

# Supervision and Consumer Protection

**T**he core mission of the OTS is to supervise U.S. thrift institutions and their holding companies, and ensure proper consumer protection.

The agency formulates nationwide supervision policies, procedures and guidance for its examination workforce and for the thrift industry. Under the OTS examination strategy, agency examiners analyze the safety and soundness of financial institutions as they concurrently review institutions' compliance with regulations protecting consumers, countering terrorist financing and preventing money laundering. Each examination, as well as the agency's overall exam strategy, focuses on risk by devoting the greatest resources to the highest risk areas.

## Supervision Operations

The agency supports its core examination functions with

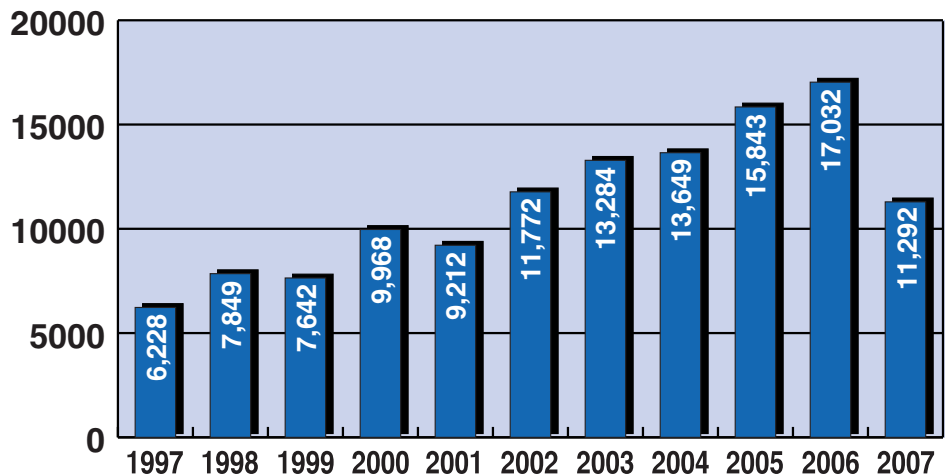
monitoring, analysis, modeling and the processing of applications and other filings.

## *Condition of the Thrift Industry*

The thrift industry performed well during fiscal 2007 and measures of financial condition remained sound, despite challenges for home lenders. After an extended period of strength, the U.S. housing market began weakening in late 2005 and continued to weaken during 2007. This weakening has been marked by slowing home sales, declining home prices and rising mortgage delinquencies and foreclosures. These factors have put pressure on recent thrift earnings and asset quality.

Despite these pressures, earnings for the year were positive and capital levels remained strong. The industry's equity-to-assets ratio was a near-

***Thrift Industry Net Income: in millions, fiscal years 1997 through 2007***



record 10.16 percent and 99 percent of all thrifts exceeded the regulatory standard to qualify as “well-capitalized.” Three thrifts were “undercapitalized” as of September 30, 2007. One thrift institution failed in September 2007, the first thrift failure since 2004. Net income for the year was down from the record levels reached during the period of extended strength in the U.S. housing market. Increased provisions for loan losses reduced net income to \$11.3 billion for FY 2007, down from the record-high of \$17 billion in FY 2006. Return on average assets was 0.74 percent in fiscal 2007, down from 1.12 percent for fiscal 2006.

Asset quality weakened during the year, reflecting the housing market weakness. Troubled assets (loans 90 days or more past due, or in nonaccrual status, plus repossessed assets) rose to 1.19 percent at the end of FY 2007 after reaching a record low of 0.42 percent in June 2005. Like the troubled asset ratio, the ratio of net loan charge-

offs to average assets rose during FY 2007 from very low levels. Net loan charge-offs (loans or portions of loans written-off as uncollectible, offset by any recovery of loans previously charged-off) measured 0.43 percent of average assets, up from 0.22 percent in fiscal 2006.

Interest rate risk increased during the year, reflecting the rise in short-term interest rates. As of September 30, 2007, 80.1 percent of thrifts had low levels of interest rate risk, 16.4 percent had medium levels and 3.5 percent had higher levels.

OTS also focused supervisory attention in 2007 on weaknesses in compliance and on meeting Community Reinvestment Act (CRA) requirements and information technology (IT) standards. As of September 30, 2007, 93 percent of thrifts were rated 2 or better in compliance (with a rating of 1 being the best); two thrifts were rated 4 and none were rated 5. On CRA, 91.9 percent of thrifts were rated satisfactory or better, as of September 30, 2007. Eight institutions received “Needs Improvement” ratings on their CRA examinations and none were rated as being in a state of “Substantial Noncompliance.” Also, at the end of FY 2007, 93 percent of thrifts were rated satisfactory or better on IT.

### *Risk Modeling*

The risk that thrifts face from fluctuations in interest rates is a key barometer of a force that can have a deep impact on the overall health of the industry. In 1991, OTS developed a proprietary simulation tool called the Net Portfolio Value (NPV) Model to measure and monitor the interest rate risk exposure within the thrift industry. The NPV Model uses detailed balance sheet information to estimate the market value of each savings association and then determines how that estimated market value is affected by changes in interest rates.

OTS recently completed a major enhancement to the NPV Model and began producing new reports using the *Enhanced* NPV Model. The *Enhanced* NPV Model provides a more 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

*Promote the very extensive benefits of the OTS thrift charter. I believe it to be the best operating charter in the banking industry.*

— Letter from thrift industry executive to the OTS

instruments and the capability of producing a series of new reports that focus on areas such as net interest income, liquidity and value-at-risk. The *Enhanced NPV Model* solidifies OTS's position as an industry leader in the high quality measurement of interest rate risk.

**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 below is a summary of applications received in fiscal 2007.

**Supervision Policy**

OTS provides supervisory guidance for examiners, thrifts and savings and loan holding companies on lending and appraisal practices, corporate governance, accounting, information technology and emergency

preparedness. The agency also conducts a wide range of educational and outreach activities.

**Lending and Appraisal Practices**

■ *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* — Responding to concerns about the risks of institutions concentrating too much on commercial real estate lending, the guidance recommends that thrifts assess their risk exposure as soon as they develop a concentration in a single class of assets. The guidance cautions that not all types of commercial lending present the same level of risk and that

*The OTS Examiners are experienced, knowledgeable, and honest. Somehow, they always manage to contribute at least one positive suggestion for improving something.*  
— Letter from thrift industry executive to the OTS

<b>APPLICATIONS ACTIVITY: 2006-2007</b>						
	<b>Applications Filed</b>		<b>Approved</b>	<b>Fiscal 2007 Decisions</b>		<b>Total</b>
	<b>FY 2006</b>	<b>FY2007</b>		<b>Denied</b>	<b>Withdrawn</b>	
Branch	259	255	248	0	0	248
Bylaw/Charter	150	136	140	0	2	142
Conditions	29	28	26	0	0	26
Control	19	19	17	0	0	17
Conversions	1	9	4	0	0	4
HC	102	127	107	0	13	120
Merger	17	15	14	0	1	15
New Institution	19	51	34	0	4	38
Oakar	35	35	35	0	0	35
Operations	658	708	677	1	24	702
Sasser	10	13	12	0	0	12
Sub Debt/MRPS	10	6	5	0	1	6
Subsidiary	55	66	57	0	10	67
Waiver	92	67	68	0	5	73
<b>Totals</b>	<b>1,456</b>	<b>1,535</b>	<b>1,444</b>	<b>1</b>	<b>60</b>	<b>1,505</b>

institutions should factor the differences into their analyses. The other federal banking agencies issued similar guidance. (December 2006)

- *One- to Four-Family Residential Real Estate Lending* — The revised Examination Handbook section incorporates changes related to the Interagency Guidance on Nontraditional Mortgage Products and provides more specific guidance for various types of

nontraditional lending. The handbook section highlights interagency concern over the practice of qualifying borrowers based on low “teaser” rate payments. It also provides guidance on stated-income and low-documentation loans. The handbook section warns savings associations against using investor underwriting standards that do not meet OTS standards to qualify borrowers for loans that will be sold in the secondary market. (March 2007)

- *Statement on Subprime Mortgage Lending* — OTS, together with the other banking regulators and the National Credit Union Administration, issued the subprime statement to provide guidance on the agencies’ expectations concerning sound practices in risk management and consumer protection in mortgage lending to subprime borrowers. The statement stresses the importance of responsible risk-management practices when offering loans to

subprime borrowers. The statement outlines the agencies’ expectations concerning risk management practices and consumer protection principles that institutions should follow for responsible lending to subprime borrowers. Additionally, the statement encourages institutions to work closely with their borrowers who have troubled loans that are delinquent, or likely to become so. (June 2007)

- *Mortgage Banking Activities* — The new handbook section provides in-depth guidance on all aspects of mortgage banking, including loan production, servicing, hedging and secondary market activities. It incorporates changes related to interagency guidance, accounting standards and industry practices. (July 2007)

### *Corporate Governance*

- *Director Training Seminar* — OTS has developed a training seminar for members of the boards of directors of savings associations. Director Reich announced the seminar in a seven-minute video available on the agency’s website. In the video, he emphasized the importance of setting corporate values for bank directors, managers and other employees. The first OTS seminar will be held in November 2007 in Schaumburg, Ill.
- *Expanded Examination Cycle* — The federal banking agencies issued a final rule expanding the pool of small institutions eligible for an extended 18-month on-site examination cycle. The final rules allow well-capitalized and well-managed banks and savings

*I have worked in the thrift industry since 1976 and have always felt comfortable with the OTS, finding it to be informed, fair, helpful, and necessary.*

— Letter from thrift industry executive to the OTS

associations with up to \$500 million in total assets and a composite CAMELS rating of 1 or 2 to qualify for the 18-month (rather than a 12-month) cycle. Previously, only institutions with less than \$250 million in total assets could qualify. (September 2007)

### *Accounting*

- *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) and Questions and Answers on Accounting for Loan and Lease Losses* — The federal banking agencies released this policy statement to replace a 1993 version. Each regulated financial institution must ensure that controls are in place to determine ALLL consistently, in accordance with generally accepted accounting principles, the institution's policies and procedures, and supervisory guidance. (December 2006)
- *Notice of Proposed Rulemaking on simplified rules on subordinated debt and mandatorily redeemable preferred stock* — The proposal would align the rules more closely with those of other federal bank regulatory agencies, reduce regulatory burden and provide more flexibility for savings associations. (January 2007)

### *Information Technology and Emergency Preparedness*

Education and outreach programs are important for communicating OTS policies. In the past year, OTS has conducted IT examiner training sessions and participated in interagency conferences, meetings

and seminars. Highlights of these activities in fiscal 2007 include:

- *FFIEC IT Symposium* — The symposium is a forum for senior examiners from the five member agencies of the Federal Financial Institutions Examination Council (FFIEC) to interact with representatives from the financial industry, government officials and other subject matter experts to explore current topics on information technology. The 2007 Symposium, led by OTS, examined the topic of remote deposit capture. It resulted in draft guidance and a work program for examiners and financial institutions. Work continues on the guidance, which is expected to be issued in the second quarter of FY 2008.
- *Outreach activities* — OTS activities during the year included the following: annual meeting of the international Information Technology Supervisors Group; Spring meeting of the National Foundation for Credit Counseling; American Conference Institute's National Forum; Webinar for BankInfoSecurity.com; Practical Privacy Seminar by the International Association of Privacy Professionals; Minority Depository Institutions Interagency National Conference; and seminars and conferences by BITS and The Santa Fe Group.

*The examiners are uniquely qualified through many years of experience in dealing with our issues... They understand our business model.*

— Letter from thrift industry executive to the OTS

## Compliance and Consumer Protection

OTS has centralized its compliance and consumer protection function at agency headquarters in Washington, D.C. The agency issues policies and guidance on the development, implementation and evaluation of compliance programs for OTS examiners and the thrift industry.

### *Compliance Policy Guidance*

*I was frustrated and didn't know where to turn and I received wonderful help from you and your department.*

— Letter from consumer to the OTS

■ *Illustrations of Consumer Information for Nontraditional Mortgage Products* — The illustrations were issued to help financial institutions comply with provisions of the Interagency Guidance on Nontraditional Mortgage Products. The final interagency guidance directs financial institutions to provide clear and balanced information to help consumers make informed choices. (June 2007)

■ *Proposed Illustrations of Consumer Information for Subprime Mortgage Lending* — The interagency Notice of Proposed Rulemaking seeks comments on the illustrations that would assist institutions in providing consumer information, as discussed in the federal banking agencies' Statement on Subprime Mortgage Lending. (August 2007)

■ *Telephone Consumer Protection Act (TCPA) Examination Procedures* — Provides examiners with procedures for examining

institutions for compliance with the TCPA. (July 2007)

■ *Consumer Credit Extended to Service Members and Dependents* — The advisory to the thrift industry provides information about a final rule published by the Department of Defense on August 30, 2007, on providing consumer credit to service members and their families. (September 2007)

■ *Unfair or Deceptive Acts or Practices* — The Advance Notice of Proposed Rulemaking seeks public comment on approaches OTS might consider in reviewing its regulations on unfair or deceptive acts or practices in the thrift industry. (August 2007)

■ *Model Privacy Notice* — The Notice of Proposed Rulemaking seeks comment on a model privacy form that financial institutions may use for their privacy notices to consumers. (March 2007)

### *Combating Terrorist Financing and Money Laundering*

OTS works to abate money laundering and terrorist financing, together with the other federal banking agencies, the Conference of State Bank Supervisors, the Financial Crimes Enforcement Network (FinCEN) and the Office of Foreign Assets Control (OFAC). This cooperative approach helps ensure examination consistency and uniform guidance for financial institutions.

■ *Interagency Statement on Enforcement of Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) Requirements* — The

statement provides guidance and insight into the considerations that form the basis of enforcement decisions on BSA matters. (July 2007)

- *Bank Secrecy Act/Anti-Money Laundering Manual* — Through the FFIEC, the federal banking agencies along with OFAC and FinCEN issued a revised manual. The BSA/AML Examination Manual and related enforcement guidance were designed to foster consistency and transparency regarding the BSA examination process. (August 2007)

- *Advanced BSA/AML Specialists Conference* — OTS, in conjunction with the other federal banking agencies, developed the conference for our most seasoned BSA experts to address emerging risks regarding money laundering and terrorist financing. The pilot conference was held in August 2007.

OTS is committed to effective examination for compliance with the USA PATRIOT Act, BSA requirements and AML guidance. In FY 2007, OTS conducted 507 comprehensive examinations and cited BSA-related violations in 62 institutions. Although most violations were technical and were remedied during the examination process with no further action, others resulted in the initiation of 21 enforcement actions.

### *Community Reinvestment Act*

In 2007, the OTS worked to align its Community Reinvestment Act (CRA) regulations with those of the other federal banking agencies.

- *Community Reinvestment Act Interagency Uniformity* — The final rule revised four areas of the regulation to reestablish alignment between OTS rules and those of the other federal banking agencies. The revisions promote consistency, facilitate objective evaluations of CRA performance for all banks and thrifts, and reinforce CRA objectives for savings associations to meet the credit needs of the communities they serve. (March 2007)

### *Consumer Protection*

Ensuring adherence to consumer protection laws is one of the primary responsibilities of the OTS. The agency meets that responsibility through a robust examination program that assesses compliance with more than 30 federal consumer protection statutes, regulations and other requirements, including the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, privacy laws and other consumer protection laws.

OTS and other federal banking regulators use data provided by banks and thrift institutions under the Home Mortgage Disclosure Act (HMDA) in examining institutions for signs of discrimination or violations of fair lending laws. The review and analysis of this information is an important factor in determining whether financial institutions are meeting the needs of their communities and

*I was thrilled to say the least when I received the letter stating I would be refunded the money... You are the type of person that restores my faith in the goodness of humanity.*

— Letter from consumer to the OTS

complying with anti-discrimination provisions of federal laws and regulations. OTS examiners evaluate thrifts in light of the data, paying particular attention to institutions with an incidence of higher-priced lending to particular racial or ethnic groups. Although the HMDA data do not include all information needed for determining the fairness of loan pricing, OTS examiners evaluate HMDA data in conjunction with other data as they use the agency's

examination procedures to develop an accurate picture of each institution's fair lending compliance.

### *Consumer and Community Affairs*

The OTS assists consumers and responds to their questions and complaints related to thrift institutions. During FY 2007, the OTS received more than 5,600 consumer complaints (plus another 10,300 consumer inquiries that did not lead to formal complaints) and resolved

more than 94 percent of the complaints within 60 days. Even when evidence showed no regulatory violations by the institution, OTS Consumer Affairs managers frequently encouraged thrifts to take voluntary action to satisfy consumers in the interest of preserving good customer relationships and enhancing the reputation of thrifts as responsive financial service providers.

Consumer complaint information is used by examiners to help identify

potential problem areas for review during on-site examinations and is an important consideration when assessing an institution's overall compliance management program. The information also helps OTS identify and monitor emerging consumer protection issues and spotlights areas where financial education materials may be helpful for consumers, or outreach and education may be helpful for the industry.

Through its Community Affairs program, OTS helps the thrift industry meet the needs of the communities it serves. OTS officials recognize the importance of financial education for consumers. In October 2006, OTS and the other federal banking agencies issued a publication to help consumers make informed choices regarding nontraditional mortgage loans. The booklet entitled, "Interest-Only Mortgage Payments and Payment-Option ARMs — Are They for You?" features a glossary of lending terms, a mortgage shopping worksheet and a list of additional information sources.

OTS officials also worked with the Federal Reserve Board to develop and release the "Consumer Handbook on Adjustable Rate Mortgages," also known as the CHARM brochure. Issued in December 2006, the brochure explains the features and risks of adjustable rate mortgage loans, such as the potential for payment shock and the possibility of the amount that a borrower owes on a loan actually rising over time. The brochure also includes discussions about "interest-only" and "payment-option" mortgages, a mortgage shopping worksheet to help consumers compare features of different products and a glossary to

*I know you probably think it's just doing your job, but not everyone does their job... Thanks to you for doing your job in such an efficient and timely manner.*

— Letter from consumer to the OTS



help them understand some of the terminology. Creditors are required to give consumers a copy of the CHARM booklet with each application for any nontraditional mortgage with a variable rate.

The Community Affairs program also developed a brochure to help consumers understand gift cards entitled, "Thrift Gift — Consumer Fact Sheet on Buying, Giving and Using Gift Cards." Another OTS brochure advised thrift customers on how to resolve complaints. In August 2007, OTS reinitiated its flagship Community Affairs publication, the "Community Liaison." The Summer 2007 issue focused on home ownership and home preservation.

### *Minority Owned Institutions Program*

The OTS's Minority Owned Institutions (MOI) program provides technical assistance and other support to promote and preserve minority-owned thrift institutions, many of which primarily serve minority communities and lower-income neighborhoods. At the close fiscal 2007, OTS supervised 22 minority-owned institutions holding approximately \$9 billion in assets. Examples of technical support OTS provides include helping MOIs find qualified board members and key personnel, and analyzing business plans and operations to provide input and direction.

OTS initiated several enhancements to its MOI program during FY 2007, including the following:

- Launching an updated section of the agency website specifically for MOIs that features resources and other information.

- Developing a survey to assess how the agency could further strengthen the MOI program.
- Participating in trade association conferences, interagency forums, roundtables and conferences that raised awareness of the MOI program.
- Continuing outreach through the agency's regional community affairs liaisons.

### **Complex & International Organizations**

The responsibility for supervising financial conglomerates, international affairs and international technical assistance is centralized at agency headquarters in Washington, D.C.

#### *Supervising Conglomerates*

OTS holding companies are players in a global financial services marketplace, operating in more than 100 countries. Several global financial conglomerates own OTS-chartered thrifts, including General Electric, AIG, American Express, Ameriprise Financial, Merrill Lynch, Morgan Stanley and Lehman Brothers. At the end of the fiscal 2007, OTS supervised 470 holding company enterprises with approximately \$8.5 trillion in consolidated total assets. These enterprises owned 436 thrift institutions with total assets of \$1.3

*It is reassuring to know that one can depend on our federal government and people such as yourself in those rare instances when the system fails the individual.*

— Letter from consumer to the OTS

trillion, or almost 82 percent of total thrift industry assets.

OTS has a program for supervising large and complex financial institutions. A highly experienced staff of examiners and specialists execute the program, which implements a risk-focused supervisory approach that combines on-site examination work, routine communication and off-site planning, monitoring and analysis into a single ongoing supervisory process.

OTS coordinates with other U.S. and international regulators to develop a comprehensive view of each firm's consolidated risk profile and financial performance. Such cooperation is essential as OTS holding companies continue to expand their international exposure.

### *International Affairs*

OTS supports international collaboration and promotes effective and efficient supervision across borders and across sectors of the global financial marketplace. In its role as home supervisor to internationally active conglomerates, OTS sponsors an annual "supervisors college" and invites banking, securities and insurance supervisors from Europe, Asia and the United States to discuss common concerns related to group supervision. As a host supervisor, OTS seeks to coordinate its efforts with the activities of foreign home supervisors on both conglomerate supervision and on supervision related to the Basel II capital regime.

OTS fostered international supervisory communications during the year as agency officials visited supervisors in

Australia, Brazil, China, the European Union, France, Germany, India, Japan, the Netherlands, Sweden and the United Kingdom to discuss consolidated supervision, money laundering, Basel II and other regulatory issues. In two cases, OTS holding company examiners participated with host country supervisors in the examination of foreign affiliate entities. The agency also hosted supervisors from China, Egypt, the European Union, Japan, Morocco, South Africa, Taiwan and Vietnam to discuss the thrift industry and the U.S. supervisory structure. In addition, OTS meets with foreign industry associations to explain U.S. regulatory policy and the thrift charter.

To formalize cooperation on supervisory matters, OTS forges information-sharing agreements and cooperation agreements with foreign supervisors. OTS completed five such agreements during fiscal 2007, bringing the total number of these agreements to 13.

During the year, OTS participated in the European Union's review of the supervisory equivalency of the United States. In previous years, OTS was designated the equivalent consolidated supervisor for GE Capital Services, Ltd., AIG Inc. and Ameriprise Financial Group, ensuring that supervision of the global activities of these firms occurs with minimal regulatory overlap.

OTS is a full member of the Basel Committee on Banking Supervision, made up of banking supervisory authorities from more than a dozen nations to encourage cooperation on banking supervisory matters and to propose broad supervisory standards

and guidance for the worldwide financial services industry. As one of the four federal bank regulatory agencies in the U.S., OTS has equal representation on the committee with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

OTS participates on the committee's working groups and is a contributing member on the Accord Implementation Group, the Policy Development Group and the Accounting Task Force. OTS also participated in a 2007 meeting of the G10 Central Bank Governors and the heads of bank supervision.

During the year, OTS and the other federal banking agencies completed work toward adopting a new risk-based capital adequacy framework to implement the advanced approaches of the Basel II Accord. The framework requires some — and permits other — qualifying banking organizations to use an internal ratings-based approach to calculate credit-risk capital requirements and to use advanced measurement approaches to calculate operational-risk capital requirements. OTS and the other federal banking agencies also began

developing a Notice of Proposed Rulemaking to implement a U.S. version of the Basel II standardized approach. That effort follows review of comments on Basel 1A, an earlier proposal aimed at providing a risk-sensitive method for assessing capital adequacy for institutions that will not apply the more complex Basel II rules. The final rule for the advanced approaches and the proposal for the standardized approach are planned for publication in the Federal Register in fiscal 2008.

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