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Statement of

John M. Reich  
Director, Office of Thrift Supervision

concerning

**The Condition of the Thrift Industry**

before the

Committee on Banking, Housing and Urban Affairs  
United States Senate

March 4, 2008

Office of Thrift Supervision  
Department of the Treasury

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DIRECTOR, OFFICE OF THRIFT SUPERVISION  
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**I. Introduction**

Good morning, Chairman Dodd, Senator Shelby, and members of the Committee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry.

Approximately four years ago, the OTS testified before this Committee on a thrift industry that was strong and growing in asset size. While that trend continues, much has changed in the underlying housing economy that is having a significant impact on thrift lenders. Key measures of financial health – including earnings and profitability, loan loss provisions and net charge offs, and loan performance – have been affected by the downturn in the housing economy over the past year. While industry capital remains strong and asset quality is relatively stable, we are maintaining a watchful eye on credit and interest rate risk, as well as loan performance and industry exposure to the fallout from problems in the subprime lending market. We are also closely monitoring thrift industry exposure to upcoming resets on prime pay-option ARMs that are expected to occur in the next several years.

While a generally favorable interest rate environment continues, the thrift industry's high levels of earnings and profitability from several years of mortgage originations and sales has abated. Although thrift earnings have been challenged in recent quarters, industry capitalization has remained strong due, in part, to good stewardship by thrift managers that have taken proactive steps to address the current challenging business environment.

In my testimony today, I first discuss the state of the OTS-regulated thrift industry, including industry data from our recent year-end earnings release, current supervisory concerns, and market stresses and challenges facing thrift lenders. I also highlight an issue with thrift industry portfolio limits that poses some risks to the ability of the industry to diversify its lending activities. In the next part of my statement, I provide an overview of the OTS's oversight and supervision of the industry, including a discussion of several issues that you have specifically asked us to address, such as



troubled debt restructurings, enforcement issues, potential contagion from the subprime market into other lending activities, and real estate appraisals. Next, I address foreclosure prevention and loan mitigation efforts, including the recent OTS foreclosure prevention proposal. I conclude my statement with a discussion of the various ideas for implementing stronger consumer protections in the mortgage markets, including your legislation, Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007.

## **II. State of the OTS-Regulated Thrift Industry**

### **A. Thrift Industry Data/Numbers**

#### **1. Overview**

The OTS-regulated thrift industry comprises a diverse group of institutions that range from small one-office depositories to large and complex institutions that operate on a nationwide basis. As of December 31, 2007, there were 826 thrift institutions with combined assets of \$1.51 trillion. Of these institutions, 39 percent are held in the mutual form of ownership, the historical form of thrift ownership, and 61 percent are stock held depositories. Virtually all stock held institutions operate within some form of a holding company structure.

The majority of OTS-regulated thrifts are full-service, community-based, financial institutions offering a wide range of products to consumers and small- to medium-size businesses. Many thrift institutions use the charter to specialize in retail mortgage and consumer lending activities, but some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

While there tends to be some diversification with the use of the thrift charter, savings and loan holding companies (SLHCs) are even more diverse. SLHCs are involved in a wide range of businesses and activities, and range in size from small shell holding companies to large international conglomerates. While the predominant characteristic of most SLHC activities involves financial services, there are a number of SLHCs that conduct operations in numerous non-financial activities, including manufacturing, industrial and retail operations. Among the larger and more complex companies owning thrifts are investment banking firms, insurance companies, and diversified financial services firms with international scope.

As of December 31, 2007, the OTS supervised 475 SLHC structures – including 109 mutual holding company structures – with aggregate consolidated assets of approximately \$8.5 trillion.



## 2. Industry Performance

The profitability of mortgage market participants was especially hard-hit in 2007, and this had a significant impact on overall thrift profitability for the year. The OTS-regulated thrift industry posted profits of \$2.9 billion for 2007, down from \$15.8 billion in 2006. The industry's return on average assets was 0.19 percent for 2007, compared with 1.06 percent for 2006.

Of particular note, the industry recorded a loss of \$5.2 billion in the fourth quarter of 2007, a record in terms of dollars, which equated to a -1.38 percent return on average assets for the quarter. While goodwill write-downs of approximately \$4 billion by a handful of institutions and a \$2.2 billion restructuring charge by one institution were significant components of the aggregate industry loss for the quarter, record levels of loan loss provisioning also played prominently in fourth quarter industry performance.

While nationwide home sales slowed throughout 2007, thrift industry mortgage originations (including 1-4 family and multifamily lending) rose for the year. Total industry mortgage originations were \$716.1 billion in 2007, up 12 percent from \$642.2 billion in 2006. While total industry originations of \$166.6 billion in the fourth quarter were down from \$185.7 billion in the third quarter of 2007, the fourth quarter of 2007 was still significantly higher than the \$134.3 billion of industry originations in the fourth quarter of 2006.

Despite the relative size of the industry to the broader mortgage market, thrifts continue to account for a sizable portion of the U.S. residential mortgage market, originating 31 percent of total 1-4 family loans in the fourth quarter of 2007. An estimated 9 percent of thrift mortgage originations were ARMs in the fourth quarter of 2007, down from 13 percent in the third quarter of 2007 and from 12 percent of all thrift originations in the year-ago fourth quarter of 2006.

Thrifts currently hold approximately two-thirds of their assets in mortgages and mortgage related instruments. As of December 31, 2007, one-to-four family mortgage loans constituted 48.9 percent of industry assets (including 7.5 percent of assets in home equity lines of credit), 4.1 percent of industry assets were in multifamily loans, and 13.7 percent of industry assets were in other mortgage related instruments. Of total outstanding one-to-four family mortgages and mortgage related instruments held by the industry, approximately 61.2 percent were adjustable rate mortgages (ARMs).

With the impact of a weak housing market on thrift balance sheets, institutions are taking appropriate steps to protect their operations. In particular, thrifts continue to add to their loan loss provisions, which increased to 0.75 percent of average assets for the year from 0.25 percent in 2006. As explained more fully below, the additions to loan loss provisions reflect the increase in non-current loans as a result of the deteriorating performance of loans originated in the past several years.

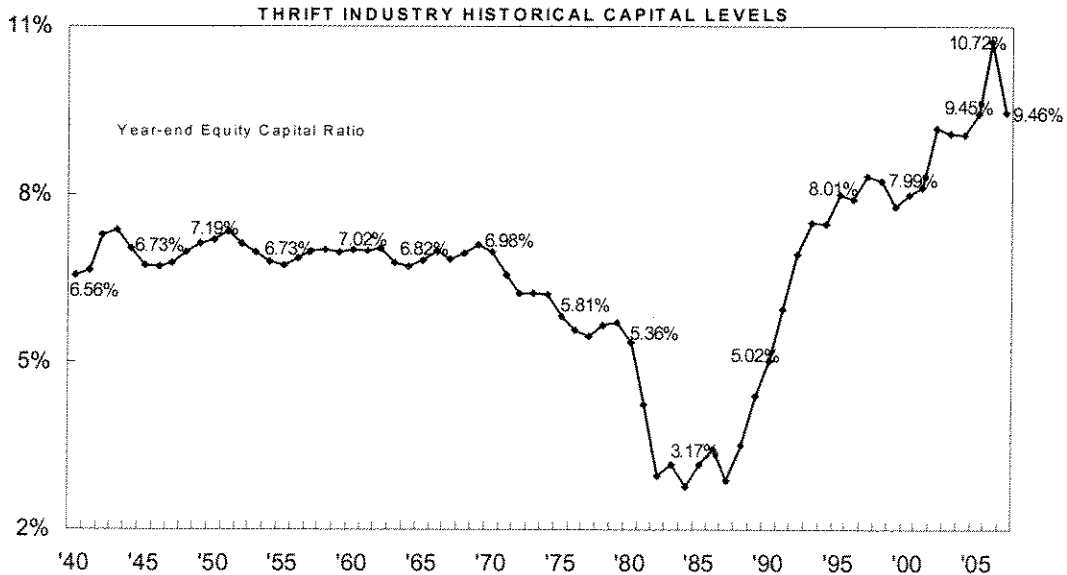


### 3. Capital, Provisioning and Loan Loss Reserves

Reflecting the current weakness in the U.S. housing market, thrift managers significantly bolstered loan loss reserves in 2007. The industry's loan loss provision expense for all of 2007 was \$11.3 billion (0.75 percent of average assets). It is notable that this amount is close to the combined loan loss provision expense of \$11.6 billion for the prior four year period from 2003 through 2006.

As previously noted, in addition to bolstering loan loss provisions, some thrift managers restructured their operations in 2007 to reflect the weak housing market. These restructuring charges – primarily write-downs of goodwill and losses incurred from exiting lines of business – were especially significant in the fourth quarter.

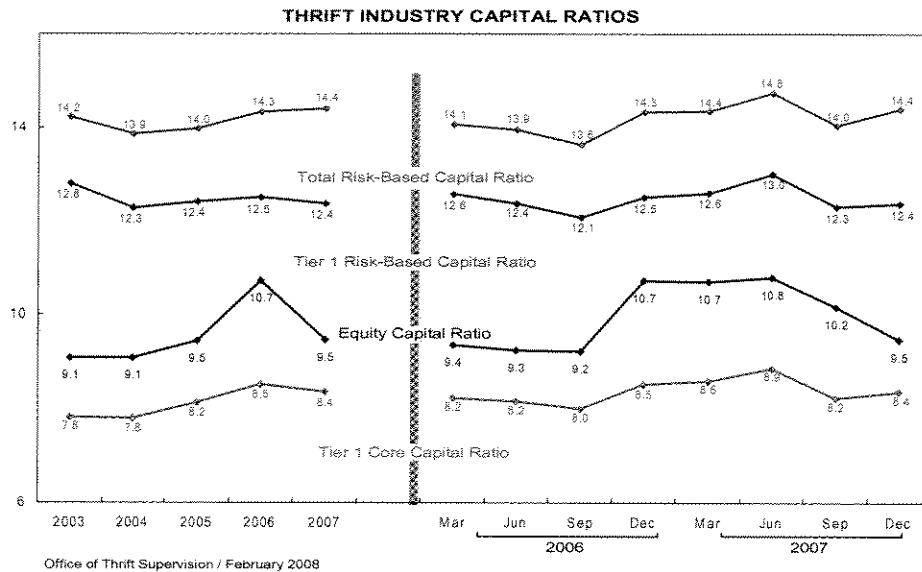
While the current housing market weakness has required charge-offs that have created earnings difficulties, it is important to stress that thrift capital levels remain strong. The industry's equity-to-assets ratio – a measure of capital according to generally accepted accounting principles (GAAP) – was 9.46 percent at year-end 2007. As shown in the chart below, thrift equity-to-assets ratio remains at historically strong level, though down from record high levels from one year ago. The combination of strong capital and bolstered loan loss reserves should help the industry withstand further weakening in the housing market.



Thrift regulatory capital measures also remain strong as shown in the following chart. As of the end of 2007, 98.5 percent of all thrifts – holding 99.8 percent of industry



assets – exceeded the “well-capitalized” regulatory standards. Regulatory capital measures exclude goodwill, so these measures were unaffected by the large goodwill write-downs taken in the fourth quarter.



## B. Current Supervisory Concerns

### 1. Overview

There are numerous supervisory concerns within the thrift industry as well as various economic factors affecting the industry that the OTS is closely monitoring. Foremost among these is the rise in loan delinquencies, especially for single-family mortgages and construction loans, attributable to the continued U.S. housing market weakness.

Non-current single family mortgage loans (i.e., loans 90 or more days past due plus loans in non-accrual status) increased to 2.35 percent of all thrift single family mortgages in the fourth quarter of 2007 from 1.61 percent in the third quarter of 2007 and 0.89 percent of thrift single family mortgages one year ago.

We are also closely monitoring the extent to which market unease may continue to inhibit the sale of loans into the secondary market, as well as affect thrifts with business lines of mortgage banking or jumbo loan products. Further, with the shut down in the secondary markets in the third quarter of 2007, many of these institutions had to adjust their entire business model. This may further pressure the profitability of thrifts



that are heavily engaged in the origination of residential mortgage loans for sale. While many thrifts adjusted by selling conforming loan products to Fannie Mae and Freddie Mac, exclusive reliance on this model tends to be less profitable and, thus, fails to alleviate earnings pressures.

Thrifts engaged in residential construction lending are also experiencing difficulties from market pressures. Thrift non-current construction loans rose significantly the last quarter of 2007 – to 4.60 percent of all construction loans held by thrifts – which is up from 2.72 percent in the third quarter of 2007 and 0.91 percent of all thrift construction loans one year ago. The over-building that has occurred in many markets has caused increases in delinquencies, extended periods of time for sales and further pressure on earnings.

Even many smaller institutions that, until recently, were operating relatively comfortably are experiencing impact from market stresses. These pressures relate specifically to their interest rate margins. Current market conditions have imposed so much pressure on deposit rates that interest rate spreads have been reduced to very narrow margins. Coupled with a decline in loan volume, these narrow margins are making it increasingly difficult to maintain profitability.

Credit deterioration is also a significant concern. As credit risks increase, loan loss provisions will continue to grow and reduce earnings with a potential future impact on capital. For example, thrift lenders holding so-called “option ARMs” have experienced increased delinquencies even before payment resets, a trend most pronounced in markets where property values have already declined significantly.

At the same time, it is important to be mindful of making sure that lenders do not unduly restrict credit standards and impair the availability of credit. This would only exacerbate an already difficult housing and mortgage market. Rather, a carefully balanced and even-handed supervisory approach will be the most effective in minimizing current and future credit risks.

As described more fully below, the lack of market liquidity, especially in markets for mortgage loans and mortgage-backed securities, is also affecting the ability to obtain an accurate assessment of market value for such assets. This, in turn, makes assessments of the adequacy of loan loss provisions more difficult.

Yet another issue, particularly for a number of medium-sized and larger institutions, is a lack of meaningful diversification. For some of institutions, diversification can be a critical component of their overall organization. As discussed later in this statement, we believe that this is an issue upon which Congress could provide some relief, if even to provide the OTS with case-by-case authority to provide institutions greater flexibility in their consumer and small business lending activities.



Finally, we are closely watching trends in unemployment, home prices, and home absorption rates. Further weakening in these broad measures may cause delinquencies to rise and necessitate higher provisions. And while interest rates are currently stable and near record lows, rising interest rates in the near-term would likely contribute to further declines in home prices and absorption rates.

For now, strong capital and higher loan loss allowances will help the thrift industry meet the challenges of possible further weakness in the housing markets. As highlighted earlier, equity capital and regulatory capital ratios remain high. In addition, the thrift industry loss coverage ratio (loss allowances plus capital to total loans) stands at 14.1 percent, which is down significantly from 15.1 for the prior quarter, but still at a relatively comfortable level. We will continue to monitor this ratio closely in the coming quarters.

## **2. Recent Examination Findings**

### **a. Capital**

During recent reviews, a number of thrift institutions have experienced declines in their capital positions that are caused mainly by operating losses. As noted above, current capital levels generally remain adequate for the risks inherent in most institutions' activities. In some instances, recommendations have been made to establish and implement a capital plan which details actions to ensure maintenance of capital ratios commensurate to the risk profile of an institution. Such plans typically detail alternatives for increasing capital levels.

We have also denied a few dividend payment requests recently to upstream dividends from a thrift institution to its parent SLHC. And there have also been a few instances in which OTS Supervision has required additional capital to be infused into an institution in order to support expanded growth plans or business strategies. To date, we have not experienced reluctance on the part of ownership to infuse additional capital in the few cases where this has been necessary.

### **b. Asset Quality**

As previously referenced, we have seen an increase in overall credit risk since previous examinations. There are similar increases in adverse classifications and delinquent loans relative to capital plus loan loss reserves. And growth in higher risk type loan concentrations has continued.

There have been numerous recommendations recently to establish concentration and loan portfolio limits relative to capital to ensure credit risk is prudently managed. Recommendations have also been made to improve construction loan monitoring and





administration procedures to ensure current construction loans remain adequately secured and institution lien positions are maintained.

Pursuant to the increase in problem credits over the last several quarters, we have advised institutions to expand their policies and procedures on impairment testing of commercial loans. We have also made recommendations to increase allocations to institution loan loss reserves for commercial loans – which are typically very collateral dependent – where an impairment test reveals a collateral shortfall.

Other recent asset quality recommendations include reducing the level of problem assets; improving systems for monitoring and classifying assets by strengthening loan review and loan monitoring procedures; identifying and monitoring loans in excess of supervisory loan-to-value (LTV) guidelines and loans-to-one-borrower (LTOB) limitations; strengthening the appraisal review function; bolstering procedures to limit concentrations in commercial real estate; establishing procedures for implementing the Interagency Guidance on Nontraditional Mortgage Products Risks; and improving policies and methodology on the Allowance for Loan and Lease Losses (ALLL).

#### **c. Management**

A key area of supervisory scrutiny during times of stress is institution management. Recent exam recommendations have focused on a wide range of management issues. These include reminding directors of the importance of participating in monthly meetings; management oversight and maintenance of capital adequacy; reducing classified assets and maintaining asset quality; strengthening the internal audit function; maintaining a focus on compliance issues and operating within approved business plans and the institution's overall risk profile; promptly filling management and board of director vacancies; and exercising independence from holding company and other affiliates.

#### **d. Liquidity**

Given disruptions in the secondary market in recent quarters, liquidity is an area of heightened examiner scrutiny. An increase in wholesale and nontraditional funding sources within the industry has also raised supervisory concerns. This has prompted recommendations to revise some institution liquidity policies to adopt additional limitations on funding sources, as well as ensuring that existing policy limitations are appropriately monitored and enforced. In addition, institutions have been advised to evaluate and monitor deposit concentrations on an ongoing basis, as well as to revise policies and procedures regarding funds management. Finally, a particularly critical issue for some institutions has been reliance on the capital markets for funding (i.e., mortgage banking entities). Where appropriate, we have advised institutions to establish a contingency funding plan to address this problem.



### **e. Earnings**

Earnings, of course, have been a significant challenge for many institutions recently. Net losses in recent quarters have become more severe, particularly as large credit losses were incurred. Recommendations to address this issue typically involve providing the OTS with a plan to improve operating results, including modifying or updating an existing business plan and stabilizing an institution's earnings profile to become less reliant on unpredictable income streams. We have also required various financial monitoring reports, including budget variance, consolidating financial statements, functional profit center reports, and risk management reports to assess potential earnings weaknesses.

### **f. Interest Rate Sensitivity**

Interest rate sensitivity is also an important issue for thrifts given their focus on mortgage lending operations and activities. As discussed later in this statement, the OTS has a highly developed and relatively sophisticated interest rate risk (IRR) net portfolio value (NPV) model that is able to predict with a high degree of accuracy an institution's overall IRR exposure in comparison to its peer lending institutions. OTS examiners use the NPV model to track each institution's overall IRR and will make recommendations, as appropriate and based on the NPV model, to an institution to develop plans to reduce the level of its interest rate risk exposure.

### **g. Compliance**

As noted previously, compliance issues may sometimes get less attention by an institution during times when it is focused on lagging performance or issues related to declining asset quality. This response, however, can often make a difficult situation even worse. Thus, we instruct OTS examiners to be vigilant in evaluating the strength and effectiveness of thrift institution's compliance risk management programs. The focus of our examiners on compliance issues includes ensuring an adequate structure and staffing of the compliance function; adequate reporting to and monitoring by senior management and an institution's board of directors; and special attention to consumer protection laws such as Fair Lending statutes, and Truth in Lending (Regulation Z) requirements.

Other compliance areas that OTS examiners will continue to focus upon during this time of economic stress include flood insurance and compliance with the Flood Disaster Protection Act; and Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) procedures. OTS examiners typically review an institution's policies and procedures for handling and timely filing of Suspicious Activity Reports (SARs). We also are carefully reviewing consumer disclosures for risks associated with non-traditional mortgage (NTM) products and compliance with NTM underwriting guidance.



### **3. Troubled Assets/Institutions**

Notwithstanding the current challenges in real estate lending, the number of problem thrifts – institutions with the lowest composite examination ratings of 4 or 5 – remain at relatively low levels. As of February 29, 2008, 13 thrifts, representing 1.6 percent of the industry, were rated a 4 or 5. Since the end of 2004, only one thrift institution has failed. While we cannot project with any certainty future thrift failures, we are working closely with all institutions currently rated a 4 or 5 to attempt to avoid further deterioration of these institutions and/or identify options to avoid failure.

As noted elsewhere in this statement, overall industry asset quality remains generally sound despite the rise in problem asset levels since the record lows experienced between 2004 and mid-2006 during the extended housing boom. An area of increased OTS oversight is the industry's troubled asset levels (loans over 89 days past due or in nonaccrual status plus repossessed assets), which was 1.65 percent of total assets at December 31, 2007. This is more than twice the ratio of 0.70 percent at the end of 2006. The recent rise in troubled assets was due to the U.S. housing market weakness.

Another measure of problem assets, the ratio of net loan charge-offs-to-average assets, remains relatively low; though, like troubled assets, it is up from the very low levels during the housing boom. Net loan charge-offs (loans or portions of loans written-off as uncollectible and offset by any recovery of loans previously charged-off) measured 0.24 percent of average assets in 2006 and increased to 0.41 percent at the end of 2007.

## **C. Market Stresses and Challenges Facing Thrift Lenders**

### **1. Housing and the Mortgage Markets**

#### **a. The Current Housing Economy**

It is expected that the current condition of the housing market will continue to have a significant impact on the thrift industry going forward. The extent and duration of the impact, however, is difficult to predict. Among the factors impacting thrifts are housing starts (for single and multi-family dwellings), which are down 27.9 percent from a year ago and, more significantly, are 60.2 percent lower in the last three months. New construction of single-family homes fell by 33.8 percent from a year ago, as home builders struggle to trim overloaded inventories. January marks the twelfth consecutive monthly drop in single family production, suggesting the contraction in the housing market is much deeper than initially projected.

According to the U.S. Department of Commerce, purchases of new homes – often a leading indicator of housing conditions – fell to a 12-year low of 588,000 units in January. For 2007, sales were down 26 percent, the worst sales decline since



recordkeeping began in 1963. Prices of new homes remained under pressure with the median sales price falling 15 percent from a year ago to \$216,000, the largest decline in 17 years. The number of new homes for sale fell to 482,000 in January, but given the current sales pace, it would take 9.9 months to sell these homes – the longest period in over 20 years.

In January 2008, sales of existing homes, which account for 85 percent of all home sales in the U.S., fell 23 percent from a year ago to 4.89 million units, the largest yearly slump in more than a decade. According to the National Association of Realtors (NAR), the inventory of existing homes available for sale rose more than 5.5 percent last month, resulting in 10.3 months of inventory (assuming the January 2008 sales pace). These inventory levels are very near the peak reached in October 2007. The median price of an existing single-family home fell 5.1 percent on a year-over-year basis in January. According to the NAR, the record low of 7.2 percent was recorded in December 1968. The current pace of home sales and large number of available new and existing dwellings suggest continued lower prices in the near term.

The plunge in home sales in 2007 resulted in the lowest yearly production of single-family loans since 2001. Approximately \$2.43 trillion in mortgage loans were originated last year, which is 18.5 percent less than in 2006.<sup>1</sup> As expected, originations of subprime and Alt-A loans were also significantly lower, especially in the second half of 2007. Subprime loan issuance was down 61 percent from the third to fourth quarter of 2007 for a total of \$11.94 billion, 55 percent less than 2006.

Mortgage loan performance also deteriorated in December 2007, as reported by LoanPerformance.<sup>2</sup> The national delinquency rate for prime loans climbed to 3.44 percent in December 2007, almost a full percentage point higher than a year ago. On a monthly basis, greater borrower stress was exhibited by subprime and Alt-A loans, which experienced a 1.29 percent and 0.96 percent increase, respectively, in late payments from November to December 2007. Foreclosures displayed similar characteristics with larger monthly and yearly increases in ARMs and non-prime mortgages.

#### **b. Current State of the Mortgage Markets**

Another indicator of home prices, the S&P/Case Shiller® Home Price Index (HPI), demonstrates that home prices continue to weaken across the U.S. Based on the HPI, existing home prices in 20 U.S. cities fell for the twelfth consecutive month in December 2007, for a year-over-year decline of 8.9 percent, a record low. The largest decline prior to December was a year-over-year 6.3 percent decline recorded in April 1991. The impact of falling home prices exacerbates mortgage default problems. Coupled with the fact that many mortgages in recent years have been issued with

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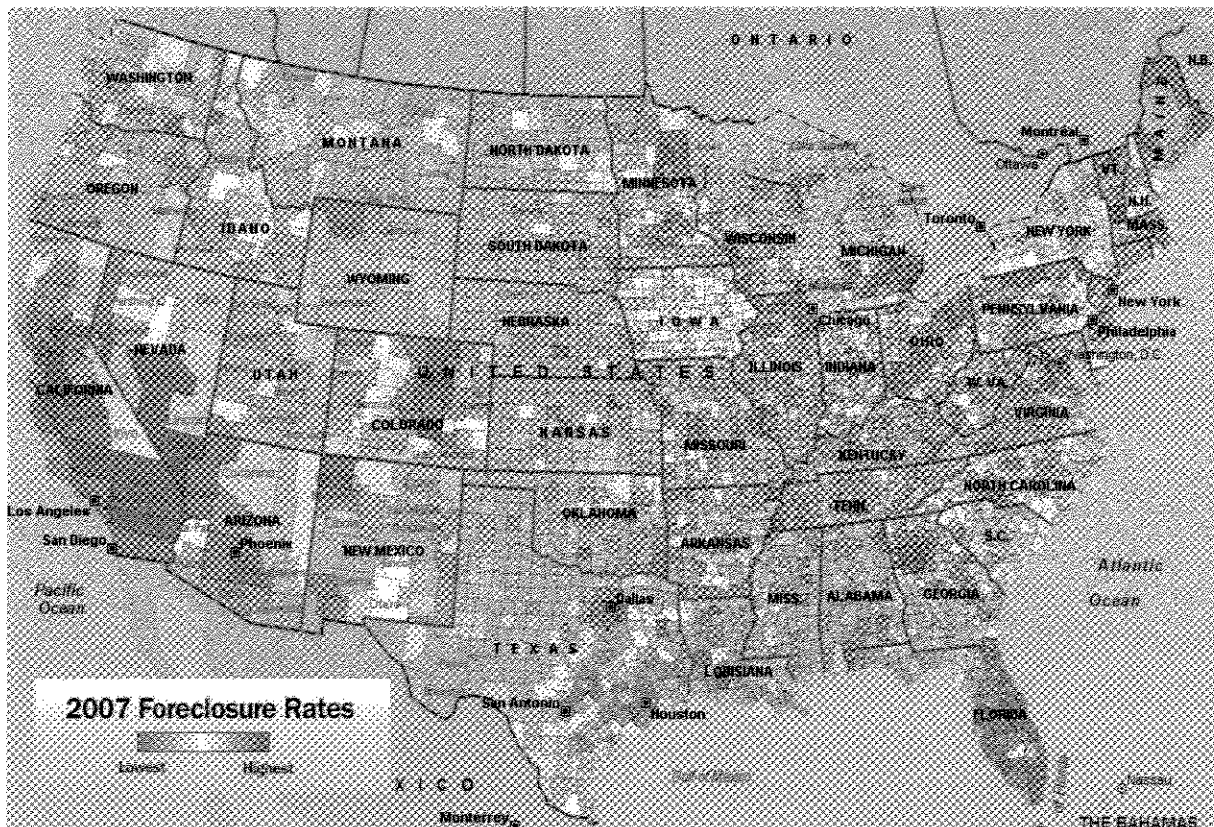
<sup>1</sup> Inside Mortgage Finance, January 2008.

<sup>2</sup> LoanPerformance is a subsidiary of First American Real Estate Solutions (FARES).



“simultaneous seconds” (i.e., second mortgages issued to borrowers in lieu of the imposition of private mortgage insurance), many properties currently have high loan-to-values on the combined first and second mortgages in various parts of the country.

The combination of high LTV ratios and the decline in home prices is forcing many mortgages “underwater,” a situation in which the borrower owes more than the home is worth. This has had a dramatic effect on increased foreclosure rates. As evidenced in the following chart from RealtyTrac.com, higher foreclosure rates are no longer isolated to the previously “hot” real estate markets, but are now evident in many areas of the country.



As can be expected, the current performance trend for residential mortgage loans is challenging. November 2007 data from LoanPerformance show marked increases in delinquencies among ARM, Alt-A and subprime loans from the previous month and year. Foreclosure rates displayed similar behavior. The bulk of 2/28 and 3/27 ARMs originated in 2005 have experienced their first rate reset and servicers are likely to have



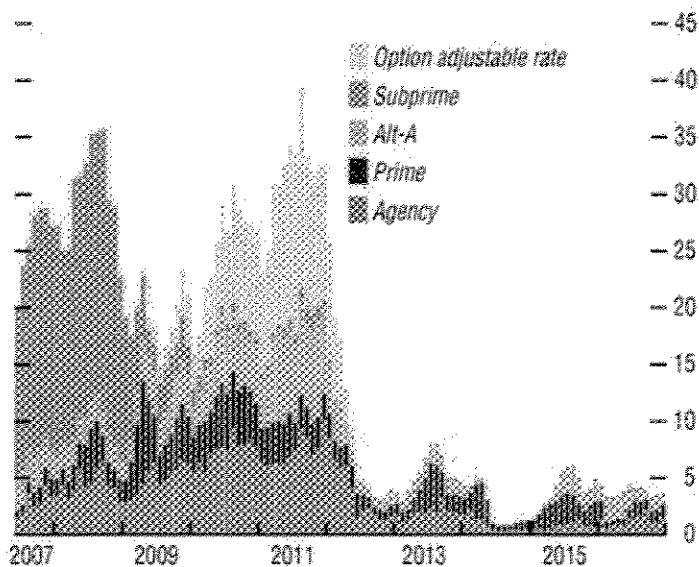
less volume over the next three months. However, there are another 1.5 million loans scheduled for rate resets in 2008, and there are many prime option ARMs approaching their first rate reset, which has the potential to produce further increases in mortgage loan delinquencies.

While there are different estimates of the projections and impact of rate resets on an already volatile housing market, we know that neither subprime nor option ARM rate resets have peaked. As the graph prepared by Credit Suisse indicates, subprime resets are expected to peak some time later this year; and option ARM resets will not peak for another several years, until some time in 2011.

Coupled with the possibility that many resetting loans may already be underwater, upcoming rate resets pose serious challenges, and potential opportunities, for thrift mortgage lenders. As explained later in my statement, we believe now is the time to identify creative approaches to addressing these problems. And it is my

intention that the OTS and the thrift industry play an important role in ensuring the continued viability, sustainability, and affordability of the U.S. housing markets.

**Figure 1.7. Monthly Mortgage Rate Resets**  
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

## 2. Thrift Industry Access to Funding

### a. The Capital Markets

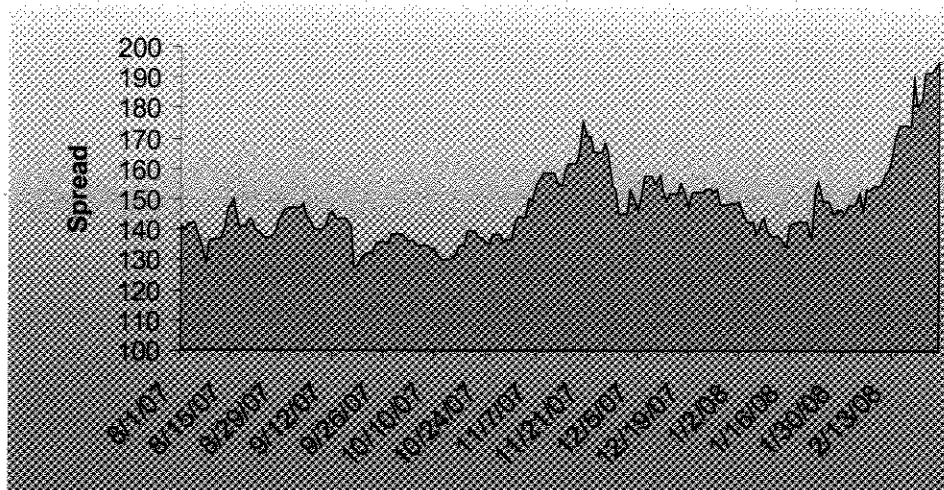
The capital markets continue to grapple with investor aversion to credit risk and lack of liquidity in the private label mortgage securities market. Fear of further credit losses among bond insurers and financial strain among the government-sponsored enterprises (GSEs) have contributed to higher funding costs for thrifts as investors demand higher than average yield premiums. As highlighted in the following chart, this past week the yield premium demanded for agency-issued mortgage-backed securities



rose to its highest level since November 2007 (its previous peak) as investors expressed concern that future write-downs of loans could cause the GSEs to sell mortgage assets.

**30-Year FNMA MBS vs. 10-Year Note**  
August 1, 2007 - February 26, 2008

High 195.2 2/26/08  
Low 102.8 9/18/07



SOURCE: BLOOMBERG, LP

While liquidity conditions are not as strained as they were during the credit crises encountered in the summer of 2007, the demand for private label securities remains sparse. Jumbo loan-backed securities are also experiencing little demand, while liquidity for Alt-A backed securities has diminished markedly in the last two months. Investors are approaching any purchase of Alt-A backed loans with great caution due to expectations that near-term rate resets of these loans may lead to greater losses in the asset class. What this all means is that virtually all thrifts have turned back to traditional sources of funding – insured deposits and Federal Home Loan Bank advances.

### **b. Deposits**

Insured deposits continue to be the primary funding source for thrift assets. Deposits funded 58.9 percent of industry assets at the end of 2007, down from 62.1 percent one year ago, but up from 57.1 percent at the end of 2005. In addition, the number of deposit accounts held by thrifts has trended up. Thrifts held 88.8 million deposit accounts at the end of 2007, up from 84.0 million in 2006 and 79.6 million in 2005.



### **c. Federal Home Loan Bank Advances**

Federal Home Loan Bank (FHLB) advances increased as a funding source for thrifts in 2007 as thrifts took advantage of relatively low, long-term interest rates to secure stable sources of funds in times of uncertainty and unrest in the capital markets. FHLB advances rose to 20.0 percent of industry assets at the end of 2007, from 15.2 percent one year earlier, and from 18.7 percent at the end of 2005. Like deposits, FHLB advances continue to be an integral source of funding for thrift institutions.

## **3. Portfolio Limits and Diversification**

### **a. Statutory Lending Requirements**

Currently, OTS-regulated thrifts are subject to two distinct statutory restrictions on their assets. The first is a requirement that thrifts hold 65 percent of their assets in qualified thrift investments. This is a test generally intended to ensure that thrifts maintain a focus in mortgage and retail consumer lending activities. The second set of restrictions relates to specific limitations imposed on the ability of thrift institutions in various asset types, including consumer, commercial and small business lending. While there is merit for maintaining restrictions to ensure that thrift institutions remain focused on mortgage and retail consumer lending activities consistent with the underlying purpose of the thrift charter, certain asset restrictions run counter to the underlying purpose of the charter and/or draw into question safety and soundness.

For example, thrifts are currently permitted to do unlimited credit card lending, an unsecured lending activity, but are limited to 35 percent of their assets in secured consumer lending activities. This has the clearly unintended effect of promoting unsecured consumer lending activities (via a credit card) over secured consumer lending. Similarly, the existing 20 percent of assets limit imposed on thrift institution small business lending tends to discourage thrifts from pursuing business activities that could diversify their lending operations and credit risk. As described below, we have offered several legislative proposals to address these shortcomings.

### **b. OTS Legislative Proposals to Provide Diversification**

The OTS has made recommendations to increase the ability of OTS-supervised institutions to engage in small business and consumer lending. These increases would not only strengthen OTS-regulated institutions by further diversifying their business lines, but would also increase the availability of credit in local communities. Small business lending, in particular, is a key to economic growth and recovery, particularly in low- and moderate-income areas. Earlier versions of this proposal were part of





legislation passed by the House in both the 108th and 109th Congresses and we continue to seek favorable consideration of both of these proposals in the future.

In particular, we seek to broaden the ability of savings associations to engage in small business lending by either increasing the existing limit or eliminating it altogether. Alternatively, case-by-case authority granted to the OTS would permit the OTS Director to waive the (20 percent of assets) small business lending limit for institutions that can demonstrate a need for the waiver, as described below.

With respect to existing limits on secured consumer lending, this limit currently applies to all secured loans for personal, family, and household purposes. Ironically, institutions are subject to no limit on unsecured consumer credit card lending. As previously noted, this anomaly exists even though the proceeds of the loan may be used for the same purpose. Give that the current limit may actually encourage more risky lending behavior by thrift institutions, we propose eliminating the 35 percent of assets limit on secured consumer lending activities. Alternatively, as with small business lending, waiver authority could be provided to the OTS Director to waive the limit on a case-by-case basis.

If case-by-case waiver authority is provided to the OTS, both small business lending and secured consumer lending could be restricted to permit institutions to expand existing lending programs to address local, regional and national constrictions in credit availability arising from current economic conditions. The increase in lending pursuant to either of these provisions would be subject to existing safety and soundness controls and OTS oversight. OTS currently monitors these lending activities (at currently permissible levels) at all OTS-regulated institutions.

### **III. OTS Oversight and Supervision**

#### **A. OTS Supervisory Approach**

The core mission of the OTS is to oversee and supervise U.S. thrift institutions and their holding companies, and to ensure sound consumer protections to thrift customers. 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. The agency supports its core examination functions with monitoring, analysis, modeling and the processing of applications and other filings.



The OTS provides supervisory guidance (available on the OTS website) for examiners, thrifts and savings-and-loan holding companies on lending and appraisal practices, corporate governance, accounting, information technology and emergency preparedness. We also conduct a wide range of educational and outreach activities.

## **1. Interest Rate Risk Management**

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, as discussed in more detail below, 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 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.

## **2. Credit Risk Management**

Thrift industry credit risk is primarily driven by the performance of residential mortgage loans; however, thrift credit exposure is not limited to the mortgage loan sector. Thrifts are also exposed to the business sector, with 3.8 percent of thrift assets held in commercial loans and another 12.3 percent of assets held in construction loans and nonresidential and multifamily mortgage loans. Further slowdowns in the economy could pressure the cash flow of commercial borrowers. We are carefully monitoring this situation within the industry. Alternatively, a steep rise in interest rates could also impact commercial borrowers, since business loans typically carry floating rates of interest. Credits highly dependent on low interest costs for positive cash flow would be most vulnerable to rapid increases in interest rates.

Credit review is a significant priority in our examination process, with the scope of our review formed by economic trends and expectations. Our analysis shows that as interest rates rise after a trough, many mortgage lenders lower credit underwriting standards to maintain high loan origination volumes. Such vintages often significantly underperform other vintages. Consequently, if rates begin to rise, OTS examiners will focus even greater attention on thrifts' underwriting processes, credit quality, reserve policies, and capital adequacy.



We are remaining vigilant in assessing the industry's credit risk exposure, particularly for institutions heavily concentrated in a very narrow product mix. We support the industry looking for ways to be less reliant on interest income. We emphasize, however, that expanding into new areas requires investment in the right people, systems, internal controls, and internal audits.

### **3. Compliance and 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.

The OTS centralizes 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.

### **4. Complex and International Organizations**

Historically, interest in the thrift charter has been focused primarily on entities conducting domestic consumer retail banking operations. Since the mid- to late-90s, however, a number of firms engaged in a wide range of financial services activities, both domestically and internationally, have been attracted to the charter. As a result, the OTS developed 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.

Pursuant to the OTS complex and international organization program, the agency 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.



## **B. Supervision and Enforcement Issues**

### **1. Troubled Debt Restructurings**

The OTS has consistently encouraged the institutions we regulate to work constructively with borrowers whose mortgage loans are in default or for which default is reasonably foreseeable. We continue to stress with the industry that prudent workout arrangements, conducted in accordance with safe and sound lending practices, are generally in the long-term best interest of both borrowers and lending institutions.

Pursuant to effective credit risk management procedures, institutions should work with borrowers to alter repayment terms, reduce interest rates, forgive principal due to a borrower's financial difficulties, or take any other steps appropriate to protect both the borrower and the institution. When modifying or restructuring existing credits, it is incumbent on an institution and our examiners to ensure that loans are properly identified, risk rated, accounted for, and reported to preserve the accuracy and integrity of financial statements. Loan modifications that are not properly accounted for will have the effect of masking delinquency and nonaccrual levels, which could lead to inaccurate ALLL calculations. While properly accounting for a troubled debt restructuring will have an impact on an institution's bottom line, it generally remains a significantly less costly alternative to foreclosure.

Many mortgages are held in securitization trusts that have outside servicers to manage the cashflows arising from the underlying mortgages. Most loan servicing agreements have been structured under the assumption that loan modifications are rare and would be pursued on a case-by-case basis. Generally, delinquent loans can be modified under this approach if the borrower demonstrates a willingness and ability to repay the loan under modified terms and it was in the best interest of the investors to modify the loan rather than foreclose. However, a loan-by-loan evaluation is very time consuming. With the rate of delinquencies in the mortgage market and the impending payment resets of various ARM products, there is little time for this type of in-depth loan-by-loan analysis. As a result, there have been a number of initiatives proposed to address this problem.

To date, there has been support for private sector initiatives to develop and implement a streamlined plan, such as articulated in the American Securitization Forum's statement of principles on this issue and the efforts of the HOPE NOW alliance, a private sector group comprising about 84 percent of subprime lenders. HOPE NOW programs include a streamlined approach to allow approximately 1.2 million subprime borrowers to be fast-tracked into affordable refinanced or modified mortgages.

While private sector programs are the lynchpin to the success of troubled debt restructurings, there are also important roles for policymakers, consumer advocates,



academics and individual borrowers. Engaging all of these parties, along with industry players, is the key to resolving the many troubled mortgage loans currently outstanding or that may experience difficulties in the coming months and even several years out. It is with this in mind that the OTS proposed its ideas, discussed below, on ways to prevent avoidable foreclosures of underwater mortgage loans

## **2. Transparency**

While OTS regulated institutions are active participants in the securitization markets, they are not typically sponsors of other structured finance products, such as structured investment vehicles (SIVs); collateralized debt obligations (CDOs); or asset-backed commercial paper (ABCP) conduits.

Where a thrift institution becomes involved in a structured finance arrangement, we will encourage greater disclosures by sponsors of, and investors in, the structured finance vehicles regarding the types of underlying assets and risks posed by the arrangement. We will also require greater disclosure of the valuation methods for the arrangement, including whether valuation estimates are derived from active or inactive markets or models. Other important factors include key assumptions and drivers of value; how such assumptions were determined; and sensitivity analysis about the impact on value if the actual results differ from the assumptions. Equally important is how risks are hedged, and the degree to which hedges were effective.

While no OTS-regulated thrifts have been required to consolidate structured finance vehicles on their balance sheets because of market illiquidity and/or credit market disruptions, these events have impacted thrift access to the capital markets. As a result, we continue to monitor this activity in the markets.

## **3. Enforcement Issues and Activities**

When an institution's lending programs are found to be potentially predatory or lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to stop these practices and correct the situation. These include formal enforcement actions and informal agreements. Our jurisdiction and oversight of an institution's lending programs also extends to the holding companies, affiliates, service providers, and other contractual relationships that an institution may utilize.

For example, we previously announced the execution of a significant formal supervisory agreement to address and remedy problems created by a subprime lending program that was conducted out of a thrift affiliate. Our action against the thrift was based on its failure to manage and control in a safe and sound manner the loan origination services outsourced to its affiliate. Our supervisory agreement required the institution to identify and provide timely assistance to borrowers who were negatively affected by the



loan origination and lending practices of the thrift's affiliate and who are at risk of losing their homes in foreclosure.

Pursuant to the supervisory agreement, a reserve of \$128 million was established to cover costs associated with providing affordable loans to borrowers whose creditworthiness was not adequately evaluated when their loan was originated and to reimburse borrowers who paid excessive broker or lender fees at the time of the origination. In addition, the institution agreed to increase the reserve if the costs of remediation efforts turn out to be higher than initially estimated and, in fact, the reserve has already been increased by another \$35 million. Finally, the institution and its affiliates committed to donate another \$15 million to be used for financial literacy programs and credit counseling.

In another case involving an institution with a high level of customer complaints regarding potentially abusive servicing practices, OTS examiners were sent to the institution to review the institution's lending practices and program. Pursuant to that review, the institution was directed to implement adequate policies to address and resolve various unacceptable lending practices. When the institution failed to address these issues in a timely manner, the OTS initiated an enforcement action against the thrift.

The institution signed a written Supervisory Agreement with the OTS in which it agreed to improve its compliance with the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act and the Fair Credit Reporting Act. In addition, the institution agreed to create a "Consumer Ombudsman" responsible for "fairly and impartially reviewing and addressing [customers'] borrowing issues in a timely and effective manner." The agreement also required the development of borrower-oriented customer service plan/practices, and a consumer dispute resolution initiative plan among other things. It is also worth noting that approximately one year following the execution of the supervisory agreement, the OTS approved the institution's request for a "voluntary dissolution."

In two other cases, similar results were achieved. Using a combination of formal and informal enforcement actions, the agency forced the discontinuation of lending operations by two federally chartered thrifts based on poorly supervised lending activities. In both cases, subprime lending programs that exhibited abusive features coupled with lax management oversight controls were effectively terminated. A significant concern by the OTS staff was an effort by both institutions to attempt to exploit the charter to engage in lending programs lacking adequate consumer protections and management controls.

In one of these cases, OTS staff shut down a program that utilized brokers to do out-of-state lending activities that were lacking sound consumer protections and controls. The agency's directive to the institution concluded that the activity was tantamount to a



charter rental strategy intended to avoid State and OTS oversight of out-of-state lending activities by the institution.

We also impose conditions requiring responsible lending policies and barring abusive practices by an institution, its holding company and affiliates at the time of an acquisition. Typically, these types of conditions are appropriate when we know or have reason to believe that an acquirer plans to start or continue an existing subprime lending program at a newly acquired or de novo institution. Whenever such conditions are imposed, regional staff will work closely with and monitor the institution and its holding company/affiliates to ensure that adequate controls are imposed and maintained in connection with the subprime lending program.

We have also been vigilant in the oversight of appraisal practices within the industry. Since January 2006, the OTS has had nine formal enforcement actions addressing appraisal-related issues at OTS-regulated thrift institutions.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

#### **4. Impact of Mortgage Market Contagion**

Another issue garnering increased supervisory attention in recent months is the potential for contagion from the subprime markets affecting other sources of credit, including commercial real estate, credit card, automobile and general consumer lending, and leveraged loans. There is clearly fallout in all of these markets both from credit tightening and the adverse wealth effect that consumers are experiencing from the reduction in value of their homes, which is the biggest single asset held by many American consumers. Further exacerbating what is an already difficult credit market is the effect on institutions of turbulence in the bond insurance market, which has the potential to carry over to all aspects of the credit markets. While the current situation is presenting many challenges, OTS-regulated thrifts are responding appropriately to protect their balance sheets, but are also continuing to conduct their lending operations in a prudent and safe and sound manner.

#### **5. Real Estate Appraisal Issues**

Given the tremendous growth in originations over the last several years and increasing competition, institutions are challenged to expedite their processes and embrace, to the extent possible, available technology in providing timely underwriting



decisions. Institutions are expected to insulate their real estate appraisal and evaluation function from such pressures. The OTS and the other federal banking agencies (FBAs) maintain common appraisal regulations that include minimum standards for the performance of real estate appraisals and requirements for appraiser independence.

During examinations, we scrutinize the appraisal and evaluation function as part of our overall assessment of an institution's asset quality. Institutions are expected to document all aspects of its policies and procedures, including those for obtaining appraisals and evaluations and performing pre-funding and post-audit assessments. Starting in 2003, the OTS and the other FBAs undertook efforts to address certain concerns identified during examinations. These efforts contributed to the issuance of final interagency guidance on independent appraisal and evaluation functions in October 2003, collateral credit risk management guidance for home equity lending in May 2005, frequently asked questions on the appraisal regulation in March 2005, and frequently asked questions on residential tract development lending in September 2005.

Appraisal practices continue to receive national attention from policymakers, regulators and industry groups in light of the unprecedented level of mortgage fraud cases and continued weaknesses in the U.S. housing and mortgage markets. As draft legislative provisions and other solutions for promoting mortgage quality are debated, the OTS findings suggest that current appraisal requirements and associated guidance for federally regulated institutions are appropriate for promoting sound real estate appraisal and evaluation practices. As with any processes or systems, appropriate staffing as well as effective internal controls and audits are essential. Institutions must be vigilant in obtaining accurate appraisals and evaluations and ensuring that individuals performing these valuations are independent of the loan production process.

### **C. Interagency Guidance**

An important role of the federal banking agencies during the course of activity in the mortgage markets the past several years has been the issuance of various statements and guidance on subprime lending, non traditional mortgage products, loan modifications and mortgage servicing. This guidance, available at the OTS website at [www.ots.treas.gov](http://www.ots.treas.gov), includes the following:

- Illustrations of Consumer Information for Nontraditional Mortgage Products that directs financial institutions to provide clear and balanced information to help consumers make informed choices.
- Proposed Illustrations of Consumer Information for Subprime Mortgage Lending seeking comment on the illustrations to assist institutions in providing consumer information on subprime lending programs.





- Interagency Guidance for Nontraditional Mortgage Product Risks addressing supervisory concerns with the use and proliferation of certain nontraditional mortgage (NTM) products.
- Statement on Subprime Mortgage Lending to address issues relating to certain adjustable-rate mortgage (ARM) products that can cause payment shock.
- Statement on Workouts/Loan Modifications With Borrowers encouraging institutions to work with homeowners who are unable to make mortgage payments.
- Statement on Servicing for Mortgage Loans encouraging servicers of securitized residential mortgages to determine the full extent of their authority to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

#### **IV. Foreclosure Prevention and Loss Mitigation Efforts**

##### **A. OTS Foreclosure Prevention Proposal**

In exploring solutions to foreclosure prevention or effective loss mitigation efforts, it is important to understand the role and interests of the various participants involved in and/or affected by actions to alter the normal course of events that were anticipated when a mortgage loan was made and, in many cases, subsequently securitized. In fact, the understanding and analysis of these various relationships provides the framework for the foreclosure prevention proposal set forth by the OTS. It is important to understand these relationships in considering any solution to foreclosure prevention in the current market context.

##### **i. Overview of Affected Parties/Participants**

The first and most obvious group of affected participants is the borrowers. Even within this group, however, there may be various competing interests represented with the result that there often is not a typical borrower profile. This, of course, complicates appropriate responses and solutions aimed at assisting borrowers on a blanket or wide-scale basis. Generally, borrowers can be sub-grouped into three broad classes:

- Borrowers not able to sustain the financial demands of homeownership;
- Borrowers who can be helped, and who were put into their current situation because they were victims of predatory lending, poor loan advice, or poor judgment on their own part; and



- Borrowers who can be helped, and were put into their current situation because of a change in their personal circumstances and now require payment flexibility to get back on their feet.

The next most obvious group of participants in the process is lenders. Within this group, there are generally two sub-groups – portfolio lenders and lenders who originated for sale into the secondary market. While it is relatively straightforward to understand the interests of a portfolio lender, the interests of lenders who originated for sale may be more difficult to gauge. For example, originators that maintained good documentation and underwriting standards will generally be able to approach any solutions with the knowledge that they can do so from a position of relative strength given potential litigation risks. In contrast, originators that failed to document and/or conduct good underwriting may be forced into solutions that are not optimal for them (and sometimes even the borrower) because of the threat of litigation.

The next group of participants with a keen interest in any potential foreclosure prevention of loss mitigation activities is investors in the securitization. Again, there are multiple layers or sub-groups within this group of participants in a securitization. A typical securitization has a number of different investor types with differing risk profiles, return expectations, and interests in the securitization. For example, there will be the highest rated investors who have agreed to take a lesser return and assume a lower risk profile in exchange for a more stable and predictable income stream. Next, the typical securitization will have a mezzanine tranche of investors who have a more elevated risk profile than the AAA (highest rated) investors, but who also expect a certain return on their investment in the securitization. Finally, at the other extreme are the residual owners or investors in the securitization. These investors bought into the deal with the understanding that they had the potential for significantly high returns if the securitization performed as expected, but they would also take the first losses if the securitization did not perform as expected.

Next, we have the interests of the securitizers, as well as the trustee of the trust established to hold the mortgages pursuant to the securitization. While the interests of these two groups are not clearly aligned, both will attempt to ensure that the best interests of the investors are served. While the trustee will pursue this agenda with the understanding that it has a fiduciary duty to the investors to do so, it is sometimes confusing to figure out exactly how this fiduciary duty may be served in protecting the interests of different types of investors in the securitization. In contrast, the securitizer will typically attempt to make sure that a securitization remains intact to avoid litigation exposure and potential tax and accounting issues arising from its initial actions in establishing the securitization.

Finally, perhaps the most complicated and complex interest in a securitization is that of the servicer whose job it is to make sure the mortgage loans perform and payments are made to the mortgage trust based on the timetable established in the securitization. In



effect, the servicer is the banker as well as bill collector for the securitization. In this regard, the role of the servicer is critical to the success and continued viability of a securitization. For the same reason, the servicer also figures prominently in any efforts to prevent foreclosures of mortgage loans held by the trust, as well as in loan modification and loss mitigation efforts to keep borrowers in their homes. Providing proper financial incentives and/or aligning the interests of the servicer with the other parties in a securitization is, we believe, an important key to the success of any foreclosure prevention or loss mitigation program.

## **ii. The OTS Proposal**

In examining the various issues in the current market context, the OTS set out to identify and address what it perceives to be the most significant problem in today's housing market. In our view, this problem is avoiding foreclosures of owner-occupied properties held in securitizations where a distressed borrower – including a borrower facing an insurmountable reset – is unable to refinance a loan because the fair market value of the property is less than the current outstanding loan amount.

In pursuing a solution to this problem, we had a number of objectives. First, we were seeking to identify a market-driven solution that relies on existing (or already proposed) programs and avoids a new government guarantee or assistance. We also wanted to ensure that any solution minimizes motivations for “gaming” the system by borrowers currently able to pay under their existing loan. Similarly, we sought to avoid providing a windfall to borrowers and investors in the securitization. And we were attempting to identify a solution that optimizes servicer incentives to seek it out and investor incentives and motivations to accept it.

Finally, we sought to ensure that the solution that we identified to meet these objectives involves implementing a program in which OTS-regulated institutions could actively participate, along with other lenders, without taking additional, undue risks onto their balance sheets.

Pursuant to the OTS proposal, depository institutions would offer and underwrite FHA-insured loans (i.e., under the FHA's existing standards and FHA programs already in place) based on the current fair market value of the property. Depending on how a program is structured, such loans could be at the FHA-insured maximum 97 percent LTV ratio, or a lesser percentage LTV. The proceeds of the new FHA-insured loan would then be used to provide a partial pay-off of the outstanding balance of original mortgage loan to the holder of that loan. And, finally, the key to all of this is that the original investors would receive a “negative equity interest” (e.g., a negative equity certificate representing an interest in the negative equity) in the difference between partial pay-off (from the FHA-insured loan) and the balance of the original mortgage loan held in the securitization pool.



As we have structured the proposal, upon the subsequent sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the investors with the proceeds of the FHA-insured loan) would be payable to the investors up to the full amount of the negative equity interest held by the investors, with any sale proceeds beyond that amount being payable back to the borrower.

Finally, we have had numerous discussions with policymakers over the past few weeks and several additional ideas have come out of these discussions that we believe may provide useful refinements to the proposal. Chief among these is the idea that the negative equity interest created under the proposal could be shared among the existing holders of the loan currently in the securitization, the FHA or other government entity (recognizing the government's interest arising from FHA's insurance, which is a critical component of the program), and even the borrower/homeowner to maintain appropriate incentives if the value of the property eventually begins to appreciate and puts the negative equity interest "in the money." On this latter point, giving the homeowner even a nominal amount in the upside appreciation of the property will keep intact incentives for the borrower to maximize value on resale and continue to maintain the property.

Another concept that has been broached recently is the idea that it may make more sense from the standpoint of the FHA's interest in maximizing its existing resources and risk exposure to have a program in which the new FHA-insured loan is at a LTV ratio less than the current 97 percent maximum permitted by the FHA (e.g., a 90 percent LTV). Depending on the risk profile of the borrower and the nature of the real estate market in which the property securing the mortgage is located, the FHA may choose to tighten its standards (by lowering the LTV ratio) and/or structuring its insurance premiums to mitigate increased risk exposure. Under this scenario, as with the full 97 percent LTV, the difference between the old loan and the new loan would be allocated to the negative equity interest or certificate representing that interest.

We are continuing to work with policymakers and industry officials to identify issues and potential weaknesses in our proposal, as well as to make further refinements to improve it. Our goals and underlying rationale for the proposal remain:

- Providing a market-driven solution that does not "bail out" investors or borrowers, but rather promotes responsible lender and borrower behavior;
- Requiring investors to take a lesser amount at payout, but not a dramatically reduced recovery such as that in a foreclosure of the original loan (thereby providing incentives for investors to pursue the program);
- Avoiding a windfall to borrowers by requiring appreciation in a subsequent sale to be paid to investors up to the amount of the negative equity interest



(perhaps adjusted for borrower incentives paid out of the negative equity interest in order to protect underlying property valuation);

- Relying on existing FHA and similar programs – including FHA-insurance – to help in resolving problem loans in securitizations;
- Creating a potentially marketable financial instrument in the negative equity interest that could be tradable;
- Providing adequate and proper incentives for servicers to implement foreclosure prevention programs that are in the best interests of investors and borrowers (and acceptable to investors);
- Maintaining the integrity of the securitization structure and terms of the pooling and servicing agreement with minimal disruption to the mortgage securities market; and
- To the extent practicable, identifying a tax-neutral solution that does not involve forgiveness of debt and thereby create an immediate taxable event for a borrower.

## **B. Loan Modifications and Workouts**

One of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset – or for which a rate reset has already occurred – in order to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practicable to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as ensure the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about two million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. The initial "starter rate" for these loans typically ranged from 7 percent to 9 percent; and about 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and



2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. In fact, as recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to rise from about 6 percent currently to about 10 percent by 2009.

There are several important factors in structuring a viable loan modification program that can influence these projections downward. First, as I note at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should be eligible if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for a minimum of 36 months, but a good argument can be made for a minimum of five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable for an additional 36 months or longer.

We are aware of a number of loan modification programs that have already been established. While these programs have been in place for generally short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more comprehensive fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We are supportive of all of these programs and efforts to address the problem and encourage that any standards or guidelines provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical in exploring viable solutions that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While there have been some who have suggested that solutions from the capital markets have fueled speculative and unsafe



mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. In other words, we must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads to addressing the wave of rate resets for subprime 2/28 and 3/27 mortgage loans. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done – and soon.

As recently reported, there have been significant industry efforts to identify practices and approaches to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe that legislative and/or regulatory actions could hinder rather than help at this point in the process. Instead, we encourage the industry to identify and implement solutions that work, with the full understanding that regulatory intervention will occur quickly if it becomes clear that any proposed solution(s) will not be effective.

## **V. Strengthening Consumer Protections in the Mortgage Markets**

For most Americans, a home is their single largest investment, as well as the single largest debt obligation they will incur during their lifetime. However, many of the types of fundamental consumer protections in place with respect to investing in the securities markets or depositing your money at a financial institution are not paralleled when it comes to investing in a home. In our view, strengthening consumer protections in the mortgage markets not only protects borrowers, it also protects lenders and all other participants in the mortgage process from the types of market meltdown and contagion we are currently experiencing.

There have been a number of suggestions for improving protections for homebuyers/borrowers that are important in understanding how we can improve the mortgage markets. These include two regulatory initiatives, the OTS Unfair or Deceptive Acts or Practices (UDAP) proposal and the Federal Reserve Board's Regulation Z proposal; a separate OTS proposal aimed at tightening federal regulation and oversight of mortgage banks and originators; and various legislative proposals, including your bill,



Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007, which would reform and bolster existing consumer protections in the mortgage markets.

#### **A. The OTS UDAP Proposal**

On August 6, 2007, the OTS issued an Advance Notice of Proposed Rulemaking (ANPR) requesting comment on the issuance of additional OTS regulations implementing section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive acts or practices (UDAPs). The ANPR solicited comment on a wide range of potential UDAPs in addition to those already covered by the existing OTS Credit Practices Rule.

Based on our review of comments from consumer advocates, industry representatives, members of Congress, and the general public, we are working to issue a Notice of Proposed Rulemaking (NPR) in the near future. We expect the UDAP rule will address certain practices that have raised concern, including retroactive rate increases and double cycle billing. In response to commenters' requests for consistent interagency standards and an even playing field, we have invited the other federal agencies with FTC Act rulemaking authority – the Federal Reserve Board, Federal Trade Commission, and National Credit Union Administration – to participate in the rulemaking. Our goal is to issue an interagency proposal this spring.

#### **B. The FRB's Regulation Z Proposal**

Another regulatory proposal aimed at addressing certain consumer protection issues in the mortgage markets that have been prominently highlighted in recent years is the FRB's Regulation Z proposed rulemaking. Under the amendments proposed to Regulation Z by the FRB, a new category of "higher-priced mortgages" would be established with additional consumer protections. These would include a requirement to assess a borrower's ability to repay a loan, limits on prepayment penalties, and escrow requirements. In addition, the proposal would impose certain requirements on all mortgages, including severe restrictions on yield spread premiums, appraisal standards, and barring certain predatory billing and deceptive advertising practices.

Without commenting on the specifics of the FRB's proposal, we are supportive of its efforts to address consumer protection deficiencies in our current mortgage market. As I noted earlier, correcting such deficiencies will benefit all market participants and the overall health and stability of the housing and mortgage markets.

#### **C. S. 2452 and Other Pending Legislative Proposals**

We have also reviewed your legislative proposal, Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007, which would reform and





bolster existing consumer protections in our mortgage market. Your bill would expand protections and coverage for high cost loans, including restricting the financing of points and fees; barring prepayment penalties, yield spread premiums and balloon payments; and requiring a “net tangible benefit” to the borrower of a high cost loan.

Like H.R. 3915, the House-passed mortgage reform bill, your legislation would subject most non-prime loans to certain requirements, including demonstration of an ability to pay the loan. It would also impose certain duties on lenders and other participants in the mortgage process in their dealings with borrowers.

While we are continuing to study the potential impact on the mortgage markets of your proposal, Mr. Chairman, that are two remaining provisions of the bill that deserve mention and serious consideration in any mortgage reform legislation. These are the foreclosure prevention counseling requirements, and extending to the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation authority to issue regulations under section 5 of the FTC Act (i.e., UDAP regulatory authority).

I look forward to working with you, Mr. Chairman, on S. 2452 and all other relevant legislative proposals to amend, revise and/or reform our mortgage system.

#### **D. Federal Regulation and Oversight of Mortgage Banks and Brokers**

At the OTS, we focus our regulatory approach on maintaining a mortgage lending industry that complies with applicable consumer protection laws and regulations. We strive to achieve these objectives with a minimum of burden on the industry and with expert staff that have a unique understanding of the financial services and mortgage industries. We support private sector solutions that promote innovation and competition over excessive regulation, but we also ensure that OTS staff are fully engaged and committed to our mission of protecting the safety and soundness of the institutions we supervise, examining for compliance with consumer protection laws, and encouraging a competitive industry that meets the financial services needs of its customers.

A prominent issue in the in the context of the current mortgage market situation has been the lack of meaningful oversight of certain key players in the mortgage process. While there has been a lot of attention directed at bolstering oversight of mortgage brokers and originators – which we strongly support – we also believe federal oversight of the entities that fund the mortgage process would be beneficial. It is critical to ensure that mortgage banks be forced to compete by the same set of standards as insured depository institutions.

Establishing a partnership between the states and a federal overseer to set and enforce minimum mortgage funding standards would ensure accountability and consistency throughout the mortgage lending process. This would be similar to the partnership that exists between the FDIC and state banking commissioners in the



oversight of state-chartered banks. Such a partnership need not involve establishing a federal mortgage banking charter, but rather a federal-state partnership to regulate these entities and ensure nationwide uniformity.

The OTS has extensive expertise in the oversight and supervision of mortgage banking operations, as well as mortgage originators, that I believe would benefit both the mortgage origination process and the currently unregulated mortgage banking market.

While it is not my intention to expand our regulatory authority, the OTS is in a unique and skilled position to help level the playing field by acting as a backstop for state licensing and registration for originators, as well as participating in a prudential federal-state supervision of state mortgage bankers who fund mortgages. If Congress determined that the OTS could provide the best solution by taking on these responsibilities, we would assume these duties by applying a wealth of institutional knowledge and experience supervising and regulating all aspects of the mortgage markets.

## **VI. Conclusion**

Thank you, Mr. Chairman, Senator Shelby and Members of the Committee, for the opportunity to testify on behalf of the OTS on the current condition of the thrift industry and on various OTS proposals to address existing issues and problems in the mortgage markets.

As detailed in my statement, disruptions in the mortgage markets are having a significant impact on the financial condition of the thrift industry; however, the industry's capitalization remains strong and asset quality is relatively stable. We continue to monitor industry exposure to the fallout from problems in the subprime lending market; and we are also closely monitoring thrift industry exposure to upcoming resets on prime option ARMs that are expected to occur in the next several years.

We are also continuing to study various issues and problems in the mortgage markets that are affecting thrift lenders and other market participants. Among the solutions that we believe have merit are a foreclosure prevention proposal to keep distressed borrowers in their homes by partially paying off their current "underwater" mortgages with an FHA-insured loan and allocating the balance to a negative equity interest that would pay out in the event of future appreciation upon sale of the property. We also encourage the Committee to consider OTS-proposed legislation that would permit thrift institutions greater diversification of their assets into small business and consumer lending activities. Finally, we encourage the Committee to consider legislation to provide federal oversight and regulation of mortgage banks and brokers, including whether the OTS could provide the best solution by taking on these responsibilities.



We look forward to working with you, Mr. Chairman, Senator Shelby and the Members of the Committee to address the current and upcoming challenges in the mortgage markets. Thank you.