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Responses to the Questionnaire on Supervision compiled by OTS

Holding Company Supervision

OTS supervises savings associations and their holding companies to maintain safety, soundness, and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs. As the primary federal regulator of savings and loan holding companies, OTS has the authority to supervise and examine each holding company enterprise, but relies on the specific functional regulators for information and findings regarding the specific entity for which the functional regulator is responsible.

The focus of this authority is the consolidated health and stability of the holding company enterprise and its effect on the subsidiary savings association. OTS oversees the enterprise to identify systemic risks, issues and weaknesses, as well as ensure compliance with regulations and laws that govern permissible activities and transactions. The examination goal is consistent across all types of holding company enterprises; however, the level of review and amount of resources needed to assess a complex structure is vastly deeper and more resource-intensive than what would be required for a less complex holding company.

Effective enterprise risk management, commensurate with the size and complexity of a financial institution's operations, is paramount. The lessons learned from this economic cycle support this conclusion. A holistic approach to identifying, assessing and managing risk is relevant not only for financial institutions, but also for the regulatory environment. The interdependency of each risk area warrants a comprehensive solution from financial institutions and the agencies that regulate them.

A savings and loan holding company is subject to ongoing monitoring and examination. Managerial resources, financial resources and future prospects continue to be evaluated through the CORE holding company examination components (i.e., Capital, Organizational Structure, Risk Management and Earnings). The OTS holding company examination assesses capital and earnings in relation to the unique organizational structure and risk profile of each holding company. During OTS's review of capital adequacy, OTS considers the risk inherent in an enterprise's activities and the ability of the enterprise's capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

OTS conducts examinations of thrift holding companies based on a range of factors including risks the holding company or its subsidiaries may present to the thrift institution. For example, OTS recently conducted an examination of a subsidiary of a savings and loan holding company that was engaged in a significant subprime lending program. The examination, which was part of a review coordinated with the Federal

Reserve, as the other holding company regulator, and non-bank regulators including the FTC and state banking departments, focused on adherence to a broad range of federal consumer protection laws. Participating state bank regulators focused on adherence to applicable state consumer protection laws. OTS is utilizing the lessons learned from the holding company examination to assess the manner in which the Agency conducts examinations of holding company subsidiaries in the future

OTS assigns a holding company enterprise to one of the following three categories: noncomplex and low risk holding company enterprises, complex or higher risk holding company enterprises, and conglomerates. OTS defines conglomerates as corporate enterprises comprising multiple companies or legal entities that operate in different fields. OTS has developed a continuous supervision program for conglomerates and certain higher risk holding company enterprises. The approach tailors the examination and supervision to address the complex and unique characteristics of this type of enterprise. Specific examination procedures for conglomerates have been established.

OTS determines the complexity and level of risk by considering:

• The level of interdependence among the corporate entities in the enterprise, including the thrift's dependence on the holding company and other affiliates to perform core functions;

• Reliance on intercompany borrowings and the method by which the thrift or significant affiliates are funded;

•Type and character of intercompany transactions;

• The risk profile and risk concentrations of the enterprise, including a review of the nature and type of business activities in which the entities in the enterprise engage;

• Financial strength and stability of the holding company enterprise;

• Review of functional supervisors' findings at regulated entities in the holding company enterprise; and

• Review of foreign supervisors' findings at foreign regulated entities in the holding company enterprise.

Institution Level Supervision

OTS conducts comprehensive examinations combining safety and soundness and consumer compliance reviews. OTS examination teams author one report of examination that covers both compliance and safety and soundness issues. These examinations evaluate the association's ability to identify, measure, monitor and control risk. The OTS tailors its supervisory oversight to the risk profile of each thrift institution, conducting an onsite examination every 12- to 18-months to assess safety and soundness, and compliance with consumer protection laws and regulations. Each examination, as well as the agency's overall examination strategy, focuses on risk, devoting the greatest resources to the highest risk areas. Examiners also monitor thrifts through off-site analysis of regularly submitted financial data and routine contact with thrift managers.

OTS examination procedures direct savings associations to conduct robust self-assessments of their policies, procedures, and compliance with applicable laws and regulatory guidance. OTS examiners review such self assessments, along with reviews prepared for internal or external audits during examinations, as a component of following agency or interagency examination programs. However, self assessments are considered in the course of conducting examinations and do not replace the examination function.

With respect to consumer protection supervision, the OTS expects all institutions, both large and small to develop an effective compliance risk management program, including systems, policies and controls to ensure compliance with the broad range of consumer protection statutes, regulations and other requirements. The compliance program may vary from an enterprise wide solution for large and complex institutions to a less structured program for smaller, less complex institutions. OTS does not dictate the structure itself, encouraging institutions to tailor their program based on the structure and needs of the thrift, provided the compliance program is effective.

As OTS-regulated organizations become more dynamic and complex, their operations require ongoing oversight rather than a periodic examination. Accordingly, OTS implements a continuous supervision program for its most complex savings associations and holding companies. Continuous supervision and examination combines on-site examination work, routine communication, and off-site planning, monitoring, and analysis into one ongoing examination process. The ongoing examination process includes developing planning documents; performing examination work; annually aggregating findings, recommendations, and corrective actions into a report of examination; and assigning examination ratings.

Further, the examination of related organizations is essential in evaluating the overall safety and soundness of a savings association. Related organizations can significantly affect the operations and overall financial condition of their parent thrift. The purpose of the examination is to determine the extent to which the related organization poses a risk to the parent thrift. In identifying areas of risk, examiners must fully understand the relationship between the parent thrift and its related organizations. This relationship will vary depending on, among other considerations, the amount of the parent thrift's investment, the organization's activities, the extent to which business is conducted through multiple "lower tier" entities, and restrictions imposed by regulation.

A thrift's conduct of activities through a related organization can involve complex management issues, legal obligations to honor the organization's debts if separate corporate identities are not maintained, or a negative effect on the parent thrift's consolidated income stream. Conversely, related organizations may serve to isolate risky activities in a separate corporate entity, allow geographic expansion or joint investment opportunities with other thrifts, and provide increased consolidated earnings.

The primary purpose of examining related organizations is to evaluate the level of risk that these entities pose to the parent thrift and thereby the insurance fund. The examination procedures highlight the following four primary areas of review: management quality; asset quality; earnings analysis; and compliance.

Actions Resulting From Lessons Learned

OTS is taking steps to adjust its examinations based on the lessons learned during the economic crisis. For example, OTS has established a Large Bank Unit that monitors the operations, identifies emerging risks, reviews draft examination reports, and has input into the comprehensive supervisory approach of large and complex thrifts in coordination with Regional examination staff and management. Concentration risk, liquidity risk, capital adequacy, allowances for loan and lease losses and fair value accounting are critical areas where risk management deficiencies contributed to the recent turmoil. OTS is committed to refining and improving its oversight to ensure that financial institutions adopt stronger risk management programs.

OTS identified growing risks associated with nontraditional mortgage loan products including Interest Only and Payment Option ARM loans. As such, OTS played a material role in coordination with the other federal banking regulators in developing the Interagency Guidance on Nontraditional Mortgage Products, (Guidance) released for comment in December of 2005 and finalized in 2006. The Guidance emphasized prudent underwriting standards, including an analysis of a borrower's capacity to repay the debt by final maturity at the fully indexed rate; heightened supervisory expectations and scrutiny of reduced documentation; and the need to adequately monitor and manage concentrations in nontraditional mortgage products.

The guidance also addressed a broad range of consumer protection issues and concerns including the need to present consumers with balanced information on the risks and benefits associated with nontraditional mortgage products; the need to ensure that nontraditional mortgage lending programs were in compliance with consumer protection laws including those prohibiting unfair or deceptive acts and practices; and the importance of effective disclosures of material terms to help the potential borrower make an informed choice concerning whether to accept a nontraditional mortgage. OTS also played a significant role in developing Interagency Nontraditional Mortgage Product Illustrations that institutions could use to conform with the consumer protection principles identified in the Guidance.

Recent events illustrate that liquidity risk management at many insured depository institutions needs improvement to comply with existing guidance. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, insufficient cash flow projections and a lack of viable contingency funding plans. The current crisis also identified areas where it is necessary to strengthen supervisory guidance and oversight. In mid 2007, the secondary mortgage markets began showing signs of stress as investor appetite for non-conforming mortgages greatly diminished. Many large institutions that relied on the originate-to-distribute model were trapped by the speed and magnitude of market liquidity evaporation. As the size of their mortgage warehouse ballooned, lenders and depositors became increasingly concerned about the financial health and long-term viability of these organizations. Those institutions that had a strong contingency funding strategy were able to find temporary relief until they could develop longer-term solutions.

OTS is working with the other U.S. banking agencies to issue updated interagency guidance on funding liquidity risk management. The revised guidance will incorporate the recent lessons learned and the liquidity guidance issued by the Basel Committee on Banking Supervision. As part of this guidance, the agencies will reiterate the need for diversified funding sources, stress testing and an unencumbered cushion of highly liquid assets that are readily available and are not pledged to payment systems or clearing houses. This increased emphasis on high-quality liquid assets is important because many firms had a misconception about the extent to which decreases in market and funding liquidity are mutually reinforcing. As market liquidity erodes, so does the availability of funding. The regulatory agencies released the revised guidance with a notice for public comment in June 2009.

OTS is mindful of the risk management recommendations presented in the Senior Supervisors Group report on Risk Management Practices, the Financial Stability Forum's report on enhancing market and institution resilience, the Basel Joint Forum's report on the identification and management of risk concentrations, and the Government Accountability Office (GAO) report on regulatory oversight of risk management systems. The agency reviews these reports and integrates their findings when revising regulatory guidance and examination programs. OTS participated on the Joint Forum working group that produced the report on risk concentrations. Several of the report's recommendations derive from OTS expertise in supervising or regulating financial institutions ranging from community banks to international conglomerates. All of the federal banking agencies are members of the international Basel Committee on Banking Supervision, which comprises banking supervisors worldwide. The Basel Committee on Banking Supervision provides an international forum to collaborate and improve the quality of bank supervision. Managing compliance with consumer protection laws is also a critical element of effective enterprise risk management and is a focus of OTS supervisory oversight of risk management.

The OTS is working with the other federal banking agencies and global policymakers to revise or enhance existing policies, including involvement in the Basel Committee's recent proposals to enhance the Basel II framework for re-securitizations, certain liquidity facilities, and improved value-at-risk models and stress testing. Policy changes are being considered in a number of areas, including liquidity supervision; treatment of shadow banking (off-balance sheet vehicles, private equity, hedge funds); remuneration and corporate governance; and cross-border resolution and supervisory coordination. OTS is actively involved in efforts to strengthen enterprise-wide risk management and stress testing practices for large financial organizations.

OTS saw breakdowns in market discipline, which was an important element of our supervisory assessment. Areas that we now know were flawed included: over reliance on financial models, rating agency influence on structured products, lack of due diligence in the packaging of asset-backed securities, underwriting weaknesses in originate-to-distribute models, and lack of controls over third-party (brokers, conduits, wholesalers) loan originators.

In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on historical data. This led to an underestimation of the unprecedented economic shock and misjudgment of stress test parameters.

To be effective, supervisory intervention must be timely when an institution is experiencing a rapid and severe deterioration in its financial condition. However, because Prompt Corrective Action (PCA) is linked to declining capital categories, we have learned that its utility is limited in a liquidity crisis, particularly when the crisis is widespread. We have witnessed severe and rapid declines in the financial condition of well or adequately capitalized institutions that were precipitated by an inability to meet rapid, sustained deposit outflows or other cash and collateral demands. In the current crisis, PCA has not been an effective supervisory tool because its triggers for supervisory action are capital driven. Extraordinary liquidity demands typically do not produce the gradual erosion of capital envisioned by PCA. It is possible to modernize the PCA framework to link the PCA system to other risk areas.

OTS has learned multiple lessons during this economic cycle and has used this knowledge to refine and improve its regulatory program. The agency conducts independent internal failed bank reviews for savings associations placed in receivership and generates a series of recommended actions to supplement and improve its regulatory oversight. Upon finalizing each review, senior management distributes internal guidance identifying lessons learned to improve examiners' focus on critical risk management areas. OTS also committed to implement the recommendations from the Material Loss Review reports from Treasury's Office of the Inspector General. The agency has made substantial progress in implementing the recommended actions to improve regulatory oversight.

Specific actions taken to improve regulatory oversight include:

- OTS is also strengthening its examination and supervision of savings associations with high-risk business models or reliance on volatile funding sources. In some cases, the OTS is obtaining daily liquidity monitoring reports from financial institutions to identify cash in-flows and out-flows and the availability of unpledged collateral. We are also stressing the need for institutions to test the actual availability of lines of credit and to work actively with their respective Federal Home Loan Banks to ensure sufficient borrowing capacity. OTS is also conducting a review of liquidity risk management to identify best practices and issue guidance to savings associations. The agency is using the review to develop additional liquidity metrics as a tool for examiners to use to identify institutions with developing liquidity problems.

- OTS is collaborating with the OCC to produce a quarterly Mortgage Metrics Report that analyzes performance data of first lien residential mortgage loans serviced by federally regulated savings associations and national banks. The goal is to provide a comprehensive picture of mortgage servicing activities of the industry's largest mortgage services. This report includes data on mortgage delinquency rates, home retention actions, and foreclosures on over 60 percent of residential mortgages serviced in the United States.

- In March 2009, established a Large Bank Unit to manage and monitor significant issues facing OTS-regulated savings associations with assets exceeding $10 billion or institutions identified by senior management that warrant additional monitoring.

- On May 14, 2009, alerted institutions and examiners to new "other-than-temporary impairment" accounting guidance for debt securities.

- On May 22, 2009, issued a summary of sound practices observed in connection with the OTS 2008 horizontal review of the Allowance for Loan and Lease Loss methodologies of a number of large thrifts. The purpose of the guidance was to highlight savings association best practices. This guidance discussed inflection points or periods of increasing or decreasing losses, the use of lagging data when loss rates change quickly, and validation methods that rely on leading data rather than historical loss experience.

- On June 25, 2009, issued guidance further explaining and providing examples of how to risk weight downgraded securities in recognition of stresses in the market and numerous rating changes assigned by nationally recognized statistical rating organizations.

- On June 30, 2009, released for public comment an interagency policy statement on liquidity-risk management to provide consistent interagency expectations on sound practices for managing funding liquidity risk. The guidance summarizes the principles of sound liquidity-risk management that the agencies have issued in the past and are currently outstanding, and, where appropriate, brings these principles into conformance with the international guidance recently issued by the Basel Committee on Bank Supervision entitled "Principles for Sound Liquidity Risk Management and Supervision."

- On July 9, 2009, issued guidance to re-emphasize important risk management practices for financial institutions' boards of directors and management and to encourage institutions to revisit their existing concentration policies given the current economic environment.

Supervision of Smaller Institutions

OTS supervises a substantial number of smaller thrift institutions. As such examiners need a solid understanding of bank operations. For the most part these thrifts tend to be less complex and take on less risk, other that the concentration risk of making mostly mortgage and consumer loans. The smallest of these institutions do not engage in secondary market sales and thus keep all of their loan production on their own books.

The skill set required to examine smaller institutions is a more basic set. Whereas larger institutions or those with greater complexity require examination skills that are often specialized into Capital Markets, Credit and Interest Rate Risk the smaller exams do not usually require such specialties.

Concentration Risk

Poorly managed concentration risk contributed significantly to the deterioration in performance of several OTS-regulated problem banks. Concentrations are groups of assets or liabilities that have similar characteristics and expose a financial institution to one or more closely related risks. OTS defines a concentration as an asset, liability, or off-balance sheet exposure that exceeds 25 percent of the association's core capital, plus allowances for loan and lease losses. The agency encourages its examiners to use discretion in identifying higher-risk assets or liabilities that may not meet this threshold, but still pose a concentration risk. OTS also encourages financial institutions' Boards of Directors to approve limits and monitor concentrations based on their exposure relative to Tier 1 capital and allowances for loan and lease losses.

Concentrations pose risk because the same economic, political, geographic, or other factors can negatively affect the entire group of assets or liabilities. The financial industry and the regulatory community have learned a valuable lesson about the risk exposure of asset, liability and off-balance sheet concentrations. Institutions with concentrations need to manage the risk of individual assets or liabilities, as well as the risk of the whole group. For example, an institution may have a portfolio of prudently underwritten loans located in a single geographic location. The geographic concentration exposes otherwise prudent loans to the risk of loss because a single regional economic event can expose the entire portfolio to losses. If the institution does not appropriately manage its geographic lending activity through size, sector and counterparty limits, then it has heightened risk exposure. Management should regularly evaluate the degree of correlation between related assets or liabilities, and establish internal guidelines and concentration limits that control the institution's risk exposure.

The Basel Committee on Banking Supervision Joint Forum's paper on concentration risk surveyed and summarized concentration risk management among financial conglomerates. While its focus was on financial conglomerates, the principles of concentration risk it identified are applicable to all financial institutions. It suggests that concentration risk has three elements. The first element of concentration risk is materiality. Financial institutions must identify whether the risk concentration can produce losses that threaten their health or ability to maintain their core operations. They must also determine whether an interruption in the concentrated business activity would lead to a material change in their risk profile. The second element is the identification of single, or closely related, drivers of risk that may affect each part of the institution differently. Effective risk management requires that the impact of these drivers be integrated into any analysis to assess the overall risk exposure of the institution. The third element is that risk concentrations arise not just in assets, but also in liabilities, off balance sheet items, or through the execution or processing of transactions.

OTS captures each of these elements in its supervisory program and requires examiners to document concentrations of assets, liabilities and off-balance sheet activity in each comprehensive examination report. The agency is acutely aware of the risk that a concentration can pose to an institution, whether the concentration arises from a business strategy, a product type, or a funding program. OTS guidelines recommend establishing limits based on a ratio of the asset, liability, or off-balance sheet item to core capital and allowances for loan and lease losses. In many cases, OTS places limitations on the amount of assets, liabilities, or other activities that expose the institution to concentration risk through the regulatory process. Firms should also have additional capital as a buffer against the larger loss potential that a concentration can present. The agency also has expectations that savings associations with high concentration risk establish robust risk management practices to identify, measure, monitor and control the risk.

A key concentration risk that OTS identified in the current crisis is the risk exposure of warehouse and pipeline loans in financial institutions that engage in an originate-to-sell business model during stressful market events. In response, OTS updated its one- to four-family real estate lending examination handbook in September 2008. The agency also distributed a letter to Chief Executive Officers outlining revised recommendations for monitoring and managing the level of pipeline, warehouse and credit-enhancing repurchase exposure for mortgage loans originated for sale to nongovernment sponsored purchasers. In the letter, OTS states that any concentration that exceeds 100 percent of Tier 1 capital will receive closer supervisory review. This revised guidance was in response to the lessons learned from recent bank failures and a horizontal review of all OTS institutions to assess the examination and supervision of mortgage banking activity.

Another example of the regulatory expectations for concentration risk management is the 2006 guidance on managing commercial real estate concentration risk. The guidance applied to savings associations actively engaged in commercial real estate (CRE) lending, especially those that are entering or rapidly expanding CRE lending. The guidance states that institutions should perform a self-assessment of exposure to concentration risk. They should continually monitor potential risk exposure and report identified concentration risk to senior management and the board of directors. The guidance also recommends implementing risk management policies and procedures to monitor and manage concentration risk based on the size of the portfolio and the level and nature of concentrations.

The OTS expects savings associations to continually assess and manage concentration risk. OTS conducts quarterly monitoring of savings associations' investments to determine compliance with portfolio limitations and to assess each association's exposure to concentration risk. An institution should hold capital commensurate with the level and nature of its risk exposure. Accordingly, savings associations with mortgage banking or commercial real estate concentration exposure should assess the credit risk, operational risk and concentration risk of those business activities. In assessing the adequacy of an institution's capital, OTS also considers management expertise, historical performance, underwriting standards, risk management practices and market conditions.

By the nature of the thrift charter, savings associations are required to hold a concentration in real estate mortgage or consumer lending-related assets. OTS-regulated savings associations are subject to two distinct statutory restrictions on their assets, which contribute to this inherent concentration in mortgage lending. The first is a requirement that thrifts hold 65 percent of their assets in qualified thrift investments. This ensures that thrifts maintain a focus on mortgage and retail consumer lending activities. The second set of restrictions includes limitations on the ability of savings associations to engage in specific lending activities, including consumer, commercial and small business lending. Although there is merit for maintaining restrictions to ensure that savings associations focus on mortgage and retail consumer and community lending activities consistent with the purpose of the thrift charter, certain asset restrictions contradict the purpose of the charter and compromise safety and soundness. For example, savings associations have no limits on 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 over secured consumer lending. Similarly, the existing 20 percent of assets limit on small business lending discourages thrifts from pursuing business activities that could diversify their lending operations and credit risk.

Systemic Risk

The establishment of a systemic risk regulator is an essential outcome of any initiative to modernize bank supervision and regulation. OTS endorses the establishment of a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose a risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including but not limited to companies involved in banking, securities and insurance.

For systemically important institutions, the systemic risk regulator would supplement, not supplant, the holding company regulator and the primary federal bank supervisor. A systemic regulator would have the authority and resources to supervise institutions and companies during a crisis situation. The regulator should have ready access to funding sources that would provide the capability to resolve problems at these institutions, including providing liquidity when needed. We also support the establishment of a strong and effective Council. Each of the financial regulators would provide valuable insight and experience to the systemic risk regulator.

Given the events of the past year, it is essential that such a regulator have the ability to act as a receiver and to provide an orderly resolution to companies. Efficiently resolving a systemically important institution in a measured, well-managed manner is an important element in restructuring the regulatory framework. A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

The continued ability of banks and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator would be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and other factors, should be as comparable as possible for entities that have multinational businesses.

Although the systemic risk regulator would not have supervisory authority over non-systemically important banks, the systemic regulator would need access to data regarding the health and activities of these institutions for purposes of monitoring trends.

Shadow Banking System

The problems at the root of the financial crisis fall into two groups, non-structural and structural. The non-structural problems relate to lessons learned from the current economic crisis that have been, or can be, addressed without changes to the regulatory structure. The structural problems relate to gaps in regulatory coverage for some financial firms, financial workers and financial products.

In assessing what went wrong, it is important to note that several key issues relate to such things as concentration risks, extraordinary liquidity pressures, weak risk management practices, the influence of unregulated entities and product markets, and an over-reliance on models that relied on insufficient data and faulty assumptions. All of the regulators, including the OTS, were slow to foresee the effects these risks could have on the institutions we regulate. Where we have the authority, we have taken steps to deal with these issues.

For example, federal regulators were slow to appreciate the severity of the problems arising from the increased use of mortgage brokers and other unregulated entities in providing consumer financial services. As the originate-to-distribute model became more prevalent, the resulting increase in competition changed the way all mortgage lenders underwrote loans, and assigned and priced risk. During the then-booming economic environment, competition to originate new loans was fierce between insured institutions and less well regulated entities. Once these loans were originated, the majority of them were removed from bank balance sheets and sold into the securitization market. These events seeded many residential mortgage-backed securities with loans that were not underwritten adequately and that would cause significant problems later when home values fell, mortgages became delinquent and the true value of the securities became increasingly suspect.

Part of this problem stemmed from a structural issue— inadequate and uneven regulation of mortgage companies and brokers — but some banks and thrifts that had to compete with these companies also started making loans that were focused on the rising value of the underlying collateral, rather than the borrower's ability to repay. By the time the federal bank regulators issued the nontraditional mortgage guidance in September 2006, reminding insured depository institutions to consider borrowers' ability to repay when underwriting adjustable-rate loans, numerous loans had been made that could not withstand a severe downturn in real estate values and payment shock from changes in adjustable rates.

When the secondary market stopped buying these loans in the fall of 2007, too many banks and thrifts were warehousing loans intended for sale that ultimately could not be sold. Until this time, bank examiners had historically looked at internal controls, underwriting practices and serviced loan portfolio performance as barometers of safety and soundness. In September 2008, the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale were forced to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

One lesson from these events is that regulators should consider promulgating requirements that are countercyclical, such as conducting stress tests and lowering loan-to-value ratios during economic upswings. Similarly, in difficult economic times, when house prices are not appreciating, regulators could consider permitting loan-to-value (LTV) ratios to rise in certain situations. Other examples include increasing capital and allowance for loan and lease losses in times of prosperity, when resources are readily available.

Another important nonstructural problem that is recognizable in hindsight and remains a concern today is the magnitude of the liquidity risk facing financial institutions and how that risk is addressed. As the economic crisis hit banks and thrifts, some institutions failed and consumers whose confidence was already shaken were overtaken in some cases by panic about the safety of their savings in insured accounts at banks and thrifts. This lack of consumer confidence resulted in large and sudden deposit drains at some institutions that had serious consequences. The federal government has taken several important steps to address liquidity risk in recent months, including an increase in the insured threshold for bank and thrift deposits.

Another lesson learned is that a lack of transparency for consumer products and complex instruments contributed to the crisis. For consumers, the full terms and details of mortgage products need to be understandable. For investors, the underlying details of their investments must be clear, readily available and accurately evaluated. Transparency of disclosures and agreements should be addressed.

These examples illustrate that non-structural problems, such as weak underwriting, lack of transparency, accounting issues and an over-reliance on performance rather than fundamentals, all contributed to the current crisis.

The crisis has also demonstrated that gaps in regulation and supervision that exist in the mortgage market have had a negative impact on the world of traditional and complex financial products. In recent years, the lack of consistent regulation and supervision in the mortgage lending area has become increasingly apparent.

Independent mortgage banking companies are state-licensed and regulated to varying degrees. Currently, there are state-by-state variations in the authorities of supervising agencies, in the level of supervision by the states and in the licensing processes that are used. State regulation of mortgage banking companies is inconsistent and varies on a number of factors, including where the authority for chartering and oversight of the companies resides in the state regulatory structure.

The supervision of mortgage brokers is even less consistent across the states. In response to calls for more stringent oversight of mortgage lenders and brokers, a number of states have debated and even enacted licensing requirements for mortgage originators. Last summer, a system requiring the licensing of mortgage originators in all states was enacted into federal law. The S.A.F.E. Mortgage Licensing Act in last year's Housing and Economic Recovery Act is a good first step. However, licensing does not go far enough. There continues to be significant variation in the oversight of these individuals and enforcement against the bad actors.

As the OTS has advocated for some time, one of the paramount goals of any new framework should be to ensure that similar bank or bank-like products, services and activities are scrutinized in the same way, whether they are offered by a chartered depository institution, or an unregulated financial services provider. The product should receive the same review, oversight and scrutiny regardless of the entity offering the product. Consumers do not understand — nor should they need to understand — distinctions between the types of lenders offering to provide them with a mortgage. They deserve the same service, care and protection from any lender. The "shadow bank system," where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks.

Another structural problem relates to unregulated financial products and the confluence of market factors that exposed the true risk of credit default swaps (CDS) and other derivative products. CDS are unregulated financial products that lack a prudential derivatives regulator or standard market regulation, and pose serious challenges for risk management. Shortcomings in data and in modeling certain derivative products camouflaged some of those risks. There frequently is heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on insufficient historical data. This led to an underestimation of the economic shock that hit the financial sector, misjudgment of stress test parameters and an overly optimistic view of model output.

We have also learned there is a need for consistency and transparency in over-the-counter (OTC) CDS contracts. The complexity of CDS contracts masked risks and weaknesses. The OTS believes standardization and simplification of these products would provide more transparency to market participants and regulators. We believe many of these OTC contracts should be subject to exchange-traded oversight, with daily margining required. This kind of standardization and exchange-traded oversight can be accomplished when a single regulator is evaluating these products.

The agencies did recognize in time the extent of the liquidity risk of the "super senior" credit default swaps. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities and did not sufficiently assess the susceptibility of highly illiquid, complex instruments (both CDS and CDOs) to downgrades in the ratings of the company or the underlying securities, and to declines in the market value of the securities. No one predicted, including OTS, the amount of funds that would be required to meet collateral calls and cash demands on the credit default swap transactions. In retrospect, if we had identified the absolute magnitude of CDS exposures as a liquidity risk, we could have requested that firms reduce its exposure to this concentration.

Stress Tests

OTS has been subjecting the institutions under its jurisdiction to an interest rate risk stress test since 1991. To conduct this stress test, OTS relies on its proprietary interest rate risk model, the Net Portfolio Value (NPV) Model. Using quarterly balance sheet information, the NPV Model estimates each bank's market value of portfolio equity and the degree to which that market value changes after instantaneous, parallel shocks to the yield curve of +/- 200 bps. Using the output from this stress test, each bank is classified (via a supervisory matrix) as having a *minimal*, *moderate, significant* or *high* level of interest rate risk.

Every institution that files Schedule CMR with the Thrift Financial Report receives a copy of its own, institution-specific Interest Rate Risk Exposure Report. OTS supervisory officials use the results from the NPV Model to identify outliers that are in need of greater supervisory attention and to monitor systemic trends in the industry. It should be noted that this process is applied to <u>all</u> OTS supervised institutions, not just to the largest.

Overall, OTS believes that supervisory stress testing is a useful exercise in that it allows for the benchmarking of institutions using a common set of assumptions. Based on 18 years of experience with the NPV Model, however, stress testing has its limitations.

Developing an appropriate set of assumptions and a meaningful set of stress scenarios is a challenging exercise because the stress tests often involve the use of a single risk factor and historical information that may or may not prove relevant for a future crisis. Additionally, supervisor-imposed stress tests often become the “de facto” standard to which all banks manage. We also found that collecting and scrubbing the necessary data that supervisors need from each firm in order to conduct a comprehensive stress test is inherently labor intensive and error prone.

These limitations notwithstanding, however, OTS believes that the approach to monitoring interest rate risk is worthwhile because it allows the agency to monitor trends within the industry and provides a starting point for discussions with management.

The 2009 mandated stress test only included certain bank holding companies. As such, thrift holding companies were not included in the 2009 stress test; however, OTS has long been an advocate for the use of stress-testing as an integral part of a firm’s internal risk management and governance process, and expects stress-testing to be performed depending on the size and materiality of exposure. We believe that enterprise-wide stress testing should be a part of any rigorous Enterprise Risk Management function, and should be performed on a quarterly basis. We do not believe that supervisors need to define the parameters of such modeling, but assess the adequacy, reliability, and sufficiency of the bank’s internal models as part of their on-going large-bank supervisory exam processes.

As noted above, OTS has its own model, data collection, and data cleansing process for interest rate risk; however, the agency does not have an internal model for credit risk or the financial system. Notably, the OTS has worked at creating a standardized model that considers, simultaneously, credit and interest rate risk. However, due to data limitations, OTS has found the model difficult to implement without considerable new data requirements being placed on the industry, data requirements that we have found many organizations unable to fulfill.

The OTS believes that more sophisticated and standardized data collection processes on the part of bank supervisors would allow for better horizontal analysis of large, complex banking organizations; such analysis could include the simultaneous modeling of market, interest rate, and credit risk(s); however, the production of a routine standardized test runs the risk of becoming the “de facto” standard for each bank, which should be avoided. Moreover, any standardized model produced runs the risk of subjecting the entire system to the model risk of the standardized model, and in some cases could curb/limit model innovations that are productive and healthy.

As noted above, OTS does not believe that a uniform stress test needs to be mandated; stress-testing, by itself, is not a panacea for risk measurement and control; however, large financial firms should be required to perform enterprise-wide stress testing on a routine basis. These internal tests should be reviewed by the regulator; underlying assumptions and output could be shared via public reporting allowing for greater transparency of a firm’s internal processes for stress testing and portfolio analytics, as well as the opportunity for market discipline to play a role in the evaluation of a firm's overall assumption and output quality.

Market Discipline

Liquidity and funding problems can stem from a lack of investor confidence in an institution's financial condition. In the current environment, this may also stem from a lack of confidence in balance sheets of financial institutions and a belief that there is insufficient transparency. While institutions report well-capitalized ratios, investors are questioning the value of those ratios under extreme financial stress when it is difficult to value assets. Some have also questioned the quantity and quality of capital and the validity of capital buffers in stressful periods. The economic crisis demonstrates the interrelationship of portfolio risk, liquidity, risk-based capital rules and Prompt Corrective Action. The OTS and the other Agencies will continue to review our rules in light of these lessons learned.

With regard to the market factors that exposed the true risk of credit default swaps and other derivative products, shortcomings in data and in modeling certain derivative products camouflaged some of those risks. There frequently is heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on insufficient historical data. This led to an underestimation of the economic shock that hit the financial sector, misjudgment of stress test parameters and an overly optimistic view of model output.

Cooperation and Collaboration among Supervisors

OTS exercises its supervisory responsibilities with respect to complex holding companies by communicating with other functional regulators and supervisors who share jurisdiction over portions of these entities and through our own set of specialized procedures. With respect to communication, OTS is committed to the framework of functional supervision Congress established in Gramm-Leach Bliley. Under Gramm-Leach Bliley, the consolidated supervisors are required to consult on an ongoing basis with other functional regulators to ensure those findings and competencies are appropriately integrated into the assessment of the consolidated enterprise and, by extension, the insured depository institution.

The most significant barrier to disclosure is that if a regulator discloses confidential supervisory information to another regulator, the disclosure could lead to further, unintended disclosure to other persons. Disclosure to another regulator raises two significant risks: the risk that information shared with the other regulator will not be maintained as "confidential" by that regulator, or that legal privileges that apply to the information will be waived by such sharing.

The regulator in receipt of the information may not maintain confidentiality of the information because the regulator is required by law to disclose the information in certain circumstances or because the regulator determines that it is appropriate to do so. For example, most regulators in the United States or abroad may be required to disclose confidential information that they received from another supervisor in response to a subpoena related to litigation in which the regulator may or may not be a party. While the regulator may seek to protect the confidentiality of the information that it received, the court overseeing the litigation may require disclosure.

In addition, the U.S. Congress and other legislative bodies may require a regulator to disclose confidential information received by that regulator from another regulator. Moreover, if a regulator receives information from another regulator that indicates that a crime may have been committed, the regulator in receipt of the information may provide the information to a prosecutor. Other laws may require or permit a regulator in receipt of confidential information to disclose the information, for example, to an authority responsible for enforcement of antitrust laws. These laws mean that the regulator that provides the information can no longer control disclosure of it because the regulator in receipt of the information cannot guarantee that it will not disclose the information further.

With respect to waiver of privileges through disclosure to another regulator, legislation provides only partial protection against the risk that legal privileges that apply to the information will be waived by sharing. When privileged information is shared among covered U.S. federal agencies, privileges are not waived. 12 U.S.C. § 1821(t). This statutory protection does not, however, extend to state regulators (i.e. insurance regulators), nor foreign regulators. The law facilitates information-sharing with foreign regulators, however, by providing that, subject to certain conditions, a federal banking agency cannot be compelled to disclose confidential supervisory information received from a foreign regulator except pursuant to an order from a court or a request from Congress. 12 U.S.C. § 3109(c).

To reduce these risks, OTS has information-sharing arrangements with all but one state insurance regulator, 17 foreign bank regulators, and one foreign insurance regulator. (Some of these foreign bank regulators may also regulate investment banking or insurance.) OTS is in the process of negotiating information-sharing arrangements with approximately 20 additional foreign regulators.

OTS also shares information with regulators with which it does not have an information-sharing arrangement on a case-by-case basis, subject to an agreement to maintain confidentiality and compliance with other legal requirements.

In terms of practical steps to ensure a robust flow of communication, OTS as part of its supervisory planning identifies foreign and functional regulators responsible for major affiliates of its thrifts and maintains regular contact with them. This interaction includes phone and email communication relating to current supervisory matters, as well as exchanging reports of examination and other supervisory documentation as appropriate. With its largest holding companies, OTS sponsors an annual supervisory college to which US and foreign regulators are invited to discuss group-wide supervisory issues.

As OTS began its early supervision of large and complex holding companies such as conglomerates, our first step was to better understand its organizational structure and to identify the interested regulators throughout the world. In this regard, conglomerates typically have a multitude of regulators in numerous countries involved in supervising pieces of the firm. OTS established relationships with these regulators, executed information sharing agreements where appropriate, and obtained these regulators' assessments and concerns for the segment of the organization regulated.

Consistent with this commitment and as part of its comprehensive, consolidated supervisory program for complex holding companies, OTS began in 2005 to convene annual supervisory college meetings. Key foreign supervisory agencies, as well as U.S. state insurance regulators, participated in these conferences. During the part of the meetings devoted to presentations from the relevant company, supervisors have an opportunity to question the company about any supervisory or risk issues. Another part of the meeting includes a "supervisors-only" session, which provides a venue for participants to ask questions of each other and to discuss issues of common concern regarding the company. OTS also uses the occasion of the college meetings to arrange one-on-one side meetings with foreign regulators to discuss in more depth significant risk in their home jurisdictions.

Regulatory Arbitrage

The OTS policy regarding charter conversions is reflected in the FFIEC Statement on Charter Conversions. When a state or national bank wishes to convert its charter to a savings association charter, an application is filed with the OTS. The application requirements are established in the agency's rules and regulations. Generally, the applicant must provide a business plan that shows the operational and strategic plans for the resulting savings association.

As described in the FFIEC statement, financial institutions choose to operate under the state or federal charter that best accommodates their business and strategic needs. Regulatory guidelines allow institutions to change their chartering authority or primary federal regulator through an application process with a prospective supervisory agency. Given the current stressed environment, rating downgrades and supervisory actions have become more frequent. To maintain the integrity of the regulatory system and the safety of financial institutions, it is essential that the opportunity for charter conversions does not undermine current or prospective supervisory actions.

The FFIEC has issued the statement to re-affirm that charter conversions or changes in a primary federal regulator should only be conducted for legitimate business and strategic reasons. This furthers the FFIEC's responsibilities of maintaining uniform supervisory principles and standards for all regulated entities, regardless of chartering authority.

Conversion requests submitted while serious or material enforcement actions are pending with the current chartering authority or primary federal regulator should not be entertained. Such requests could delay or undermine appropriate supervisory actions that, if left unresolved, could place the institution at greater risk of failure. With respect to any outstanding corrective program, a conversion request will be evaluated on the specific facts and circumstances, but at a minimum, it is expected that the corrective program's requirements will be maintained and compliance overseen by the successor supervisor.

Institutions that intend to change their charter or banking supervisor, through either a direct conversion or a conversion by merger, will continue to seek approval through an application process with the prospective chartering authority and primary federal regulator, in consultation with the appropriate state regulatory authorities. In the FFIEC statement the OTS agreed to consult with the FDIC in its role as deposit insurer and receiver, and the Federal Reserve, as the consolidated holding company supervisor, on any application involving an institution for which its current supervisor has either rated or proposes to rate that institution a 3, 4, or 5 (or "Needs to Improve" or "Substantial Noncompliance" with respect to CRA performance), or has instituted or plans to institute a serious or material corrective program with respect to that institution.

It is expected that ratings assigned under the agencies' uniform rating systems and outstanding corrective programs will remain in place following a charter conversion and/or supervisory agency change. Before acting on any conversion request, the OTS will consult with the current supervisor to obtain information on any pending or outstanding supervisory actions. To facilitate this process, the current supervisor provides the OTS with a summary of the existing examination program, including plans for ratings downgrades and enforcement actions. It is anticipated that the OTS's initial examination and enforcement action program will follow the work of the existing supervisor. If the existing supervisor's examination is not recent, or if other circumstances warrant, the OTS may choose to conduct an eligibility examination and may, depending on the circumstances, invite the current supervisor to participate to help ensure continuity in the bank's supervision. In any case, the OTS factors proposed ratings and enforcement actions into its examination planning process and fully assesses the appropriateness of current or in-process ratings downgrades only after the completion of an appropriately-scoped on-site examination.

Oversight of Supervisory Function

OTS has learned multiple lessons during this economic cycle and has used this knowledge to refine and improve its regulatory program. The agency conducts independent internal failed bank reviews for savings associations placed in receivership and generates a series of recommended actions to supplement and improve its regulatory oversight. The agency has revised its policies and procedures to correct gaps in regulatory oversight. OTS has also been proactive in improving the timeliness of formal and informal enforcement action.

Based on the knowledge we have gained through horizontal reviews of OTS-regulated financial institutions, cooperation with domestic and international financial regulators, routine examination and supervision of savings associations and their holding companies, and failed bank reviews, the agency has identified several key risk management areas for discussion. OTS communicates refinements and lessons learned in its supervisory program to examiners through examination handbooks and other internal and external issuances.

Upon finalizing each review, senior managers distribute internal guidance identifying lessons learned to improve examiners' focus on critical risk management areas. OTS also committed to implementing the recommendations derived from the Material Loss Review reports from Treasury's Office of the Inspector General. The agency has made substantial progress in implementing recommended actions to improve regulatory oversight.

Regulatory Independence

The OTS conducts its supervisory function in a professional, consistent and fair manner. Ensuring the safety and soundness of the institutions that the agency supervises is always paramount. Moreover, the use of assessments on the industry to fund the agency has many advantages. It permits the agency to develop a budget that is based on the supervisory needs of the industry. The agency does not rely on the Congressional appropriations process and can assess the industry based on a number of factors including the number, size and complexity of regulated institutions. Such a method of funding also provides the agency the ability to determine whether fees should be increased as a result of supervisory concerns.

OTS employees follow Standards of Conduct in compliance with the following federal regulations:

- Standards of Ethical Conduct for Employees of the Executive Branch (5 CFR Part 2635.101-902
- Employee Responsibilities and Conduct (5 CFR Part 735.101-203
- Department of Treasury Employee Rules of Conduct (31 CFR Part 0.201-217
- Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury (5 CFR Part 3101,101-104, 109)

A summary of the ethical conduct requirements for OTS employees is in Examination Handbook Section 020 – Conduct of Agency Personnel.

In addition, OTS has built numerous controls into its examination and oversight programs to ensure the agency adheres to the highest standards and to prevent "regulatory capture". Some of these controls include:

- Rotating Examiners-in-Charge;
- Conducting Enforcement Review Committee meetings;
- Implementing a Large Bank Unit for savings associations over $10 billion;

- Conducting quarterly high-risk briefings; and
- Conducting weekly problem bank briefings.

Resources

OTS recruits and retains a diverse workforce with outstanding abilities in the strategic competencies vital to its mission. At the end of Fiscal Year 2008, OTS had 1,070 employees, including 607 examiners possessing mission critical expertise, skills, and talent. Like other federal agencies, OTS has an aging workforce. Within the next five years, nearly 48 percent of OTS employees in mission critical positions will be eligible to retire. To prepare for these potential retirements, OTS established a program of recruitment and training for entry-level examiners.