Supervision

The OTS Supervision and Consumer Protection Team: Timothy T. Ward (center), Deputy Director for Examinations, Supervision and Consumer Protection; Left to right: Lori J. Quigley, Managing Director for Supervision; Grovetta Gardineer, Managing Director for Corporate and International Activities; Ward; Montrice G. Yakimov, Managing Director for Compliance and Consumer Protection; and Tom Day, Managing Director for Risk Management.

The core mission of the OTS is to supervise U.S. thrift institutions and their holding companies to maintain their safety and soundness, to ensure compliance with consumer laws and to encourage a competitive industry that meets America's financial services needs.

Condition of the Thrift Industry

The economic downturn and persistent decline of the housing market had pronounced negative effects on the operations of the OTS-regulated thrift industry during fiscal year 2008. As home prices continued to fall across the nation, institutions were faced with a rising tide of home mortgage delinquencies and foreclosures.

The record level of loan loss provisions recorded for the year demonstrated the impact on asset quality and earnings. The industry added $35 billion to bolster loan loss reserves during the fiscal year, resulting in weak earnings and net losses. Increased provisions for loan losses reduced net income to a negative $18.8 billion for FY 2008 from a positive $11.2 billion in FY2007. Return on average assets was also negative in FY 2008 at minus 1.29 percent, down from a plus 0.74 percent for FY 2007.

As asset quality declined during the year, troubled assets (loans 90 days or more past due, or in accrual status, plus repossessed assets) more than doubled, rising to 2.40 percent of assets at the end of FY 2008 from 1.19 percent at the end of FY 2007. Like the troubled asset ratio, the ratio of net loan charge-offs to assets increased sharply during FY 2008. Net loan charge-offs (loans or portions of loans written-off as uncollectable, offset by any recovery of loans previously charged-off) measured 1.10 percent of average assets for FY 2008, up from 0.35 percent for FY 2007.

The number of problem thrifts-with the lowest composite safety-and-soundness exam ratings of 4 or 5-also increased during FY 2008. There were 23 problem thrifts, or 2.8 percent of all thrifts, at the end of FY 2008, up from 12 (1.4 percent) a year ago. Significant disruptions in the liquidity and capital markets contributed to the failures of three thrift institutions in

FY 2008. These failures resulted in a 25 percent decline in the aggregate thrift industry assets to $1.18 trillion, from $1.57 trillion at the end of FY 2007.

Despite these pressures, capital levels remained strong. The industry's equity-to-assets ratio was 9.24 percent and 98 percent of all thrifts, holding 99 percent of industry assets, exceeded the regulatory standard to qualify as "well-capitalized." As of September 30, 2008, 12 thrifts were "adequately capitalized" and six thrift institutions were "undercapitalized."

The OTS continues to focus supervisory attention on weaknesses in compliance and on meeting Community Reinvestment Act (CRA) requirements and information technology (IT) standards. As of September 30, 2008, 94 percent of thrifts were rated 2 or better in compliance (with a 1 rating being the best); two thrifts were rated 4 and two thrifts were rated 5. On CRA, 91 percent of thrifts were rated satisfactory or better. Eight institutions received "Needs Improvement" ratings on their CRA examinations and one was rated as being in a state of "Substantial Noncompliance." Also, at the end of FY 2008, 92 percent of thrifts were rated satisfactory or better on IT.

Thrift exposure to the US housing markets continues to be a significant risk to the health of the industry. The OTS examination process includes a thorough review of each institution's risk management practices to ensure the proper level of attention to business planning, risk analysis and monitoring, account management and problem asset management. Each examination, as well as the agency's overall exam strategy, focuses on risk, devoting the greatest resources to the highest risk areas.

Mortgage Metrics

Throughout the economic downturn, as secondary mortgage markets seized up and thrift institutions faced increased levels of home mortgage delinquencies and foreclosures, OTS consistently urged institutions to work with troubled borrowers, even while they dealt with liquidity issues.

As community-based lenders, thrifts remain focused on residential mortgage lending, with 45.8 percent of assets invested in one-to-four family mortgage loans as of the end of FY 2008. The volume of mortgage refinancings, as a percentage of total mortgage originations, remained strong as borrowers continued to convert adjustable-rate mortgages to fixed-rate mortgages.

On March 3, 2008, the OTS encouraged OTS-regulated mortgage servicers to use a standard template developed by the HOPE NOW alliance to report information on modifications of securitized, subprime adjustable-rate mortgage loans. In a memorandum to Chief Executive Officers of OTS-regulated thrift institutions, the agency pointed out that the use of a standard template would support monitoring of foreclosure prevention efforts and provide transparency for investors in loan securitization trusts.

In a separate initiative, and building on the efforts of HOPE NOW, the OTS requested loan level data from a subset of its mortgage servicers to better assess mortgage loan performance and loan modification efforts. The OTS released its initial Mortgage Metrics Report on July 3, 2008. The initial report covered activity during the quarter ending March 31, 2008 and was based on data from the five largest servicers of residential mortgages among OTS-regulated thrifts and their affiliates. These five institutions serviced a combined 11.4 million first-lien residential mortgages with an aggregate outstanding balance of $2.3 trillion. The report provided a baseline of comprehensive, standardized data to track loan modifications and repayment plans, and a basis for assessing the effectiveness of foreclosure prevention initiatives.

On September 12, 2008 the OTS joined forces with the Office of the Comptroller of the Currency (OCC) to issue a combined report on mortgage performance for the second quarter of 2008. The combined report covered more than 90 percent of first lien mortgages held or serviced by federally regulated banks and thrifts. The combined portfolio in the report represents 34.7 million loans worth $6.1 trillion.

The report confirms that actions by national banks and thrifts to prevent home mortgage foreclosures have materially reduced new foreclosures despite an overall decline in mortgage credit quality. From January to June 2008, new loan modifications increased by more than 80 percent, while new payment plans grew by 8 percent, according to the report. The two types of loss mitigation actions reached more than 90,000 borrowers in June alone. The report also provides an additional tool to help examiners assess emerging trends, identify anomalies, compare institutions to the rest of the industry, evaluate asset quality and loan-loss reserve needs, and evaluate the effectiveness of loss mitigation actions.

Risk Modeling

OTS examines savings associations every 12-to-18 months for safety and soundness, and compliance with consumer protection laws and regulations. These examinations evaluate the association's ability to identify, measure, monitor and control risk. Due to the thrift industry's natural concentration in longer-term mortgage loans, funded with shorter-term deposits and borrowings, OTS closely monitors interest rate risk. OTS's enhanced Net Portfolio Value (NPV) Model provides an accurate estimate of each institution's interest rate risk profile. More importantly, it gives OTS the ability to value a much wider range of financial instruments and to produce a series of reports that focus on areas such as net interest income, liquidity and value-at-risk.

During fiscal year 2008, OTS continued to demonstrate its regulatory leadership in the area of off-site monitoring of risk. Each quarter, OTS's NPV Model produces more than 800 institution-specific interest rate risk reports. The reports are used to monitor interest rate risk trends in the industry and to identify specific institutions that may need closer supervision in the area of interest rate risk management. The new Web-based version of the NPV Model adds flexibility previously unavailable in the legacy model. The Web-based version can generate more targeted reports that analyze specific

APPLICATIONS ACTIVITY: 2007-2008

	Applications Filed		Fiscal 2008 Decisions			
	FY 2007	FY2008	Approved	Denied	Withdrawn	Total
Branch	255	314	315	0	11	326
Bylaw/Charter	136	157	151	1	10	162
Conditions	28	23	22	0	2	24
Control	19	38	33	0	8	41
Conversions	9	6	8	0	1	9
HC	127	88	77	0	15	92
Merger	15	18	13	0	0	13
New Institution	51	27	31	0	7	38
Merger with a Bank (Oakar)	35	33	30	0	3	33
Operations	708	581	560	2	25	587
Conversion to a Bank (Sasser)	13	9	9	0	1	10
Sub Debt/MRPS	6	10	7	0	2	9
Subsidiary	66	102	72	0	18	90
Waiver	67	69	60	0	5	65
Totals	1,456	1,535	1,444	1	60	1,505

portfolios on a balance sheet using a wider range of customized stress scenarios.

Applications

OTS grants federal thrift charters, approves savings and loan holding company structures, and reviews and approves changes in banking activities for all of its regulated institutions. The table above is a summary of all applications received in fiscal 2008.

Guidance, Outreach, and Education

OTS maintains a high level of communication with the industry, conducts numerous educational and outreach activities, provides supervisory guidance and shares information on industry best practices and emerging risks with examiners, thrifts, and savings and loan holding companies.

Guidance

- *One- to Four-Family Residential Real Estate Lending* — On September 17, 2008, the OTS revised its Examination Handbook Section 212. The guidance warns savings associations against using investors' underwriting standards that do not meet OTS standards to qualify borrowers for loans that will be sold in the secondary market. The guidance requires savings associations to establish prudent concentration limits for loan exposure from loan commitments, warehouse (unsold loans), and repurchase risk (where a loan may have to be repurchased due to documentation problems or early payment default). Such exposure must be reported to the savings association's board of directors and will be closely scrutinized by the OTS if the level exceeds the thrift's Tier 1 capital.

- *Proposed Interagency Appraisal and Evaluation Guidelines* — Throughout fiscal year 2008, the federal banking agencies worked to develop proposed guidelines to address how associations comply with their appraisal regulation in light of changes in industry practices, uniform appraisal standards, available technologies and recent volatility in certain real estate markets. The proposed guidelines include an expanded discussion of portfolio management techniques and circumstances under which a financial institution should update or replace a collateral valuation for an existing real estate transaction.

They also incorporate three new appendices on appraisal exemptions, evaluation alternatives and terminology used in the guidelines and appraisal practices. The discussion of evaluation alternatives addresses appropriate practices and controls regarding an institution's use of automated valuation models and tax assessment values as evaluation alternatives. It addresses the agencies' expectations for institutions to establish a process and procedure for determining the appropriate use of evaluation alternatives. (OTS and the other agencies published the proposed guidelines in the Federal Register in November 2008 for a 60-day comment period.)

- *Deferred Tax Assets* — The OTS and the other federal banking agencies amended their regulatory capital rules to permit banking organizations to adjust their September 30, 2008 regulatory capital calculations for the tax effects from losses on direct and indirect investments in Fannie Mae and Freddie Mac preferred stock after the federal government's intervention. The amendment permits banking organizations to proceed as if Section 301 of the Emergency Economic Stabilization Act of 2008 (EESA) had been enacted and Revenue Procedure 2008-64 (Rev. Proc. 2008-64) had been issued in the quarter ending September 30, 2008.

  Section 301 of EESA and Rev. Proc. 2008-64 provide tax relief to banking organizations that have suffered losses on certain holdings of Fannie Mae and Freddie Mac preferred stock by changing the character of these losses from capital to ordinary for federal income tax purposes.

- *Deduction of Goodwill from Regulatory Capital* — On September 30, 2008, the OTS joined the other federal banking agencies in publishing a notice of proposed rulemaking in the Federal Register to amend their regulatory capital rules to permit banking organizations to reduce the amount of goodwill acquired in a taxable business combination that a banking organization must deduct from Tier 1 capital by the amount of any deferred tax liability associated with that goodwill. For a banking organization that chooses to follow this final rule, the amount of goodwill the banking organization must deduct from Tier 1 capital reflects the maximum exposure to loss in the event that such goodwill is impaired for financial reporting purposes. It is anticipated this proposal will be effective January 1, 2009 and the final rule may permit banking organizations to elect early adoption for purposes of the regulatory report on December 31, 2008.

- *FFIEC Business Continuity Planning Booklet* — The IT examination staff of the OTS participated in the interagency effort to update guidance for examiners, financial institutions and technology service providers to identify business continuity risks, and evaluate controls and risk management practices for effective business continuity planning. The revised booklet was released in March 2008.

- *Preliminary Examination Response Kit (PERK)* — The PERK is a formal request for information that the OTS sends to regulated institutions before examinations. In 2008, OTS updated and streamlined its PERK requests. The OTS tailors each PERK to fit the institution. OTS employees carefully design each PERK package to request only the information OTS needs to conduct the examination. This approach eliminates unnecessary requests for information, reduces regulatory burden on institutions and increases the efficiency of examinations.

Outreach - Corporate Governance

- *Director's Seminars* — In FY 2008, OTS held one-day seminars in each of the OTS's five regions to assist thrift directors in becoming more aware of the best practices of effective boards of directors. Over 300 thrift directors attended the seminars. Also, in April 2008, the OTS updated two publications for thrift directors, the Directors' Guide to Responsibilities and the Directors' Guide to Management Reports. The Directors' Guide to Responsibilities is a comprehensive publication that covers topics such as selecting and retaining competent management; establishing a thrift's objectives and strategies; establishing policies and procedures to achieve those objectives; identifying and understanding associated risks; monitoring and assessing the progress of operations; and, ensuring the institution's compliance with laws and regulations. The Directors' Guide to Management Reports is a more detailed publication that explains management reports commonly used by thrifts and directors in exercising their oversight duties and responsibilities. In 2009, OTS plans to present two seminars — one in the West and one in the East — with the theme, "How Your Board Can Perform a Self-Evaluation."

Education

- *OTS IT Examination Staff Conference* — In fiscal 2008, the OTS held a three-day staff conference at its Washington, D.C. headquarters for agency staff members with responsibilities for IT supervision and examinations. Speakers made presentations on pandemic planning, identity theft prevention, authentication, payment cards industry security standards, cyber frauds, forensics, phishing schemes and business continuity. Highlights also included industry panels discussing remote deposit capture and the challenges faced daily by industry Chief Information Officers. About OTS 75 staff members attended from around the country.

- *FFIEC Information Technology Conference* — The OTS co-chaired this three-day annual event designed to inform IT examiners and safety-and-soundness examiners with IT examination responsibilities about current and emerging "hot topics" in the areas of information security, identity theft and IT risk management. Speakers were nationally recognized industry leaders.

Disaster and Emergency Preparedness

The OTS is actively involved in initiatives to address emergency and disaster preparedness. In October 2007, the OTS urged thrifts in areas affected by the Southern California wildfires to consider all reasonable steps to meet customers' financial needs while maintaining standards of safety and soundness. OTS emphasized that thrifts in affected areas could:

- Consider temporarily waiving charges for late payments and penalties for early withdrawal of savings;
- Reassess the credit needs of their communities and offer prudent loans to help rebuild;
- Restructure borrowers' debt obligations, when appropriate, by adjusting payment terms;
- Solicit state and federal guarantees and other means to help mitigate excessive credit risks; and
- Consider all available programs offered by the Federal Home Loan Banks.

For the past 20 years, the OTS in conjunction with the other FFIEC agencies has issued guidance to the industry with regard to disaster recovery and business continuity planning. During examinations, OTS reviews each institution's plan for continuity of operations and emergency preparedness. OTS participates on the Financial and Banking Information Infrastructure Committee to improve the reliability and security of the financial industry's infrastructure.

Global Financial Services

The OTS supports international collaboration, and promotes effective and efficient supervision across borders and across sectors of the global financial marketplace. The OTS is the supervisor for U.S. thrift holding companies, including a number of financial conglomerates active in the European Union (EU). The EU seeks to enhance coordination among relevant supervisors and to ensure that financial conglomerates domiciled outside EU member countries are subject to an equivalent level of supervision by foreign supervisors. The OTS was the first regulatory authority designated by the EU as a consolidated coordinating regulator of a holding company with operations in the EU.

In its role as home supervisor to internationally active conglomerates, the OTS sponsors an annual “supervisors college,” where banking, securities, and insurance supervisors from Europe, Asia, Latin America and the United States discuss common concerns related to group supervision. As a host supervisor, OTS coordinates its efforts with foreign home supervisors-on conglomerate supervision and on supervision related to the Basel Committee Bank Supervision regime.

Additionally, to formalize cooperation on supervisory matters, the OTS forges information sharing agreements and cooperation arrangements with foreign supervisors. The OTS has information sharing arrangements with 16 foreign supervisory agencies. During 2008, the OTS and the other US bank regulatory agencies opened negotiations for such agreements with several more.

The OTS maintains an active presence in international supervisory and industry organizations. OTS is on two Joint Forum working groups that deal with issues common to banking, securities and insurance sectors, including regulation of financial conglomerates. Because of the significant number of major insurance firms that hold thrift charters, the OTS is an observer in the International Association of Insurance Supervisors and monitors international insurance issues. The OTS is also a member of the Association of Supervisors of Banks of the Americas, improving cooperation with supervisors throughout the North American and South American continents.

International Basel II Risk-Based Capital Framework

In late 2007, the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), OCC and OTS approved a final rule regarding the advanced approaches for computing large bank risk-based capital requirements. The rule became effective in April 2008. Although the timetable remains unclear for banks to begin the multi-year transition process to full implementation, the federal banking agencies are continuing preparatory efforts toward that end.

On July 2, 2008, the OTS approved an interagency notice of proposed rulemaking along with the FDIC, FRB and OCC that would, if finalized, offer savings institutions the option of adopting a less complex approach for calculating risk-based capital requirements under the Basel II capital framework. This “standardized” approach would be available to all banking organizations, except those that meet the definition of a core banking organization (generally over $250 billion in assets, or $10 billion in foreign exposures). Although the standardized approach is a less complex alternative than the advanced approach, it is more risk-sensitive and more complex than the existing risk-based capital rules. The existing rules will also remain an option for all but the largest organizations.

Ombudsman

OTS recognizes that its decisions have a significant effect on the institutions it regulates and that supervisory decisions or examination findings may be challenged. The Ombudsman serves as a bridge between the OTS and the institutions it regulates to ensure that such decisions and findings are consistent and objective. In 2008, the Ombudsman established a formal Appeals Committee and developed a new process for the review, appeal and reconsideration of disputed material supervisory decisions. Guidelines governing the appeals process and a description of the functions of the Ombudsman’s office are contained in a Thrift Bulletin (68b) issued to all OTS regulated institutions in July 2008 ■