segments. All entities that originate home loans should be required to comply with basic credit principles, such as a reasonable assessment of each borrower's ability to repay.

At the OTS, we have begun to study the best ways to implement a new regulatory system that would provide us the authority to supervise mortgage companies currently subject to a less stringent regulatory and supervisory framework than the one that applies to insured depository institutions. We plan to complete our regulatory proposal later this year, drawing on the expertise developed over the years in regulating and supervising entities that are primarily mortgage lenders. Several essential elements of the proposal, however, are already clear.

Regulation of mortgage originators or brokers should contain three ingredients:

- Barriers to entry – Mortgage originators should be registered and licensed on a nationwide basis. This approach would prevent originators from avoiding scrutiny by moving from state to state. Although states would retain the role of licensing mortgage brokers, the OTS would work with state regulators to ensure adequate licensing and supervision of brokers. There should also be requirements for annual continuing education and biannual mandatory training. This approach would establish minimum standards by which brokers would abide, help to maintain these standards in the industry and keep them updated over time.
- Financial investment – Mortgage originators should not only have an initial and ongoing licensing requirement, but also a financial obligation that would



ensure a level of stability and commitment. Such a requirement could include a minimum net worth, or the ability to obtain a bond.

- Changes to compensation incentives – Because mortgage originators have been paid “up front,” when they make loans, they have had an incentive to make as many mortgage loans as possible without considering whether the loans would default. We believe that compensation should be tied to the long-term viability of the loans originated. Paying compensation over a longer period and making the payout contingent on continued loan performance would protect borrowers’ economic best interests. The typical compensation structure for life insurance agents provides a good model.

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Regarding regulation of mortgage companies, we believe the best solution is to establish a partnership between the states and a federal regulator to set and enforce minimum mortgage funding standards. This partnership would ensure accountability, consistency and transparency throughout the mortgage lending process. The change would not involve establishing a federal mortgage banking charter, but rather institute federal-state cooperation to regulate these entities consistently and ensure nationwide uniformity.

The OTS and the individual states have followed this model successfully in supervising many state-chartered savings associations through joint or alternating examinations. The OTS would work with state regulatory groups to develop these partnerships.

Selecting a strong regulator to monitor this new level playing field is critical for protecting consumers and avoiding another mortgage market meltdown. The OTS has the most extensive expertise of any regulatory agency in the oversight and supervision of mortgage banking operations and we believe the OTS is in the best position to assume federal authority to regulate the currently under-regulated players in mortgage banking.

## **VI. Basel II**

Regarding the Chairman’s question in March about the possible need to rethink the assumptions underlying Basel II before its implementation, the OTS believes that the phased implementation of Basel II affords ample opportunity to assess the impact and effectiveness of the capital standards and to make any adjustments deemed necessary.

The federal banking agencies built critical safeguards into the process and we believe those safeguards are adequate. Only in the U.S. did we include a four-year implementation period: a first year parallel run, followed by three years with capital floors. At each step, a bank can only move forward with supervisory approval.

Each of the agencies has committed to make necessary framework changes along the way to maintain capital levels commensurate with risk—as risk changes—as part of a safe and sound banking system. Although Basel II was developed during a vibrant



economic period, the agencies have been adamant about making changes, as needed, to incorporate a stress period. Today banks are still building the framework for estimating potential loss. We expect the recent experience with significant stress will yield even more rigorous loss estimates as we move through the years of implementation. Finally, the agencies have also committed to undertake a study of the advanced approach after we obtain sufficient data from the parallel run. That study will provide further information to review in considering refinements.

In sum, long before the new capital framework is adopted and fully operational for any bank, the agencies will be able to assess the current crisis and make necessary refinements to the Basel II capital standards to ensure the continuation of a safe and sound U.S. banking system.

## **VII. Bank Risk Management**

The Chairman also asked in March about future changes in the OTS's supervision of bank risk management practices. In many cases, it is clear that bank risk management practices were not sufficiently robust to forecast the current crisis and accurately assess the scope of its impact. Bank management is largely about managing risks, so learning lessons from these recent experiences, doing a better job of identifying and measuring risks, and thereby preventing a recurrence are essential to the safety and soundness of the financial system.

Managers who have operated in prolonged periods of economic strength tend to underestimate the severity of emerging problems until they become fully evident. As regulators, we need to point out potential problems on the horizon, even when good times make that potential seem remote.

Now that serious risks are apparent, our job as regulators is to accurately assess risk profiles and, when appropriate, pursue either formal or informal enforcement action. In recent months, we have stressed specific areas where managers of thrift institutions should be focusing in assessing the risks that their institutions face in the current economic climate. Our West Region has written to thrift CEOs outlining the supervisory expectations of the OTS and similar letters are being sent to OTS-regulated institutions nationwide. (A copy of this letter is attached for reference.) As the letter reminds thrift executives, "Effective risk management of the loan portfolio and the credit function is fundamental to an institution's safety and soundness." We intend to emphasize these subjects during the town hall meetings with thrift CEOs that top OTS officials regularly hold.

We expect thrift institutions to have the appropriate processes and systems in place to identify emerging risks and to manage and service any increase in the level of problem assets. In light of the housing and economic environment, institutions should ensure the proper level of attention to business planning, risk analysis and monitoring,



account management, and problem asset management. In the letter, we provide details on how thrift executives should focus their attention on each of these areas.

### **VIII. Foreclosure Prevention**

The OTS has played an active role in the public policy debate in recent months on ways to prevent American families from losing their homes to foreclosure. The OTS effort has focused on avoiding foreclosure and its harmful impact on local communities, while ensuring that no government bailout would take place, that real estate speculators would not be rewarded and that borrowers who are able to pay their mortgages would not receive an incentive to stop doing so.

A team of OTS policy leaders held a series of meetings during the early part of this year to discuss the issue and explore possible solutions. The discussion eventually narrowed in focus to owner-occupied homes where it was reasonably foreseeable that the borrower would default, and the value of the property was less than the outstanding mortgage.

The OTS unveiled its Foreclosure Prevention Proposal on February 20 of this year. The proposed solution was a market-driven approach calling for refinancing the underwater mortgage into a new loan insured by the Federal Housing Administration based on a percentage of the current fair market value of the property, such as 90 percent. The proceeds from the new loan would provide a partial payoff of the outstanding balance of the original mortgage loan. The holder of the original loan would receive a "negative equity interest" equal to the difference between the partial payoff and the balance of the original mortgage loan, typically held by a securitization pool. Alternatively, the negative equity interest would be shared among the original loan holder, the FHA, and/or the homeowner, as needed to best align incentives.

The OTS proposal became an important part of the national dialogue on foreclosure prevention and some of its key elements are contained in the legislation now proceeding through Congress.

The OTS, in conjunction with the other federal regulators, has also taken a number of actions to encourage the industry to work with borrowers having trouble making their mortgage payments. On April 17, 2007, we issued the Statement on Working with Mortgage Borrowers, encouraging financial institutions to work constructively with homeowners facing difficulty making their mortgage payments when their adjustable rate payments reset.

Another notable initiative by the OTS on foreclosure prevention is the effort to improve the collection of data on loan modifications and refinancings by OTS-regulated institutions. Building on a reporting template developed by the HOPE NOW Alliance, the OTS has begun to collect extensive loan-level data on modification efforts by its six largest mortgage servicers. These six institutions collectively service more than \$2.5



trillion in first lien mortgages. With this data, we will be able to assess the progress being made, as well as the relative success over time of different loan modification strategies.

Before receiving the data from our servicers, the OTS held discussions with several servicers and found that loan workout activity at our institutions had increased notably over the past twelve months. The servicers indicated that the activity was costly and did not always result in successful loan modifications. However, public recognition of lenders' willingness to work with borrowers has grown, resulting in a much better response by borrowers to outreach efforts.

Several OTS-regulated servicers have indicated that early contact and open communication with borrowers is the most essential step in helping to prevent default. It allows the servicer to understand a borrower's specific needs and circumstances, so the servicer can work with the borrower to develop the most viable solution. There are several approaches for reaching out to borrowers, including personalized mailings, telephone calls to delinquent borrowers, and the use of automated commitments to pay.

For the more formal data collection effort, the OTS has retained the HOPE NOW Alliance data aggregator to collect and process the data for us. Servicers submit the requested data to the aggregator, which compiles the information and provides reports to the OTS. We are now reviewing a just-received summary report covering the first quarter of this year. Going forward, we expect to receive such reports monthly, allowing us to assess more accurately the effectiveness of efforts to assist troubled homeowners, including initiatives established by legislation.

## **IX. Consumer Protection**

On May 1, the OTS approved a proposed rule on unfair or deceptive acts or practices (UDAP) related to credit cards and overdraft protection programs. This approval represented a milestone for consumers. For the first time, federal banking regulators went beyond merely requiring disclosures about credit cards terms and conditions by proposing outright prohibitions on certain practices considered unfair.

The proposed rule was the second step in a three-step rulemaking process. The OTS unilaterally took the first step last August by issuing an Advanced Notice of Proposed Rulemaking, asking for comment on whether to take action and whether certain practices were unfair. At the time, the OTS expressed hope that other regulators would join the rulemaking effort, so the financial services industry would have a level playing field in this area. Since that time, the other two agencies with UDAP rulemaking authority under the Federal Trade Commission Act—the Federal Reserve and the National Credit Union Administration—have joined the OTS in proposing a UDAP rule that would apply across the financial services landscape.



The proposed rule addresses several practices criticized by consumers and addressed in proposed legislation, such as raising interest rates on existing credit card balances, allowing inadequate time for consumers to pay their credit card bills and charging fees for overdraft protection without allowing consumers to opt out.

The proposed rule was published this week in the Federal Register, beginning a 75-day comment period. The three agencies will review and discuss the comments before issuing a final regulation.

## **X. Conclusion**

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In summary, Mr. Chairman, Senator Shelby, and members of the Committee, the OTS-regulated thrift industry is continuing to face imposing challenges from a weak economy and slumping housing sector but, all things considered, is holding up remarkably well. The industry is on stable footing and is poised to return to thriving status once the housing market recovers and the economy again swings upward.

Thank you again for having me here today.

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# ATTACHMENT

Regional Bulletin: 08-04

*Credit Risk Management*



**Dear Chief Executive Officer:**

### SUMMARY

The current economic environment presents significant challenges, particularly in the area of credit quality and asset management. In many parts of the West Region, we are seeing declining home prices and real estate values, growing inventories of unsold homes, and increasing delinquencies, non-performing assets, and real estate owned. We have received many questions about OTS's expectations for thrift institution Boards of Directors and management in these areas.

We expect thrift institutions to have the appropriate processes and systems in place to identify emerging risks and to manage and service any increase in the level of problem assets. Effective risk management of the loan portfolio and the credit function is fundamental to an institution's safety and soundness. To assist thrift institutions with their management of credit risk, OTS has issued a significant amount of national guidance in this area. This guidance can be located in sections of the OTS Examination Handbook including:

- 201, Overview: Lending Operations and Portfolio Risk Management
- 212, One- to Four-Family Residential Real Estate Lending
- 213, Construction Lending
- 251, Real Estate Owned and Repossessed Assets
- 260, Classification of Assets

Additionally, the OTS has issued a number of CEO Letters referencing both interagency and stand alone OTS guidance relating to credit risk including:

- 261, Loss Mitigation Strategies for Servicers of Residential Mortgages (September 4, 2007)
- 257, Statement on Subprime Mortgage Lending (July 10, 2007)
- 256, Interagency Guidance on Nontraditional Mortgage Product Risks (April 27, 2007)
- 255, Statement on Working with Mortgage Borrowers (April 17, 2007)
- 252, Office of Thrift Supervision Guidance on Commercial Real Estate (CRE) Concentration Risks (December 14, 2006)
- 222, Credit Risk Management Guidance for Home Equity Lending (May 16, 2005)



To the Chief Executive Officer

March 21, 2008

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We support the vital role that thrift institutions play in meeting the credit needs of their communities in a safe and sound manner. This Bulletin serves as a timely reminder of good practices in credit risk management.

## **DISCUSSION**

In light of the current housing and economic environment, institutions may need to increase attention towards business planning, risk analysis and monitoring, account management, and problem asset management.

Risk Analysis and Monitoring – Thrift institutions should have effective systems in place to analyze, monitor, and manage portfolios for adherence to underwriting standards and the early detection and monitoring of problem assets. Examples of items to monitor include:

*For all loans:*

- Credit concentrations (e.g., geographic, borrower/developer, common industry, employer, riskier products.)
- Pre- and post-closing quality control reviews to ensure adherence to underwriting standards.
- Undisbursed credit lines.
- Exposure to third-party mortgage insurers.
- Exposure due to recourse obligations.
- Lender liability.
- Risk layering.
- Collateral value.
- Demographic indicators, including unemployment levels in geographic lending areas.
- Economic indicators such as interest rates, consumer spending patterns, and lending trends.

*For loans secured by 1-4 single family residences:*

- Production and portfolio trends by product, loan structure, originator channel, credit score, loan-to-value (LTV), debt-to-income (DTI), lien position, documentation type, owner/investor, market, and property type.
- Delinquency and loss distribution trends by product and origination channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI).
- Vintage tracking.
- Performance of third-party originators (brokers and correspondents).
- Market trends by geographic area and property type to identify areas of rapidly changing housing values.
- Recast schedules for Pay Option ARMs.

*For loans secured by income properties:*

- Rent rolls, periodic operating statements, and property inspections.
- Borrower and guarantor financial condition.
- Current and projected operating expenses for different types of properties.
- Valuation trends.

*For construction and development projects:*

- Current and projected vacancy, construction, and absorption rates.
- Global borrower cash flow on all unfinished projects.
- Inspection progress reports.
- Current and projected lease terms, rental rates, and sales prices, including concessions.

Also, consider increasing the frequency of internal asset reviews for income properties, construction, and development loans, particularly if a loan or group of loans have higher risk characteristics (i.e., located in a deteriorating real estate market, borrower has other problem loans with institution, etc.)

As appropriate, stress test analysis should be utilized and address the following: increased delinquency rates; current LTVs (e.g., using automated valuation models); real estate value declines; interest capitalized; and changes in economic indicators (e.g., rental rates, commercial property vacancy trends, bankruptcy levels, unemployment rates, etc.)

Business Planning – The Board in conjunction with management should ensure that the institution's current business plan reflects current market risks and that the institution has appropriate policies and procedures relating to:

- Product types offered. Determine if changes are needed to product types offered and asset mix.
- Underwriting standards. Review underwriting standards in light of risk tolerance and consider whether standards such as loan-to-value ratios (LTVs), debt-to-income (DTI) requirements, credit scores, documentation standards, cash equity requirements (especially for land/construction/development loans), and risk layering are appropriate.
- Concentration limits. Review and update risk concentration limits as appropriate in light of changing circumstances.
- Quality and frequency of asset reviews. Ensure appropriate early warning systems are in place to timely identify problem assets. Consider expediting review timeframes for problem loans and those in significantly stressed markets.
- Appraisal standards. Ensure appraiser independence, conduct in-house review of outside appraisers, and confirm licensing and quality.
- Third party originations. Ensure appropriate policies and procedures are in place for brokers and correspondents including verifying licensing requirements are met, conducting background checks, implementing appropriate quality control standards, and monitoring loan performance.

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- Capital support. Ensure appropriate strategies are in place to maintain capital levels and ratios commensurate with the institution's risk profile.

Account Servicing – Management should evaluate the effectiveness of credit management processes considering the current economic environment, including:

- Develop a matrix of early warning signals or triggering events and have a plan for addressing them.
- Establish criteria for changes in loan terms (e.g., line amount, renewal period, minimum payment amount, payment timing), including account freezing/termination. Ensure the established criteria are based on economically supportable factors and are not discriminatory. If revised criteria impact a broad spectrum of accountholders, ensure the criteria is based on economically supportable factors.
- Maintain compliance with consumer protection regulatory requirements, such as Regulation Z and Regulation B, if home equity lines are reduced or terminated.

Problem Asset Management – Management should establish loss mitigation strategies while enhancing, if necessary, systems and controls to manage increasing asset quality problems, including:

- Maintaining staffing levels and experience sufficient to handle the level of problem assets (i.e., servicing staff for increased delinquencies and asset management staff for loan modifications, real estate owned (REO), and loans in foreclosure.)
- Designating criteria for various loan modification options and respective qualification standards. Separately monitor the modified loan portfolio(s).
- Ensure the timely identification and appropriate on-going accounting for Troubled Debt Restructurings (TDRs) and REO. Some examples:
  - Determine whether loan modifications are TDRs.
  - For TDRs, require a loan level analysis to identify the loss to be recognized.
  - Institutions must ensure REO is initially recorded at fair value (less selling costs) and subsequently at the lower of that value or updated fair value (less selling costs). This includes the on-going determination of the REO fair value while in the disposition process.
- Develop criteria for REO decisions, such as:
  - Timing of property disposal (i.e. hold, lease, or sell analysis), and
  - Method of REO property disposition (i.e. sold through internal staff, real estate brokers, or auction).
- Provide ongoing internal asset review of REO and problem assets, including periodic evaluations or reappraisals.
- Establish risk management procedures for vendor relationships. Outside vendor fraud or vendor incompetence can result in significant losses to lenders.

To more fully address some of the questions and issues that have been raised, the West Region is conducting four Chief Credit Officer Credit Forums to be held in various locations throughout the West Region. See Regional Bulletin 08-03 for complete details.

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Please share this memorandum with your Chief Credit Officers and Chief Lending Officers. You can contact your Assistant Director, or Regional Examiner David Henry at [david.henry@ots.treas.gov](mailto:david.henry@ots.treas.gov) for questions related to this Bulletin.

Sincerely,

Darrel W. Dochow

Regional Director

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