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THE STATE OF THE BANKING INDUSTRY: PART II

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE CURRENT STATE OF THE U.S. BANKING INDUSTRY

THURSDAY, JUNE 5, 2008

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THE STATE OF THE BANKING INDUSTRY: PART II

THURSDAY, JUNE 5, 2008

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:07 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning, everyone. The Committee will come to order.

I thank all of our guests here this morning. I want to thank our witnesses for being back before the Committee.

This morning the Committee convenes to examine the supervision and regulation of the banking industry, as a follow up hearing to the Committee hearing held on March 4th. At that hearing, Senator Shelby and I expressed, I think, in no uncertain terms our intention—indeed, our determination—to reconvene this panel of witnesses to assess the efforts and effectiveness of the agencies represented here during these extraordinary times for our economy and for the financial services sector in particular.

I look forward, as all of us do this morning, to your testimony and hearing your views regarding the current condition of our banking industry and assessment of your supervision response to the recent and ongoing turmoil in the U.S. credit and mortgage markets, and your analysis of what lessons have been learned as a result.

Perhaps most importantly, 3 months after your previous appearance before this Committee, I look forward to hearing about what each of you intend to do and hopefully have already begun to improve your regulatory oversight and address the issues of ongoing concern for the banking industry and in anticipation of future challenges.

Recent history tells us that many banking officials, private sector CEOs, bank presidents and executives, and officials in the public sector including some of the regulatory institutions represented here this morning, expressed the opinion last year that the problems in the credit markets were contained and nearing an end. Those pronouncements were wrong, of course, the unjustified optimism that may have led to a complacency on the part of some that, at least in part, may have allowed problems that originated in the subprime mortgage market to evolve into a global credit crisis, a

crisis that crippled the balance sheets of some of the world's largest banks and spread to non-mortgage related credit areas including student loans, credit cards, commercial real estate. And as Senator Reed and I were talking about recently, maybe into auto loans and the like.

These concerns were not unknown. In fact, some of us had expressed the need for regulators to intervene to address the problems in the subprime market.

A look at the transcript for the March 4th hearing reflects that many of you then, and I assume now, believe you could have and should have done more under the respective authorities of your agencies to address this crisis earlier on. I mention this not to engage in revisionist history—quite the contrary—or to assign blame, but rather to urge you to be vigilant and proactive in your regulatory and supervisory responsibilities moving forward.

If my words are not enough to encourage your continued vigilance, then some of the data recently reported by the FDIC in its quarterly banking report certainly should be. The report includes some worrisome data suggesting that the banking industry continues to grapple with the fallout of the credit mortgage market turmoil and the effects of a weak economy.

Among its findings are the following: ongoing problems in the real estate market continue to eat into bank profits. Commercial banks and thrifts reported a decline in profits of 50 percent in the first quarter of 2008, compared with the first quarter of 2007. Over half of the insured institutions reported lower net income in the first quarter. Bank earnings in the fourth quarter of 2007 were revised downward to their lowest levels in 18 years. An additional $26 billion in outstanding loans were delinquent—90 days or more past due is what we describe as being delinquent—from the previous quarter. And while much of that increase was mortgage related, credit card and auto loan delinquencies also increased, further proof that the ongoing credit mortgage market turmoil, coupled with the economic slowdown is destabilizing the economic condition of American families.

The number of troubled U.S. banks grew, as well, with the FDIC now tracking 90 problem banks, the highest number in nearly 4 years. This is a significant likelihood—there is a significant likelihood that that number will continue to grow and that even larger institutions may end up on the problem list.

At the same time, the FDIC's reserve fund is at its lowest level, 1.19 percent of covered deposits, in more than a decade. These findings strongly suggest that our banks, their customers, and our economy will likely continue to grapple with the economic fallout of the meltdown in the credit mortgage markets for the foreseeable future, and perhaps well into 2009.

So while I look forward to hearing your assessment of whether or not the worst is truly behind us, what is of greater interest to me, and I hope to my colleagues as well, and I imagine to other members of this Committee and others, is your outlook for what the future holds and what steps you have taken to ensure that there will be no more surprises for the members of this Committee and for our banking industry, which is so vital to our Nation's economic well-being.

As I said in our very first hearing, the regulatory agencies that oversee our banking industry play an indispensable role, not only in the economic activities of the institutions that they regulate but the economic life of our Nation as a whole. You serve as the gatekeepers of the credit that fuels the world's largest and most dynamic economy. And through your regulation of insured institutions, which holds in excess of $4 trillion in deposits, you serve as the guardians of the interest of the American taxpayers, who are ultimately liable when institutions fail.

Yours is a Herculean mission and one that I know you and your dedicated colleagues strive to fulfill every single day. So I look forward to learning from each of you this morning not only your views regarding the current state of our banking industry, but also the concrete steps that you are taking to address the lessons learned in the recent market failures.

With that, I thank you and I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

There have been some significant developments in the banking sector since our last hearing, making this meeting I think both timely and very important.

The most significant development has been the collapse of Bear Stearns, including the Federal Reserve's efforts to intervene and its willingness to open the discount window to the 19 primary securities dealers. While this action provided a source of stability for the financial system, it also raised a number of policy questions which we can explore further today.

Since March, the so-called problem bank list has also grown. As these numbers rise, I am concerned that the Deposit Insurance Fund reserve ratio is at its lowest level since 1996. I believe that it is critical to ensure that the fund remains healthy as we work through this period of stress.

Finally, there has been a large number of earnings restatements in the banking industry for the fourth quarter of 2007. Earnings were originally reported at $5.8 billion but sizable restatements by a few large institutions caused fourth net income to decline significantly.

If the credit crisis has demonstrated anything, I believe there is no substitute for sound risk management. In this time of turmoil, I think we must be confident that the Nation's financial institutions are operating in a safe and sound manner. This requires vigilance and clear guidance from you, the regulators.

As the credit crisis continues to affect many of our Nation's financial institutions, I am also interested to hear today what you, as regulators, believe may be on the horizon. I am particularly interested to hear about the exposure of financial institutions to commercial real estate and the construction lending tied to the mortgage market.

I would also like to hear how you are ensuring that banks operating in some of the most overheated markets are adequately prepared to deal with the stresses of the next several months which they will clearly face.

As we discussed in March, banks have been well capitalized coming into this period of stress, which is good news. But as we transition to new capital standards, however, I think we must continue to examine how Basel II will hold up in periods of stress because it has not been tested yet.

I believe it is important to look at the number of facts, including general liquidity, the risk weighting of securitized assets, as well as a host of other factors. And with the list of troubled financial institutions growing, there is little doubt that bank failures will rise.

The question for our witnesses, among others, is how do you intend to mitigate the fallout?

I welcome all of our witnesses here today and I am sure we are going to be spending a lot of time together in the next year or so.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Shelby, very much.

Let me ask my colleagues, Senator Reed, any opening comments?

STATEMENT OF SENATOR JACK REED

Senator REED. Mr. Chairman, you and Senator Shelby have articulated very well the continuing challenge in the credit markets. Just yesterday Moody's announced that MBIA and Ambac have been placed on the negative watch list. And after the Federal Reserve's timely intervention with respect to Bear Stearns, they have now securities which I presume are rated by Ambac and MBIA. That goes to the question of the Federal Reserve's position with respect to these securities.

That is just one indication of the continuing significant difficulties in the credit markets.

The housing market continues to deteriorate, as you have illustrated and indicated. Credit card problems, Sheila Bair has pointed out the correlation between housing problems and credit card defaults and delinquencies.

All of this requires continued observation and scrutiny and I think this hearing is timely and extremely important.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I want to thank you and Ranking Member Shelby again for convening this hearing. I think it is important that we have a thorough understanding of the dynamics that are going on out there in the banking and the various money markets and everything. And this will help.

Also, today we continue to examine the state of the banking industry and the wide effects of housing and mortgage problems, what they have had on our entire financial system, and the continued deterioration in real estate and construction loans has put a persistent strain on the banking industry and there is a reason why industry earnings declined 49 percent from the previous year.

There is also a contraction of the credit markets, and this has caused problems for consumers. I think it has had an impact on home loans. It has had an impact on auto loans and what not, and

I would like to hear some of your views as we move forward with that. So it has become much harder to borrow and obtain credit in many of these areas.

If these lenders are not able to continue to lend or are unwilling to lend, it could have a huge impact on our economy and its ability to grow. So in time of record gas prices and higher food prices, the American consumer needs to be kept in mind, I think, as we move forward on these tough times.

Now we are continuing to see a number of banks added to the problem list, which has been mentioned by my colleagues. But we also—I do not believe we have seen an increase in or experienced a spike in failed institutions. So I would like to have you comment a little bit about how that is happening and how we are moving forward and maybe we are not seeing a spike in failed institutions—I think in past times perhaps we would have seen a spike—and what we put in there that is acting as a cushion.

So finally, I just think in this time of economic uncertainty we need to remain confident that our banking industry and economy as a whole will rebound and continue to foster growth, and so we are all eager to hear your assessment of the state of the banking industry and your insights, which I think will be helpful as we consider the various policy issues.

Thank you.

Chairman DODD. Thank you, Senator.

Senator Dole, any comments?

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Yes. And again, I want to thank you for holding this hearing this morning, you and Ranking Member Shelby.

First, there is no question, as you have already underscored, that the credit and housing crisis continues in earnest to this day. While this Committee has been active in looking into a number of the problems associated with the current crisis, for many Americans this issue came to the forefront after the near collapse of Bear Stearns, closely followed by the unprecedented Government-assisted sale of that firm to JPMorgan, an event that continues to be widely scrutinized.

I believe that without the prompt action from the Federal Reserve and Treasury Department over those few days in March, our financial markets could have been exposed to systemic risk. While I remain concerned about the precedent this action sets for future crises, as well as the perceived exposure to the U.S. taxpayer as the ultimate backstop as part of the Federal Reserve/Treasury negotiated agreement, it appears that the regulators on the ground made the most of the situation at hand.

Recently, there have been some encouraging signs. Confidence in the credit markets appears to have improved somewhat over the past 2 months, represented by the fact that the so-called yield spreads between bonds issued by securities firms and U.S. Treasuries have narrowed, which some economists would point to as a positive indicator.

In addition, the IPO market appears to be showing some signs of life. As of the end of May, the Renaissance IPO Index had gained

nearly 17 percent over the past 3 months, albeit still well below comparable activity levels from 2007.

Clearly, we are not out of the woods yet. Consumer confidence, as calculated by the University of Michigan, sank to a 28-year low last month. This comes on top of the widely followed Case-Shiller Housing Index which showed that home prices nationwide plunged 14 percent in the first quarter.

Finally, as the events of this week have already demonstrated, with the major investment banks slated to begin reporting second quarter earnings in the next few weeks, there is an ever-increasing likelihood that there will be additional losses and further asset write-downs at these institutions.

Mr. Chairman, when this Committee examined the Government's facilitated buy-out of Bear Stearns in early April, I brought up the issue of credit defaults swaps and the role they could have played in its demise. As I mentioned, as I understand it, this market has exploded in size, from an estimated $1 trillion in 2000 to $62 trillion in market exposure this year. This dwarfs the size of the underlying bond issuances and has the potential to unwind the credit markets by exposing counterparty risk.

While the regulator aspect of credit default swaps might seem like an esoteric issue for some, although $62 trillion can hardly be considered esoteric, I think it underscores an important point. These instruments, like so many other structured products and derivatives, operate in an environment where there is no formal clearing process or minimal public reporting regarding the true value of these assets.

While I do not question that the creation of these structured products has delivered a measurable benefit to the American consumer by lowering borrowing costs, it is becoming clear that a lack of transparency in the pricing and trading of these instruments has contributed to the credit crisis.

I challenge Federal regulators to begin more closely monitoring these effects and to seek ways to improve transparency regarding the pricing and trading of these instruments across the financial marketplace.

Last week, the FDIC published its quarterly banking profile for the first quarter of 2008, which provides insight about the stability of the U.S. banking industry. Several items caught my eye. Industry earnings declined 46 percent from last year. Loan loss reserves now absorb a higher share of revenues, which eclipsed $37.1 billion in the first quarter. And problem loans continue to rise across many banks' real estate portfolios.

In addition, the FDIC reported that the number of so-called troubled institutions increased from 76 to 90 in the first quarter, with no end in sight. This marks the sixth consecutive quarter that the number of problem institutions has increased and reflects the largest number of institutions on this list since the 3rd quarter of 2004. Clearly, these are not promising developments and I hope that Congress has empowered the FDIC—which I believe is responding to this crisis to the best of—its ability, with the necessary tools and resources to handle the new realities facing the banking industry.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Corker, any comments?

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Mr. Chairman, as usual, I look forward to hearing from the witnesses.

Thank you.

Chairman DODD. Thank you very much, Senator.

I do not know whether Senator Martinez or Senator Bunning, I am not sure what order they came in. I apologize.

Senator MARTINEZ. Mr. Chairman, I will defer to my senior colleague from Kentucky.

[Laughter.]

Senator BUNNING. Senior colleague, thank you very much.

Chairman DODD. It is been amazing how you have grown, Mel, in understanding.

Senator BUNNING. I deeply appreciate that, and I think Senator——

Chairman DODD. He offered his—he did not defer to Senator Hagel, who is leaving, of course. He is deferring to you.

Senator BUNNING. I know, because I got here just a little ahead of Senator Hagel.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Mr. Chairman, I want to thank you for holding this second hearing on this critical issue.

After all the problems in the financial system over the last year, we would all like to think our banks are out of the woods, but they are not. Hopefully, we are getting closer to the end than we are to the beginning.

Home prices are continuing to fall and problems still exist in the credit markets. Unfortunately, it appears that troubles at banks around the country are on the rise. The FDIC problem list is getting longer. Four banks have already been closed this year, and it seems like there is speculation every day about the health of the major banks. I think we are all worried about that.

I hope to hear from our regulators today that they are closely monitoring the health of the banks and are ready and able to respond even if a major bank fails. I also hope to hear that they do not expect that to happen.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Bunning.

Senator Hagel? Senator Martinez?

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. I will be very brief. Thank you, Mr. Chairman.

I appreciate this hearing and I am glad that we are keeping a close eye on our banking industry, which is so important to our Nation.

Chairman Bernanke, in speaking to the International Monetary Conference yesterday, noted that although we may see somewhat better economic conditions during the second half of 2008, until the housing market—and particularly housing prices—show clear signs of stabilization, downward growth risk will remain.

On that note, I would like to sound a note of cautious optimism that in the real estate market in Florida, it appears that we are heading in a better direction. Florida Realtors recently reported an upswing in existing home and condominium sales from March to April of 2008. And Realtors around my State are reporting an increase in phone calls, home showings, and buyer activity. The market appears to be stabilizing and we are working through the huge backlog of inventory that exists.

Economists at the National Association of Realtors predict that home sales and prices throughout most of the Nation will improve in the second half of the year, especially if access to mortgage backed by the Federal Housing Administration, Fannie Mae, and Freddie Mac increases.

So I believe we are witnessing, in many ways, the market's reaction to various steps Congress has taken to help alleviate the current housing crisis. Congress has much to finish on this front, including finalizing the pending legislation. As we work toward that end, we should be moving simultaneously to ensure we do not ever find ourselves back in the kind of situation we are in today to the extent possible.

I continue to be concerned about the availability of credit and the condition of our banking system as we work through the crisis. Some of my friends in the industry in Florida complain about excessive regulation, the increase in reserves to a point where they now are constraining their ability to continue to be a resource to those who would create the conditions for the market to come back.

So I hope we will continue to shed light on this situation through today's hearing and look forward to hearing from the witnesses.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

And again, welcome to our witnesses this morning. We have six very distinguished witnesses this morning, and I am going to ask all of you, if you would, to try and keep your remarks to around 5 to 6 or 7 minutes, if you could. Obviously, all of your full statements and any supporting documentation you think would be valuable for the Committee will be included in the record.

I will ask you to proceed in the order that you are sitting, Sheila beginning with you and ending up here at the other end of the table. Good to have you with us here this morning, as well. Mr. Karsky, is that how you pronounce it?

Mr. KARSKY. Sure.

Chairman DODD. And we will proceed along those lines, and then we will get to some questions. But we thank all of you for being here and coming back to the Committee.

Sheila Bair.

STATEMENT OF SHEILA BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Chairman Dodd, Senator Shelby, and members of the Committee.

I appreciate the opportunity to testify on behalf of the FDIC regarding the condition of the banking industry.

Uncertainties in today's economic environment continue to pose significant challenges for banks, households, and bank regulators.

As I said before, I believe that the distress in the housing market is the key to our broader economic problems. In order to return stability to the credit markets, we must ensure that future mortgage lending is properly underwritten and results in loans that are sustainable over the long term for borrowers.

In addition, we must deploy multiple tools to combat unnecessary foreclosures that create a self-reinforcing downward spiral for housing prices.

Last week, the FDIC released its quarterly banking profile, a comprehensive summary of financial results for all FDIC-insured institutions for the first quarter of 2008. Although the industry reported earnings of $19.3 billion, the data showed financial performance that was significantly lower than in past years. The economic slowdown brought on by the disruptions in credit availability is expected to exert continuing downward pressure on industry earnings over the coming quarters.

The construction and development segment of commercial real estate lending stands out as the most important short-term credit quality issue. Loss rates have risen dramatically on C&D loans through the first quarter of 2008 and likely will increase because of the current oversupply of new housing units.

The FDIC is taking aggressive steps to work with our supervised institutions. Examiners have conducted targeted visits in institutions with C&D lending concentrations in former high growth markets and determined that a rapid increase in problem loans may translate into significant further losses this year. As a result, we are intensifying our supervision of these institutions and we are accelerating onsite reviews and expanding examination tools to deal with these developments.

In addition, we are taking steps to improve our capability to handle future bank failures. So far this year, four institutions have failed, with total assets of $2.2 billion and estimated losses of $225 million to the Deposit Insurance Fund. The number of failures in recent years has been unusually low by historic standards and we expect that bank failure activity in the near term will be higher.

As we reported last week, there were 90 institutions with total assets of $26.3 billion on the FDIC's problem bank list at the end of the first quarter, up from 76 with total assets of $22.2 billion at the end of 2007. Nevertheless, about 99 percent of all insured institutions, representing over 99 percent of industry assets, met or exceeded the minimum regulatory capital standard for well capitalized status under PCA.

As of March 31st, the balance in the Deposit Insurance Fund stood at $52.8 billion. The strong growth in insured deposits, together with the increase in loss provisions, pushed down the DIF reserve ratio to 1.19 percent from 1.22 percent at year-end 2007. As insurance losses increase due to failures, combined with strong deposit growth, the fund could drop below the 1.15 percent minimum of the statutory range. I can assure this Committee that the FDIC Board will act as necessary under the statutory requirements of the Reform Act to maintain the integrity of the DIF.

Because the rate of bank failures is expected to return to a level above that of recent years, and with the current uncertainties in the banking industry, the FDIC is actively ensuring that we have

the capacity and appropriate skills to address the resolution of failed institutions. With the significant consolidation in the banking industry, we are focusing particularly on unique issues associated with large financial institutions.

Even though the probability of such a failure is extremely unlikely, the development of mega-institutions means that the FDIC must ensure that its processes and systems are capable of handling the complex issues such a failure would pose. For example, some institutions may have millions of deposit accounts. The ability to determine their insured status quickly is essential to a successful resolution of a large failed bank.

After 2 years of study and public input, the FDIC Board will be considering at our next meeting a new regulation to require certain large banks to modify their deposit systems to facilitate deposit insurance determinations.

The FDIC also is working to improve our ability to respond effectively to larger and more complex portfolios of qualified financial contracts held by banks. The new rule will ensure that critical information about these complex financial relationships is available to the FDIC under the very tight timeframes necessary to achieve an orderly resolution of a failed bank.

As part of our contingency planning for increased bank failures, we have beefed up our resolution and receivership staff and cross-trained over 1,200 existing staff who can help with various aspects of the resolution process. We have also been running bank failure readiness exercises to test our preparedness for the resolution of larger, more complex institutions. We are taking these measures as a precaution. We feel we must be prepared for any contingency.

Finally and most importantly, I commend the Committee on passing legislation to expand eligibility for loans guaranteed by the FHA, combined with GSE modernization and regulatory reform. This legislation is laudable and will help many borrowers.

We have also welcomed the opportunity to discuss with Committee members individually our suggestions for additional tools to combat escalating foreclosures. My written statement includes a description of the Home Ownership Preservation loan proposal that would provide loans to pay down distressed mortgages to an affordable level with repayment costs shared by borrowers and mortgage investors. We believe this proposal could be a valuable compliment to the current FHA proposals recently approved by this Committee.

This concludes my testimony. Thank you very much.

Chairman DODD. Thank you very much, Ms. Bair.

John Dugan, thank you.

STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, UNITED STATES TREASURY

Mr. DUGAN. Chairman Dodd, Senator Shelby, and Members of the Committee, I am pleased to be here today to update the Committee on recent events in the financial markets and the condition of the national banking system.

When I testified before this Committee in March, I reported that two powerful and related forces were exerting real stress on banks of all sizes and in many different parts of the country. One was the unprecedented series of credit market disruptions precipitated by

declining house prices and severe problems with subprime mortgages. The other was the slowdown in the economy which had begun to generate a noticeable decline in credit quality in a number of asset classes.

As we assess the impact of these forces today, I would say this: Credit markets are somewhat better, while credit quality, meaning the performance of loans and other credit extensions to which banks are exposed, is worse.

On the first point, we are beginning to see improvements in several key segments of the credit markets. In particular, there is significantly more liquidity in money markets, and spreads on credit default swaps have narrowed. Financial institutions have raised unprecedented amounts of capital since October 1st of last year, over $100 billion by national banking organizations alone. And this shoring up of their balance sheets has helped restore confidence and liquidity in the interbank market. In addition, the pipeline of hung leveraged loan deals has slowly begun the clearing process.

While these are all good signs of progress, we clearly are not out of the woods. There continues to be considerable uncertainty among market participants about the underlying strength of the economy and the ongoing effects the recent market disruption and economic downturn are having on financial counterparties, consumers, and commercial borrowers. This uncertainty may lead to continued volatility in the financial markets that we and the institutions that we supervise will need to monitor carefully. Moreover, securitization channels for residential mortgages remain largely closed, except for conforming mortgages sold to the GSEs and FHA. Although banks and other portfolio lenders have taken up some of this slack, they cannot provide the same level of credit to this important part of the mortgage market as was previously provided by securitization markets.

In addition, the number of homes in foreclosure continues to rise. In this regard, we support the significant new options provided in this Committee's recent legislation that would help borrowers refinance their homes rather than face foreclosure.

On the second point, credit quality, the downturn in housing and the broader economy is indeed continuing to have an adverse effect on national banks' loan portfolios. The level of nonperforming and past-due loans is increasing. Not surprisingly, housing-related credit is of particular concern, including home equity loans, lower-quality first mortgages, and commercial real estate related to residential construction.

But credit quality is also declining in credit card loans, auto loans, small business loans, and, to a lesser extent, commercial and industrial loans and commercial real estate unrelated to housing. There are, however, two important caveats:

First, this upward trend in losses starts from a very low base of exceptionally benign credit conditions.

Second, banks in some parts of the country where regional economies are stronger have simply not experienced the same increases in problem loans.

Nevertheless, given the clear trend lines in most banks, responding to deteriorating credit quality will continue to be a major focal point for supervisors and bankers in the months ahead. In light of

these conditions, we believe the substantial increases that banks have made both to loan loss reserves and to capital in recent quarters are both prudent and warranted. Indeed, should credit performance continue to worsen, as we expect, additional loan loss reserves will be needed and, in some cases, additional capital. As always, we support maintaining strong conservative reserves, and we will continue to underscore this message to bankers, the accounting standards setters, and bank auditors.

Likewise, both on our own and in cooperation with other supervisors, we continue to identify and implement lessons learned from the recent market turmoil, especially for our larger institutions. These efforts focus on improvements to risk management, including addressing new types of liquidity risk, appropriately identifying and managing off-balance-sheet exposures, managing concentrations, and significantly enhanced metrics for aggregating risks to particular counterparties. Each of these areas is described in more detail in my written statement, and I would be pleased to address questions about any of them.

Thank you very much.

Chairman DODD. Thank you very much.

John Reich, thank you for being here.

STATEMENT OF JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to return today to give you an update on the financial condition and performance of the thrifts industry.

As I reported to the Committee in March, thrift institutions are continuing to face significant challenges from the downturn in the housing sector and general economic weakness. But despite these challenges, the industry generally is continuing to hold up remarkably well. Capital is down slightly, but it remains solid. Managers of OTS-regulated institutions are showing that they take the challenges seriously by adding a record amount to their loan loss provisions in the first quarter of this year, $7.6 billion. And I have encouraged institutions' CEOs to be aggressive in adding to their loan loss reserves. Setting aside this money has decreased earnings, but the rise in troubled assets indicates that higher provisions are necessary.

When I talk with the news media about the performance of the thrift industry, I am often asked how the current climate compares with the climate that existed in the 1980s and 1990s. One illustration I can provide is to point out the number of problem thrifts, which stood at 12 at the end of March, the end of the first quarter, and stands at 17 today, that figure compared to 1992, for example, when more than 200 thrifts were in troubled condition. During that time, industry capital was not in the solid condition that it is today. Although we anticipate the possibility of a few smaller institutions may fail in coming quarters, there is no comparison to the late 1980s and the early 1990s, when hundreds of thrift institutions failed and were closed.

My written testimony describes how OTS is emphasizing to thrift institution management the lessons learned from the current crisis

as both examiners and institution executives assess their management of risk. Bank management is largely about managing risks, and risk management in the financial services industry was clearly inadequate in anticipating the approach of the current crisis and in accurately assessing its potential impact.

Learning lessons from these inadequacies, doing a better job of identifying and measuring risks, and thereby preventing a recurrence are essential to the safety and soundness of our financial system. An attachment to my testimony is a March letter we sent to thrift CEOs describing specific areas where they should be focusing their attention in managing risks. We are continuing to emphasize these points during examinations and regular town meetings that we hold with thrift executives around the country.

I might say that I have boosted the number of outreach events that I have had done since our March hearing with institutions around the country, and I have asked all members of my senior management in Washington, D.C., and in our regional offices around the country to go out on an examination this year to get a firsthand feel. Many of our senior management has not been out on examination for 5, 10, 15 years, and it is time that they reacquainted themselves with how things really are.

Perhaps the most important lesson that we have learned from this crisis is that all of the players in the home mortgage market need to play by the same rules. There is a corrosive effect on the entire system when certain segments of the market can cut corners, unsound loan underwriting, and evade serious scrutiny.

The OTS and the other Federal banking regulators have issued guidance and focused our supervisor attention on ensuring sound underwriting for nontraditional mortgage products and subprime loans. Many States have adopted this guidance, but others have not. So uniform nationwide protections do not exist for consumers making what is probably the largest investment of their lives.

These regulatory gaps have a real impact on families across America, and in my opinion, we should make closing the gaps an urgent priority.

For home mortgages, consistent regulation is essential for the brokers who originate home mortgages and for the mortgage companies, including mortgage banks. I believe the OTS is in a unique position to work with States to close the gaps in regulation, because our agency has nearly two decades of experience in supervising financial institutions engaged primarily in home mortgage lending and in other consumer-related lines of business.

For the originators, we need nationwide registration and licensing, financial obligation, demonstration of some financial capacity, such as a net worth requirement or a bond, and a change in compensation structure so that brokers have a stake in the long-term viability of every loan that they originate. The OTS would work with State regulators to establish such a system and monitor its effectiveness.

For mortgage companies, we recommend following the model used by the FDIC and States in examining State-chartered banks, alternating examinations, or conducting joint examinations. The OTS would work with the Conference of State Bank Supervisors and other State regulatory groups to develop these partnerships, to

ensure accountability, consistency, and transparency throughout the mortgage lending process.

Thank you, Mr. Chairman, and I look forward to your questions.

Chairman DODD. Thank you very, very much as well.

JoAnn Johnson from the National Credit Union Administration, we thank you.

STATEMENT OF JOANN JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Thank you, Chairman Dodd, Senator Shelby, and Members of the Committee. Thank you for the opportunity to update the Committee regarding the state of the credit union industry in the context of your broader review of how financial institutions are performing during the recent turbulence.

The overall financial state of the credit union industry remains strong and healthy, with financial trends indicating a safe and sound industry. We do note, however, isolated but not systemic problems. I will outline key data which supports this conclusion and also underscore NCUA's belief that the industry has implemented our regulatory guidance regarding the need for increased vigilance and more careful management of credit union balance sheets.

Federally insured credit unions are well capitalized. Net worth stands at 11.1 percent, and over 99 percent are at least adequately capitalized. Total assets are at $792 billion, and aggregate net worth is $87.87 billion, the highest dollar amount in history. The Share Insurance Fund is strong, with a current 1.31 equity level. While we have increased our loss reserves, we expect the year-end equity level to be a 1.30 percent with the ability to withstand any projected potential losses.

Lending continues to be a main focus of credit union service to members. As of the end of 2007, loans represented just over 67 percent of credit union assets. Within that figure real estate loans comprise over 52 percent of total loans. Credit union mortgage lending is primarily of the traditional variety. Nearly 60 percent of credit union mortgage loans are fixed rate. Only 2.4 percent are interest-only or optional-payment loans that have garnered much of the recent attention on Capitol Hill and made this hearing, unfortunately, necessary.

Overall, loan delinquencies have decreased slightly since the last time we met to discuss this important issue from 0.93 to 0.91 percent. And real estate delinquencies now stand at 0.7 percent. Aggregate net charge-offs for all loans have increased from 0.5 percent to 0.67 percent, with real estate net charge-offs currently at 0.19 percent.

Those relatively low numbers indicate that credit unions have positioned themselves to withstand the current economic uncertainty and related mortgage problems. To make certain that continues, NCUA has played a proactive and aggressive role in issuing supervisory guidance regarding lending.

Since 1995, NCUA has issued guidance on risk-based lending and specific mortgage lending guidance that has identified potential problem areas, particularly regarding subprime lending, credit risk management, due diligence, and stringent evaluation of third-

party relationships. Home equity lines of credit and so-called exotic mortgage products, such as the interest-only and payment-optional, were also covered by this guidance.

Last year, in concert with my fellow regulators, joint guidance regarding workout arrangements, subprime lending, and loss mitigation was issued. All of this was aimed at increasing credit union awareness of the potential pitfalls inherent in a rapidly changing and complex lending landscape. It also serves as a constant reminder to the industry of NCUA's vigilant posture when it comes to identifying and managing risk. While NCUA appreciates the desire of credit unions to serve their members as fully as possible, we recognize that there is no substitute for strong supervision that enhances safe and sound operations.

Federally insured credit unions remain financially strong. They have implemented NCUA guidance related to real estate and other lending and as a result are positioned to weather the current economic turbulence. While data shows that the industry is not entirely insulated from the adverse impact of the mortgage situation, it also supports the conclusion that strong risk management and prudent standards, hopefully supervised by an engaged regulator, will ensure continued success.

Thank you, and I look forward to your questions.

Chairman DODD. Thank you very, very much.

Donald Kohn—Donald, thank you very much—Vice Chairman of the Federal Reserve.

STATEMENT OF DONALD L. KOHN, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. I appreciate this opportunity to appear today to discuss the condition of the U.S. banking system as a follow-up on our previous hearing in March.

The U.S. banking system, while still in overall safe and sound condition, continues to face challenges. As the U.S. housing market has weakened and the economy has slowed over the past year, banking organizations have recognized significant losses. These losses stem from higher credit charges against residential mortgage-related loans held on their books and from sharp asset value write-downs of securitized mortgage-related positions and of leveraged loans. The largest bank holding companies performed better in the first quarter of 2008, but softening economic conditions have caused continued problems in mortgage loan portfolios, particularly home equity lines of credit, and in loans to real estate developers.

Nonperforming assets of bank holding companies more than doubled over the past year, and loan loss provisions have also risen sharply, partly as institutions build their loan loss reserves in advance of expected further deterioration in loan quality. Bankers and their supervisors have increasing concerns about the potential for more losses from traditional lending activities, such as credit card loans, auto loans, home equity lines of credit, and loans to businesses.

U.S. bank holding companies have raised more than $80 billion in capital so far in 2008, and some have reduced dividend payouts. We support such efforts by institutions to improve their capital

bases. Stronger capital positions will allow a banking institution to participate in and support the rebound in lending that will accompany the strengthening of the U.S. economy. Banking institutions must also continue to strengthen their liquidity positions, and we are highly supportive of those efforts as well.

We see a similar overall outlook for State member banks and anticipate that the number of banks with less than satisfactory supervisory ratings will continue to increase from the relatively low levels that have existed in recent years.

As recently documented in a series of public reports, the market events of the past year point to a number of risk management lessons for financial institutions. Bankers need to properly identify and measure and understand risks. They need to understand their liquidity risk on an enterprise-wide level and exercise strong management oversight to independent risk management functions. Overconfidence and complacency need to be continually battled, especially during an extended period of good times.

On the supervisory side, we are improving our supervisory processes and supervisory guidance on liquidity risk management, compliance risk management, and other relevant areas. We are acting to ensure that banks improve their forward-looking risk identification processes, which should include a more comprehensive understanding of their main and emerging business lines and the full range of risks they generate. We are also counseling institutions to understand the limits of their more traditional risk identification processes, emphasizing the importance of stress testing and scenario analyses. Better risk management at banking organizations must also be accompanied by more robust liquidity and capital cushions.

As you know, the Federal Reserve is a consolidated umbrella supervisor of large bank holding companies in the U.S. The process of consolidated supervision generally works well with strong, cooperative relationships between the Federal Reserve and other relevant bank supervisors and functional regulators. Recent events have highlighted the fundamental importance of enterprise-wise risk management, and we need to ensure that our system of consolidated supervision keeps pace.

The Federal Reserve is enhancing its guidance on consolidated supervision to provide greater clarity for our examination staff as they deal with the challenges of supervising increasingly complex organizations. The enhancements will provide greater consistency in the Federal Reserve's consolidated supervision process, as well as improve our ability to look at risks across an entire organization regardless of the legal entities in which those risks reside.

In this manner, the enhancements will assist us considerably in our broader financial stability rule. Naturally, under the upgraded guidance, we will continue to coordinate closely with other relevant supervisors and functional regulators.

Going forward, we must continue to send strong supervisory messages to senior management at financial institutions, perhaps with more force and frequency than in the recent past, to ensure that institutions retain their focus on sound risk management in good times and bad. We continue to review our supervision practices to identify and act on potential areas for improvement in light of re-

cent events. More generally, the Federal Reserve will continue to work with other banking agencies, foreign supervisors, and the Congress to help ensure that bank safety and soundness is maintained.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Mr. Kohn.

Mr. Karsky.

STATEMENT OF TIMOTHY J. KARSKY, COMMISSIONER, NORTH DAKOTA DEPARTMENT OF FINANCIAL INSTITUTIONS, AND CHAIRMAN, CONFERENCE OF STATE BANK SUPERVISORS

Mr. KARSKY. Good morning, Chairman Dodd, Ranking Member——

Chairman DODD. Mr. Karsky, let me introduce you. He is the Commissioner of the North Dakota Department of Financial Institutions and Chairman of the Conference of State Bank Supervisors, and we thank you very much for joining us.

Mr. KARSKY. Thank you, Mr. Chairman. Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name, again, for the record is Tim Karsky, and I am the Commissioner for the North Dakota Department of Financial Institutions. I also serve as Chairman of the Conference of State Bank Supervisors, and we thank you for giving us the opportunity to discuss the state of the Nation's banking industry.

As we reported to the Committee in March, our Nation's banks are operating in a challenging economy. Unfortunately, we are seeing and will continue to see some banks fail. Based on current conditions and trends, State banking regulators do not expect these failures to be widespread or beyond our capacity to manage.

As the recent failures have demonstrated, the banking industry is strong enough to absorb failed institutions, providing stability to the local market. This was most recently illustrated by last Friday's bank failure in Minnesota, which was then acquired by a State-chartered bank in North Dakota. This largely market-based solution can be managed with limited losses to the Deposit Insurance Fund and without the Government having to provide direct support to provide market stability. We have the tools to handle this.

If we are to look for "lessons learned" from the housing and capital markets crisis and the ongoing economic downturn, I believe that "strength through diversity" should be at the top of that list. "Diversity" does not just refer to variation within an institution's lending portfolio or lines of business. It is also diversity in the number and size of institutions. It is not an accident, but rather conscious policy decisions that have fostered the breadth of banks in the United States, which now stands at about 8,500.

In my home State of North Dakota, community banking is a pillar of economic development. For this reason, I am concerned about the mission creep of the Farm Credit System and its direct competition with community banks. The preferential status of Farm Credit banks creates an unlevel playing field for community banks. This disparity could eventually result in safety and soundness issues for the banking system in my and other States.

Since this Committee's hearing in early March, the Treasury Department released its blueprint for financial regulatory modernization and the failure of Bear Stearns prompted historic action from the Federal Reserve. We must acknowledge that failures and resolutions take on a variety of forms based upon the type of institution and its impact upon the financial system as a whole. Legislative and regulatory decisions that alter our financial regulatory structure or financial incentives should be carefully considered against how those decisions affect the competitive landscape for institutions of all sizes.

We recognize that extraordinary events require extraordinary actions. To provide market stability, the Federal Reserve has provided a tremendous amount of liquidity through various lending facilities and access to the discount window by investment banks. As we evaluate our regulatory structure, we must examine the linkage between the capital markets and the traditional banking sector. Depository institutions are heavily regulated. Going forward, we believe that the capital markets, and investment banks in particular, require enhanced regulatory scrutiny.

While State supervisors are leery of a complete overhaul of the banking system, we have long recognized the need for changes to residential mortgage regulation. As a result, CSBS has been working diligently to improve cooperation and coordination among State regulators and between State and Federal authorities. CSBS contends that an enhanced regulatory regime for the residential mortgage industry is necessary to ensure legitimate lending practices, provide adequate consumer protections, and to once again instill both consumer and investor confidence in the housing markets.

We congratulate this Committee on the passage of the S.A.F.E. Mortgage Licensing Act of 2008. As recognized in the bill, the cornerstone of the State initiatives to improve mortgage supervision is the development of the CSBS–AARMR Nationwide Mortgage Licensing System. Since our last appearance before this Committee, the State Foreclosure Prevention Working Group, of which CSBS is a member, released its second data report, which is attached to my written testimony. This report contains important findings on loss mitigation efforts of mortgage servicers.

I thank you for the opportunity to testify today and look forward to any questions you may have.

Chairman DODD. Thank you very, very much, Mr. Karsky. We appreciate your being with us this morning.

Let me ask the clerk to put that clock on us here at 5 or 6 minutes, if we can, and try to get around. We have had a good number turn out here this morning, and I want to give everyone a chance to engage in the discussion. So we will begin, and I will try and keep an eye on this clock myself.

What I will suggest in advance, I suggest there will probably be a lot of questions, and we may not get to all of them. So I am going to leave that record open for several days so that if we don't get all of our questions asked, we will submit them to you quickly and ask for a quick response, if we can, as well.

Sheila Bair, let me begin with you, if I can, and your testimony warns us of more bank failures to come this morning and says that these failures may not be confined to the smaller institutions. What

specific factors do you believe lead these banks to be in that condition? And do you expect that this round of failures will pose different challenges to your agency or the agencies represented at the table than the failures did in the 1990s? And, last, are you concerned about the Deposit Insurance Fund reserve ratio?

Ms. BAIR. Thank you, Mr. Chairman. I think in terms of risk exposure, obviously those institutions that had monoline business models and were heavily involved in nontraditional subprime mortgage lending are of concern. Those institutions that have high CRE concentrations, particularly combined with rapid growth, are of concern.

Within the CRE category, we are particularly focused on residential construction and development. That is where we are really seeing the delinquencies spike. And within that category, institutions with assets between $1 to $10 billion we think warrant a particular focus.

Chairman DODD. I am sorry. Would you repeat that?

Ms. BAIR. For mid-sized institutions with assets between $1 and $10 billion with high CRE concentrations, we're seeing a significant increase in delinquencies especially for that category of assets.

In terms of the resolution activity, so far, I am very proud of the way we have handled it. We perhaps were a little rusty. We went 2½ years without any bank failures. We had three last year, four this year. The number will go up. I think we have been working very hard to prepare, to staff up. There is a broad range of institutions that we need to keep a close eye on, but I do think we are taking all the steps that we can take.

Again in terms of a very large institution failure, I don't see that happening. I would be very surprised if that happened. But we feel like we have to prepare for all contingencies.

So we have been really going on two fronts—dealing with the more traditional resolution activity for the smaller institutions, where we know we have increases, and then trying to prepare through additional staffing and conducting simulation exercises for the larger, more complex institutions, as well as finalizing this rulemaking to get large institutions to update their deposit systems so we could very quickly make an insured deposit determination if the worst happens that we would have to close one.

Chairman DODD. And the ratios?

Ms. BAIR. The coverage ratio is a particular concern, and other regulators have mentioned that as well. The coverage ratio is a ratio of loan loss reserves to non-current loans. It has been slipping. It is down to 89 cents. We would like to keep it to about a dollar. That is a conservative range, but we would like to keep it there. So it has been slipping and, again, it appears that the institutions with large CRE concentrations, especially mid-sized institutions, is where we have seen a lot of slippage. So we are very, very focused, as are all the regulators, on getting those loan loss reserves up.

I am sorry, the ratio on the Deposit Insurance Fund.

Chairman DODD. Yes.

Ms. BAIR. Yes. We are down to 1.19, mainly because of very robust deposit growth in the first quarter. But we also had an in-

crease in our contingent loss reserve which has to be removed from the account balance that we use to determine the reserve ratio.

So, as you know, Mr. Chairman, we are at 1.19 now. If it drops to 1.15, the Reform Act requires us to implement a 5-year restoration plan in a very quick time period. So, again, I think probably in mid-August we will have a better sense of how close we will be to that, but we will act very quickly.

Chairman DODD. But you are prepared to respond to that.

Ms. BAIR. Absolutely. Absolutely.

Chairman DODD. Do you anticipate that is going to happen?

Ms. BAIR. I am trying not to make predictions, Mr. Chairman, because there are a lot of uncertainties out there. So we are trying to prepare for all contingencies. It is certainly within the realm of possibility. I do not discount it, which is one of the reasons why I wanted to raise it at this hearing, so you would know and not be surprised.

Chairman DODD. Well, I appreciate that.

Let me move quickly, if I can, to—one of the fundamental questions is whether we should be relying on models in setting bank capital, which is one of the components of Basel II, as you know.

Don Kohn, my friend over here, argued that the Basel Committee will, and I quote him here, "adjust the Basel II capital requirements in light of recent market events."

Ms. Bair, you have raised some concerns in your response by pointing out, and I quote your testimony, that the "unprecedented downgrades and massive losses incurred by banks on AAA-rated structured securities such as CDOs and asset-backed securities are a prime example of why models cannot be relied upon to set capital requirements and are meant to protect and preserve the solvency of our Nation's financial institutions."

Mr. Kohn, let me ask you, how would you respond to Ms. Bair's concerns about whether or not we should be relying on these models, in light of her statements about the recent evidence that indicates that that is a dangerous precedent to be engaging in.

Mr. KOHN. Well, I certainly agree with Chairman Bair that we should not rely exclusively on models to gauge the capital adequacy of risk-based capital. Models are one input. They didn't do very well in a number of respects, in a number of types of assets, and the most recent market turmoil. We are engaged with other supervisors in looking at the implications of that for the Basel capital requirements themselves. But I would also add there is a Pillar 2 to Basel, so that the banking regulators need to be confident that the numbers coming out of Pillar 1, based in part on model simulations, are adequate. And if we think they are not, we will insist that the banks hold more capital.

So this is not—Basel II is not just relying on some mathematical formula. There is quite a bit of regulatory oversight of how those formulas are done and adjustments of the regulation and supplements to that.

Chairman DODD. Well, I know there is a lot of interest on that. Senator Reed has raised these issues before in previous hearings we have had, so we will be following it very closely.

Let me move, if I can, to the issue of credit cycle and some of the write-offs, potential write-offs. As I mentioned in my opening

statement, some people now believe that the worse is behind us in the current credit crisis, while others believe that there are still some large potential pitfalls in our path. And we do know that we have witnesses—we have witnessed an unprecedented amount of write-downs by banks, which have led them to raise additional capital. By one account, banks throughout the world have had to raise over $200 billion in additional capital to confront these write-downs and losses. So I have two questions for the panel, if you would quickly respond to them.

First, is the cycle of mortgage-related write-downs nearing an end in your view? And, John Dugan, I will begin with you on this one.

And, second, discuss the risks to financial institutions from additional credit exposures, including loans and securitizations from credit cards, commercial real estate, or other areas of lending that will need to be addressed in the coming period. Somebody mentioned auto loan issues, for instance, which are showing some stress, to put it mildly. I would like you to just quickly comment on this, if you could.

Mr. DUGAN. Well, if I may, on the first question about are we past the period of most significant write-downs, if you look at the things that caused the really huge losses—the CDOs that were on the biggest firms' balance sheets where they have taken very large write-downs already, in some cases 50 percent of the value of the asset, even though the asset continues to pay, it is a liquidity kind of write-down. We think that the pace of those write-downs has already slowed and was nearing a place where we do not think it is likely to go down too much farther, which is a good thing.

If you ask about the particular loan level things like mortgages, home equity loans, et cetera, we expect that to continue to decline in almost all asset classes, as I have described. You mentioned auto. I would say home equity is a place that because it stands behind first mortgages, takes the first loss. We have seen very significant upturns in losses in that asset class, and unlike a lot of first mortgages which are sold off to third parties, those are pretty much all on the balance sheets of the institutions that originate them. We are still starting from a very low level of delinquency, so the fact that it has gone up is a concern, but not one that we would describe as a capital event, more an earnings event.

But across all these asset classes, whether it is consumer or commercial, we are seeing an uptick—and more than an uptick in some places—of criticized and classified assets.

The one thing I would like to emphasize, though—and you mentioned this—is institutions have been able to tap the capital markets and raise a tremendous amount of capital, and they did not do that in the 1980s. Not only did they not start with as much capital, but they were not able to access and replenish it. And that has been a difference, and a very significant, very healthy, difference this time around. And we expect to see more of that.

Chairman DODD. John Reich, do you have any comment?

Mr. REICH. I think one of our biggest concerns today is housing prices and the growing inventory of housing that is for sale, to the point today where there is about an 11-month inventory of homes for sale today. The longer that continues to be the case, the more

downward pressure that puts on housing prices today. And that will have an impact on our institutions, particularly on—HELOCs have been referred to today, home equity lines of credit that stand behind, generally, first mortgages. Thrift institutions have about $1.5 trillion in total assets. About 7.8 percent of their assets are in home equity lines of credit, about $118 billion.

As I mentioned in my opening statement, we have been encouraging them to add to their reserves. A year ago, reserves for future loan losses stood at about a half of 1 percent. Today they are over 1½ of 1 percent. They have provisioned aggressively in the fourth quarter of last year and the first quarter of this year.

We are seeing some positive signs. Net interest margin is showing some sign of improvement. There has actually been some improvement in the delinquency ratios for residential mortgages in the months of April and May of this year, during the second quarter of the year.

But I am not really wanting to make any predictions either as far as what inning we are in or whether we are out of the woods. I think our institutions are—I think they have geared up. I think we are dealing with a situation as it stands today, and I have some degree of optimism. But I would hate to characterize that too clearly.

Chairman DODD. Ms. Johnson.

Ms. JOHNSON. When you consider the charge-offs, the overall delinquency rate has ticked up, and the losses as well. But it is not an alarming figure. The credit unions are very well capitalized, and we feel it is a manageable situation.

Chairman DODD. OK. Don.

Mr. KOHN. I agree with my colleagues, Mr. Chairman. I think as John Reich said, the housing market bottom is not here yet. Prices are continuing to fall in many localities. I was encouraged by Senator Martinez's comments that he was beginning to see a little bit of a bottom in Florida. I would like to see that in the data as well.

So house prices are continuing to fall, but it is also the case that expected declines in house prices have been built into many of the prices of the securities that are driving the kinds of write-downs that John Dugan was talking about. So the market expects this to happen. They have built it in, and they have written down the price of the securities. So to that extent, I think both Johns are right.

Still, as long as the housing market is on a downward path, as long as those prices continue to fall, I think there is a risk that the losses could continue to mount on a variety of loans.

It is also the case that consumers, with a soft economy, a little bit of an increase in the unemployment rate we have seen so far—we have seen consumer spendable incomes pinched by rising energy prices, and we have seen upticks in problems in various consumer loan categories. And it would be surprising if that did not continue to rise for a while. Banks need to be prepared. I think by and large they are prepared. They are well capitalized. They have good capital cushions, and they have begun to build their reserves. But I also believe that they can use more, particularly against downside risk. So I would encourage them to continue the capital-

raising path that they have been on to protect themselves against the potential that things turn out to be worse than people expect.

Chairman DODD. Mr. Karsky.

Mr. KARSKY. Thank you, Mr. Chairman. I would say that I think for State-chartered banks as a whole, we have come through a pretty good economic time where our banks have a history of high capital ratios and we have had some good periods of earnings. We have some concerns going forward. We will not make predictions, but I think our banks are in good shape to handle the future crises.

Speaking for North Dakota, if I have a risk or a concern out there, it is just that we do not run into an agricultural crisis with overlending on land values and we continue to lend on cash-flow. We have learned some pretty valuable lessons from the 1980s and 1990s, and as long as we stick to what we have learned, I think we are going to be OK. But our land prices have gone up substantially, I think, in the Midwest due to those high commodity prices. If those commodity prices drop, land values are going to drop. If our banks overlend, we are going to have some problems.

Chairman DODD. Yes. Well, thank you. And I have some additional questions. I wanted to get to this discount window issue, but I will reserve that until I get around. I went over my time, as I promised I would not, with these questions, but there are so many panelists here.

Let me turn to Senator Shelby.

Senator SHELBY. Governor Kohn, I want to pick up on some of the areas that Senator Dodd was into. As a lot of the subprime loans are reset, which they are being reset now, a lot of people in the financial markets are really concerned since this will have an impact not only on the price of housing but on the whole housing sector and financial sector. How do you see that? Is that already priced in? Or can it be priced in by the market? Because these are huge amounts of money we are talking about.

Mr. KOHN. I think it is priced in to a certain extent. A couple of comments, Senator.

One is I think because of our monetary policy actions, the threat from resets looks less dire than it did a year ago, because interest rates have come down, so they are not resetting to quite as high a rate as they were before. But they are still resetting, and many borrowers will——

Senator SHELBY. But there have got to be still concerns there for——

Mr. KOHN. There are lots of concerns, and the concerns actually perhaps are more focused on this price issue, that the price of collateral, the price of the houses going down, and people are in the so-called negative equity position, and what will they do in those situations, and how can we help them stay in their homes, prevent foreclosures. I do think that there is still mounting stress in the mortgage markets, and foreclosures are increasing, and those foreclosures will, as I think Chairman Bair said, add to the pressure on prices. So——

Senator SHELBY. Is this more regionalized or is it across the board?

Mr. KOHN. Well, it is true in a lot of places, but it is most evident in those areas that had very rapid run-up in prices, and so Cali-

fornia, Arizona, Nevada, Florida, I think were the—but those places are really stretched. They had very rapid run-up in prices, and a lot of lending to the full value of the collateral, and sometimes beyond that, on the assumption that the value of the collateral would rise and bail people out of all their problems. And now the collateral is falling very markedly.

The other stretch, geographical stretch of problems is in the upper Midwest where the industrial economy is in such bad shape.

Senator SHELBY. Ms. Bair, do you agree with his testimony? Is that some of your concerns as Chairman of the FDIC?

Ms. BAIR. I do, yes. We continue to be very, very focused on the housing market and this self-reinforcing cycle of foreclosures putting more pressure on home prices, resulting in more defaults and foreclosures.

I noticed the Mortgage Bankers Association came out with their most recent data. I think it just confirms what Don indicated. Foreclosures again were up. California, Florida, Nevada, and Arizona accounted for 93 percent of the increase in foreclosures among subprime ARMs. So particularly with those states where there was a big boom, there is a big bust now. We are getting into this dynamic where it is not just affordability of the mortgage, it is a combination of affordability plus being underwater, and at what point do more and more borrowers just give up and walk.

Senator SHELBY. Are those the areas that Governor Kohn was talking about in the country, are those where you are most concerned about bank failures?

Ms. BAIR. Well, that is a very——

Senator SHELBY. Where there is big exposure to real estate?

Ms. BAIR. Some of our more recent closings were banks who have done lending in those areas. These banks were not based in those states, but they were doing lending in those states. They were doing out-of-area lending. So that is another risk factor that we are taking a close look at.

Senator SHELBY. What is the value roughly of the FDIC fund today?

Ms. BAIR. It is $52.8 billion.

Senator SHELBY. $52 billion——

Ms. BAIR. $52.8 billion.

Senator SHELBY. Billion. And that is a lot of money, but considering the risk, you don't know as Chairman if that will be adequate down the road, do you?

Ms. BAIR. Well, our target is 1.25, which is where it has been for many years. We are at 1.19, as I indicated, and it is declining primarily because of deposit growth, but also because of increased losses due to bank failures. We do have back-up liquidity lines with Treasury. We are guaranteed by the full faith and credit of the U.S. Government. So, I think it is very important for depositors to understand absolutely the resources are there to back all insured deposits.

But I think we are fine. I think we are, even though there is an uptick in resolution activity, the number of failures is still low, certainly very low, compared to what was going on during the S&L days. So at this point, I think we are well prepared to handle it.

Senator SHELBY. Governor Kohn, I want to address another question to you, if I could. You are the Vice Chairman of the Federal Reserve. Current law, as I understand it, permits only entities that qualify as thrift, bank, or financial holding companies to exercise control over thrifts and banks. These laws were designed to protect the banking sector and have done so for about 75 years. At the same time, these restrictions limit many non-banking entities from providing capital to the banking system.

In light of the legal reality and the ongoing volatility of the financial markets—you are the Vice Chairman of the Fed—do you have any questions or concerns about the pool of capital available to banks and thrifts in today's markets?

Mr. KOHN. I think banks and thrifts have done a very good job in tapping a variety of capital in today's market, and they seem to have found ready sources of capital from a number of sources, including private equity, sovereign wealth funds, their own shareholders. I think so far there is ample capital out there if you are willing to pay for it, and they can do that.

I think the restrictions that Congress has put in place, basically in Gramm-Leach-Bliley, trying to separate banking from commerce, is what is, I think, underlying your question about what kinds of companies——

Senator SHELBY. Absolutely.

Mr. KOHN [continuing]. Should be allowed to buy banking companies. And I think if we broaden this out beyond financial holding companies, which we have now, I think that would be a very major step. I am not saying it should not necessarily be taken, but I think it would require a lot of discussion by the Congress as to whether they wanted to cross this boundary which they had drawn——

Senator SHELBY. It would be a big change from where we are today, would it?

Mr. KOHN. It would be a huge change from where we are today, and I am not sure it is necessary in order to get capital.

Senator SHELBY. But you do anticipate some of our banks—I know we do—are going to have to seek additional capital to meet what you as regulators say they need—is that correct?—considering the risk.

Mr. KOHN. I think they do. I do not think it is a risk because I think they do, they will be raising capital, and they will find that capital——

Senator SHELBY. Well, the capital is to cover the risk, isn't it?

Mr. KOHN. Yes, right. Right, they need the capital to cover particularly the downside risk in case things do not go very well.

Senator SHELBY. Governor Kohn—and I will address this to you and Chairman Bair—since the JPMorgan Chase takeover of Bear Stearns, there has been much discussion on the topic of a financial institution being too interconnected to fail, in addition to the older notion of too big to fail. The extension of the Federal Reserve discount window to securities firms, unprecedented, has now put Government funds at the disposal of these firms for the first time in our history, I believe.

I have concerns, and other people do, about the processes in place should another large and interconnected firm face financial troubles, which some people think will happen. How do you believe

a potential failure at a large and systemically important financial institution should be handled going forward? Same way you did with Bear Stearns? Which some people thought was stretching your legal authority and getting into some unknown territory.

Mr. KOHN. As you know, in order to provide liquidity support for that transaction, we, the Federal Reserve Board, had to vote that circumstances were unusual and exigent, and we did that, I did that readily in the circumstances then prevailing. The situation in the second week of March in financial markets was very, very stressed and deteriorating very badly. There was a flight to liquidity and safety. That flight caught Bear Stearns—who was probably the least strong of the major investment banks. Our judgment was that had Bear Stearns been allowed to walk into bankruptcy court, that would have disrupted the financial system and had very serious effects on the economy. And we would be—I would—if something like this were coming again, I would have to make the same kinds of judgments. My judgments are balancing the costs and benefits of any action we take——

Senator SHELBY. Continue to bail them out, in other words, is that what you are saying?

Mr. KOHN. I don't know what we would do. We would try to maintain the stability of——

Senator SHELBY. But you have set the precedent.

Mr. KOHN. We would try to maintain the stability of the financial system.

Senator SHELBY. But you have set the precedent by Bear Stearns.

Mr. KOHN. I agree.

Senator SHELBY. So some people believe that there are at least one or two more houses that if they don't fail, are going to come close to it. I hope not.

Mr. KOHN. I don't want to comment on——

Senator SHELBY. I know that.

Mr. KOHN [continuing]. The financial stability of these houses. I think that the investment banks in general have taken lessons from what happened in the first 2 weeks of March. They are building their liquidity. They are reducing their leverage. They are protecting themselves against downside risk. So I think we have a stronger set of investment banks than we had a month and a half ago.

Senator SHELBY. You really believe that now? You believe that we have a stronger set of investment banks, with all the stress and all the exposure, and most of them out looking for capital, than we did, say, a year ago? You think they are stronger?

Mr. KOHN. I said "than a month and a half ago."

Senator SHELBY. A month and a half ago. All right.

Mr. KOHN. I think they recognize the risks and they are taking steps to deal with the risks in a much more proactive way than was occurring before the middle of March.

Senator SHELBY. And a lot of that is because it is necessary to survive, is it not?

Mr. KOHN. That is right. There are very—as we were talking about the banking system, the same is true of the investment banks. There are a lot of risks out there, much of it priced into the

market, but not all of it. People are still very concerned about the liquidity and safety of where they have invested their money, and our major financial institutions need to make very sure that they understand the risks, they have got liquidity backstops to protect them against some very dire circumstances, and they have got adequate capital so that people will have no doubt about their viability.

Senator SHELBY. Have you ever seen this much stress in our financial system in your lifetime? You haven't, I know. I will answer that.

[Laughter.]

Senator SHELBY. Chairman Bair, the FDIC's bridge bank model, should it be employed in areas like this? Do you want to comment on that?

Ms. BAIR. Well, I do think it is something Congress should consider, and I would hasten to say that we fully support what the Fed did with Bear Stearns. They had a very short timeframe, and they had no playbook for the situation. I think they were very creative in how they dealt with it.

That said, I think that this does present an issue of lack of parity between how commercial banks—insured depository institutions that get in trouble—are treated if they are systemically significant, versus investment banks. The FDIC, as you know, must follow least-cost resolution, and plus make a systemic risk determination. Generally that means the bank has to be closed. It has to be put out for bid to multiple bidders. It means that equity shareholders and general creditors have to take full haircuts before we would experience losses in the DIF.

So there are very elaborate procedures. I think they are good procedures. But I think Congress should consider whether perhaps a similar set of procedures should be established for a troubled investment bank situation. We cannot deviate from least cost unless a supermajority of my board and the Federal Reserve decide that we should deviate from least cost. And, the Secretary of the Treasury has to approve it in consultation with the President. So it is a fairly elaborate procedure.

Senator SHELBY. If the Chairman will indulge me, I have got one other question.

Hedge funds and private equity firms have become, as all of you know, increasingly large participants in many sectors of the world economy. As of now, it is my understanding that these entities are only allowed to hold non-controlling stakes in banks and thrifts.

Governor Kohn, for the record, what constitutes control for each type of financial institution that you regulate? And I would also like to ask Chairman Reich this. And would you discuss the role you see private equity and hedge funds playing as large stakeholders in our financial markets as other traditional funding sources may either be strained or unavailable? And what are your thoughts about potential changes to investment limits on the harmonization of these rules?

Governor Kohn? I know that is a big question.

Mr. KOHN. Senator Shelby, I am not familiar with all of the specifics of all of our regulations, but let me give you a general answer here.

So you are right, that if you want to control a bank or a bank holding company or a financial holding company, you must be a financial institution. And furthermore, under the laws that you have passed, you must be ready to support the bank, the depository institution.

Senator SHELBY. Right.

Mr. KOHN. You must be a source of strength to that institution.

So any organization that wants to conform to those rules that Congress has established is welcome to apply to become a financial holding company to own a bank. I think there is an upper limit of 24.9 percent in the law of the shares. But even below that, obviously you could have a lower stake in a bank——

Senator SHELBY. 24 percent could be working control.

Mr. KOHN. Exactly. Exactly. And so we have put other metrics in place to ensure that Congress' intention about who controls a financial holding company is in place. So we have looked at whether the new equity owners, how many seats do they have on the board? What say do they have over the control? Do they have over the business strategy of the organization? What control do they have over hiring and firing the CEO? So we look at a number of metrics of control.

I think these are things we are looking at all the time. There are elements of flexibility there and we have those under continuous consideration because, like you, we share the desire to have as much capital as possible in this——

Senator SHELBY. Chairman Reich, quickly.

Chairman DODD. Very quickly.

Senator SHELBY. The Chairman has been very indulgent.

Chairman DODD. I know, but I have other members here.

Mr. REICH. We have two primary metrics that are involved here. One is 9.9 percent. If a private equity fund were to have 9.9 or greater percent, they would have to rebut a presumption of control. And 24.9 percent, also the same as the Federal Reserve.

We have had a number of conversations with private equity funds in the last several months. They have shown increasing interest in financial services. Most of them do not want to make an investment that would put them in the category of being a financial services holding company.

Senator SHELBY. Thank you.

Chairman DODD. Thank you very much.

And let me just quickly say and move along to other members, I happen to be in support of what the Fed did with the Bear Stearns JPMorgan Chase issue. I have questions about why we did not do something earlier, maybe to avoid the issue. But I think, given the time and framework, it was the right thing to have done. And I think it is appropriate that there is an improvement, in my view, that things have improved since a month-and-a-half ago.

And there are some additional questions I want to address on why it happened the way it did and what steps are being taken to make sure that those that are accessing that window are fulfilling some of these requirements. But we will get to that when I get back to my questioning.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Governor Kohn, I mentioned in my opening statements, both Ambac and MBIA have been placed on a watch list by Moody's. Do you have a general notion of how much exposure that they are insuring against? Is this in the trillions of dollars?

Mr. KOHN. I do not know the dollar amounts that they are insuring against.

Senator REED. But it is significant?

Mr. KOHN. It is significant. That is correct. And many banks have bought insurance from these institutions. I think, in many cases, the banks have written down the value of the insurance that they have bought from them. So they have been anticipating this weakness.

Senator REED. Let me—specifically with the Fed, the collateral that you assumed in the Bear Stearns, to what extent are those products enhanced by insurance? And to what extend that you have to take similar steps? Do you have a notion about that?

Mr. KOHN. I do not know to what extent the financial guarantors are involved. I do know that, for the most part, as was in the appendix to President Geithner's testimony, for the most part, these are mortgage, mortgage-related assets. They do have some hedges on them, which we are also taking. But I do not know the specifics of whether any of this is guaranteed by the financial guarantors.

Senator REED. It goes, I think, to the line of questioning that Senator Shelby was addressing, this interrelatedness which pops up in so many different ways, not so much—in this case, it is an insurance entity that insures some of these financial instruments that banks are holding as capital, that could become problematic.

Mr. KOHN. I think that is an excellent point. So banks thought they had protection against a risk in the mortgage markets, in the housing markets. But the people they were buying the protection from themselves had a big exposure in those housing markets so their protection was worth less than they thought.

Senator REED. And this goes beyond just the mortgage part now because credit defaults swamps, collateralized obligations, credit cards, home loans, car loans, et cetera.

Mr. KOHN. Right.

Senator REED. Let me ask Chairman Bair, in your capital discussions, which you say is adequate, are there instruments like this in that capital that you have been discussing with financial institutions about downgrading? Are you concerned about this issue that Governor Kohn illustrated?

Ms. BAIR. Yes, we are watching it very carefully. I think you need to separate their guarantee function on the structured financing versus their muni bond business. I think the muni bonds are safe with or without insurance. But there is bank exposure there, as well, particularly with the smaller banks.

A lot of these instruments have been written down significantly already. It is difficult to gauge what the impact would be, whatever the future Ambac and MBIA ratings may be. The best we can do is closely monitor it, especially individual institutions that have significant exposure or are relying on the existence of insurance to not take a write-down. That is something that needs to be vigorously addressed on an institution-by-institution basis.

Senator REED. Mr. Dugan, please.

Mr. DUGAN. Yes, most of these exposures are by the large national banks that we regulate and they have to reserve against the likelihood or unlikelihood that the protection that they have bought would not be there when they needed it and make an adjustment accordingly. We monitor that quite closely.

What Governor Kohn said about it is absolutely right, it turned out to be not as much protection as they thought they had. But in terms of national banks accounting for that in an appropriate way so that it shows up on their balance sheet, we absolutely monitor that.

Senator REED. Are you as satisfied of the structure that they are adequately monitoring for that and reserving for that risk?

Mr. DUGAN. Yes, but that is not the same as saying that the risk could not increase over time and might result in additional losses. I think they are accurately capturing what the risk is.

Senator REED. Mr. Reich, your comments?

Mr. REICH. I believe that there is not serious exposure in the thrift industry here.

Senator REED. Thank you.

Ms. Johnson, the same thing with respect to the credit union industry, not a serious exposure?

Ms. JOHNSON. That would be accurate, there are not significant volumes.

Senator REED. Let me turn quickly, Chairman Bair, to another issue. And that is the issue of credit card delinquencies, which significantly are becoming, I think, very problematic. Not only delinquencies, but defaults and also bankruptcy filings in which the individual borrower is now essentially writing off the entire credit card debt, or at least the companies are until they can recover it through legal proceedings.

Is this a significant issue that you are watching?

Ms. BAIR. Yes, credit card delinquencies are up. They are still relatively low but they are going up. As you indicated earlier, we are learning there is a clear interrelationship between mortgage distress and a consumer's ability to meet other types of consumer debt obligations, including credit cards.

So we are watching it carefully. It is going up. It is still relatively low but it is an area of increased concern.

And, because this is unsecured credit, the charge-offs come much more quickly than they would with other types of secured lending.

Senator REED. Mr. Dugan, please.

Mr. DUGAN. Yes, the national banks have about roughly about 80 percent of the credit card market. And if you look at an average charge-off rate, it is about 5.5 percent over time.

Frankly, it has been a little lower going into this and below that than we would have seen by this point. As Sheila just said, it has ticked up to that level. I think credit card providers have been more aggressive about managing credit lines and that kind of risk, and we are still at that average. It is not like what we are seeing in some of the other portfolios like home equity where the losses are way higher than historical averages. Here we come back up to historical averages, where the trend line is going up. Particularly in areas of the country where we have had bad housing market situations, we are seeing it even higher.

Senator REED. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Reed.

Senator Allard.

Senator ALLARD. Mr. Chairman, I just have one question for each member of the panel. I guess you could take 20 minutes to answer it, but I have got 5 minutes of time.

My question is this: in regard to the recent events in the markets, from your perspective, would you comment on those areas you think where adequacy has done well and areas where you think there has been some shortfalls in our current system? And maybe comment a little bit about Secretary Paulson's fairly substantial reform for the Federal Reserve and banking regulatory systems?

Ms. BAIR. I think our strong supervisory function and strong capital standards have served us well going into this. I think where we did not do as well as we should have was with monitoring underwriting standards. We let it get out of control. It was being driven heavily by the non-bank sector, but banks were involved, too.

So I think we need to get back—and we are getting back—to basics with banks and our supervisors, making sure people make responsibly underwritten loans.

Senator ALLARD. Do you need legislation to deal with the underwriting?

Ms. BAIR. Well, I think there was a lot of regulatory arbitrage going on, and there are different ways to address it. But one of the aspects of the Paulson plan would be to create a prudential supervisor and a business conduct regulator for all financial institutions, so we do not have this more Balkanized system that we have now, yes.

Mr. DUGAN. I agree that the underwriting standards, in the subprime market in particular, declined obviously dramatically. But I think we did have a problem of uneven regulation. And I think the problems were way more pronounced outside of the insured depository institution framework. We need to have a system that evens out that regulation, so that basically the same rules apply to anybody who originates a mortgage loan. We do not really have that now. We have made progress toward that goal, but we do not have that. And that is a single area where I think we need to improve.

Secondly, I agree that we had good capital coming into recent events. I think that is a positive sign. I think we, and everyone, relied too heavily on high credit ratings from the credit rating agencies. And I think that that created a false sense of security, both for institutions and for regulators. There is a lot of work being done now to examine that and reexamine not only what rules should apply to get those ratings, but also how much regulators should rely on them in the first instance. And I think this is very much worthy of review.

Mr. REICH. I agree with Comptroller Dugan. It is a cliche to say that we have had an unlevel playing field with regard to supervision, but it is true. And it is gaps in supervision that really initiated the problems that escalated to a broader area in our portfolios.

I think everyone agrees that housing and mortgage finance are major components of our economy that need continuing attention. And we need even level supervision among those areas. And I ad-

dressed in my opening statement that I thought that the Office of Thrift Supervision could be a part of the solution in leveling the playing field in that regard.

Ms. JOHNSON. Thank you. Yes, I believe that the early vigilance and the early guidance that NCUA provided to the credit unions, particularly in these lending areas, have certainly paid off, in addition to the robust exams that we performed.

We also have—credit unions are limited with more narrowly drawn investment opportunities and they have not been involved in most of this type—this part of the market.

As far as the Treasury proposal, I believe that there is strong evidence that there is a need for an independent regulator for credit unions because of the nuances of the difference between the not-for-profit cooperatives and the banking sector. And I think the success that we have had during this time of turbulence stands to support that.

Senator ALLARD. Yes.

Mr. KOHN. I think the successes include the fact that we came into this with a very, very well capitalized banking system, so that the shock—which has been tremendous, as Senator Shelby was saying—has increased failures, it has caused a lot of stress. But in the commercial banking system and in the thrift system, I think the amount of fallout, while substantial, is certainly less than it would have been if we had entered this situation with much less robust capital.

So I think the system learned a lot in the early 1990s and it has made it more robust in the mid-2000s.

I think another thing that has worked reasonably well is——

Chairman DODD. Mr. Kohn, excuse me, if I can, just a moment.

We have been—I wanted to complete this, if I could, but we have been notified that there is an objection been filed on the floor of the Senate to any committees meeting. I do not know what levity or discretion I have here to continue and finish the line of questioning, but I think under the rules of the Senate if an objection is filed, then you cannot continue to meet. I regret that deeply, this is a very important hearing.

I apologize to our colleagues who have been here all morning waiting to ask questions. So we will leave the record open for the questions. But under the rules of the Senate, I think I am obligated to terminate the hearing. And I regret having to do that.

Senator ALLARD. Those of you who did not answer my question, maybe you can get a written answer.

Chairman DODD. We will get a written statement for you. And any other questions we will have submitted and ask you to respond to our colleagues.

But this Committee stands adjourned.

[Whereupon, at 11:48 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

THE STATE OF THE BANKING INDUSTRY: PART II

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

June 5, 2008
Room 538, Dirksen Senate Office Building

Chairman Dodd, Senator Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the state of the banking industry and to describe specific actions we have been taking to address issues discussed at the March hearing on this topic.

Uncertainties in today's economic environment continue to pose significant challenges for the banking industry, households and bank regulators. Banks continue to experience increased pressure on earnings resulting from a deterioration in credit quality noted first in higher-risk nontraditional mortgage loans and now evident in other sectors. Deterioration has been particularly pronounced in construction and development (C&D) lending, which is receiving enhanced scrutiny from FDIC examiners.

My testimony will provide an update of bank financial performance during the first quarter and detail specific steps the FDIC is taking to address issues in institutions under our supervision. In addition, I will discuss initiatives that are underway to bolster our ability to address the resolution of failed financial institutions. Finally, my testimony will describe FDIC initiatives aimed at addressing the increasing number of foreclosures and problems in the mortgage credit markets. In particular, I will discuss a new proposal, the Home Ownership Preservation (HOP) loan program, which is designed to convert unaffordable mortgage loans into long-term, sustainable loans that permit borrowers to remain in their homes. HOP loans would complement the recent work of this Committee to expand the ability of the Federal Housing Administration (FHA) to refinance

unaffordable mortgages. Further, the HOP proposal would address some of the complex issues related to second liens and adverse selection.

The Banking Industry's First Quarter Performance

Last week, the FDIC released its *Quarterly Banking Profile*, a comprehensive summary of financial results for all FDIC-insured institutions for the first quarter of 2008. The banking industry's performance during the first quarter of this year highlighted the challenges facing financial institutions in the current economic environment. FDIC-insured institutions reported total industry earnings of $19.3 billion in first quarter 2008, up from $646 million during the previous quarter, but down 46 percent from first quarter 2007. Weakness in first quarter earnings was driven primarily by a quadrupling of loan loss provisions to $37.1 billion from $9.2 billion during the same quarter last year. The economic slowdown brought on by the disruptions in credit availability is expected to exert continuing downward pressure on industry earnings over the coming quarters.

The credit quality of insured institutions' lending portfolios continued to deteriorate during the first quarter. Noncurrent loans grew by $27 billion in fourth quarter 2007 and $26 billion in first quarter 2008, and now represent 1.71 percent of all loans.[1] Loans secured by real estate accounted for almost 90 percent of the total increase in noncurrent loans during the first quarter, but almost all major loan categories registered increases. Net charge-offs climbed 20 percent to $19.6 billion during the first quarter.

[1] Noncurrent loans are loans that are 90 days or more past due or in nonaccrual status.

Net charge-offs were higher than a year ago in all major loan categories, but the largest increases occurred in residential real estate loans and in real estate C&D loans.

Insured institutions continued to build their loan-loss reserves in the first quarter. The $37.1 billion in loss provisions that they added to their reserves was $17.5 billion more than they charged-off. However, the growth in loss reserves was outstripped by the increase in noncurrent loans, and the industry's coverage ratio fell for the eighth quarter in a row to 89 cents in reserves for every dollar of noncurrent loans. This is the lowest level for the coverage ratio since the first quarter of 1993. During times of stress, such as now, the risk of loss increases in both loan and investment portfolios.

The FDIC expects banks to be proactive in analyzing current credit conditions, make appropriate loan loss provisions, and maintain an appropriate allowance for loan losses. Management also needs to make sure their capital supports their institution's overall risk profile. In this regard, as credit quality decreases and noncurrent loans increase, there should be a commensurate increase in the allowance for loan losses. Based on first quarter 2008 information, allowance levels do not appear to be keeping pace with problem credits or loss rates. FDIC examiners will be vigilantly monitoring developments in credit quality and loan loss reserve levels throughout 2008.

Low net interest margins (NIM) continued to be a drag on the earnings and profitability of FDIC-insured institutions. The industry's average NIM in the first quarter held steady at 3.3 percent. However, 70 percent of institutions reported declines in their

margins as compared to their fourth-quarter 2007 levels. In fact, the average NIM of community banks was 3.7 percent during the first quarter, the lowest level since fourth quarter 1988.[2] Net interest income is particularly important to community banks. It represented 76 percent of net operating revenue at community banks during the quarter, but only 59 percent at larger institutions.

Even with the challenges in loan performance and earnings, capital ratios remained relatively strong at most FDIC-insured institutions. At the end of March, about 99 percent of all insured institutions, representing over 99 percent of industry assets, met or exceeded the minimum regulatory capital standard for well capitalized status according to the definition for Prompt Corrective Action. Management is expected to review capital not just with respect to regulatory minimums but with respect to overall loss exposure, and to build cushions beyond regulatory minimums given uncertainties in the economic environment. Many institutions have offset their losses by raising capital or by cutting dividend payments to conserve capital. Almost half (48 percent) of the 3,776 insured institutions that paid common stock dividends in the first quarter of 2007 paid lower dividends in the first quarter of 2008, including 666 institutions that paid no dividends.

Risks to the Banking Industry

Commercial real estate (CRE) loan concentrations at banks have increased significantly in recent years. Community and mid-sized banks, in particular, increased

[2] "Community banks" in this context refers to all insured institutions with less than $1 billion in total assets.

their exposure to CRE credit since it is a lending category where smaller institutions have remained competitive.[3] That said, large institutions also maintain significant CRE exposure with institutions with assets greater than $10 billion holding about half of all CRE credits. Strong real estate market conditions also led to a substantial increase in C&D lending for both large and small institutions. However, since mid-2007, the significant slowdown in home sales, turmoil in the credit markets, and the increasing probability of a sluggish economic environment have increased risks in C&D lending, and CRE lending in general. The C&D segment of the CRE lending category stands out as the most important short-term credit quality issue for the institutions supervised by the FDIC.

Given the prospect of a protracted housing market slowdown, there may be negative consequences for institutions with significant concentrations of residential C&D loans as they navigate through this corrective phase of the credit cycle. Loss rates have risen dramatically on C&D loans through first quarter 2008 and likely will increase because of the current oversupply of new housing units. In addition, weakness in the residential construction lending sector may spill over to other segments of CRE loans such as the retail and office sectors. Local real estate and economic dynamics greatly influence the credit performance of each individual institution. For example, in some markets the decline in the housing sector has begun to affect loans to develop shopping centers and other retail establishments.

[3] "Mid-sized banks," in this context, are defined as institutions with $1 billion to $10 billion in total assets.

Economic weakness and rising food and energy costs also have increased the potential risks associated with consumer lending. The consumers who are most vulnerable to default are those who are already struggling to make their mortgage payments. Credit card delinquencies and charge-offs have increased, particularly in those areas experiencing the greatest downturn in home prices. This increase in delinquencies continues a three-year trend, but is still below the highs of the previous recession. For example, the net charge-off rate on credit card loans at all FDIC-insured institutions was 4.8 percent in first quarter 2008 -- well below the 7.7 percent peak rate of first quarter 2002 following the last recession -- but up from 4.1 percent in first quarter 2007.

The FDIC anticipates a rise in the number of problem institutions over the next few quarters, but so far the number of problem institutions remains well below levels seen during previous economic downturns.[4] As of the end of March, there were 90 institutions with total assets of $26.3 billion on the FDIC's Problem Bank List, up from 76 institutions with total assets of $22.2 billion at the end of 2007. During the first quarter, twenty institutions were added and six were removed from the problem list. Three-quarters of the new problem institutions had CRE and/or C&D concentrations and, given the number of institutions with concentrations in these loan types, this trend is expected to continue. Problem institutions are currently scattered across the country; however, new additions to the list are more likely to come from the areas experiencing the highest levels of economic stress. The number of problem institutions -- and to a

[4] Federal regulators assign a composite rating to each financial institution, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" institutions are those institutions with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either a "4" or "5."

greater degree, the total assets of problem institutions -- are expected to rise over the coming quarters. However, the current list is small in comparison to the 1,430 institutions with combined assets of $837 billion that were listed at year-end 1991. Also, institutions on the problem list receive heightened supervisory attention, and most ultimately do not fail.

Last year, the FDIC closed three insured institutions with total assets of $2.6 billion and losses currently estimated at $178 million. So far this year, four institutions have failed, with total assets of $2.2 billion and estimated losses of $225 million. The number of failures in recent years has been unusually low by historic standards, and we expect that bank failure activity in the near term will be higher. There is also the possibility that future failures could include institutions of greater size than we have seen in the recent past.

The Condition of the Deposit Insurance Fund

As of March 31st, the balance in the Deposit Insurance Fund (DIF) stood at $52.8 billion. Fund growth during the first quarter, however, slowed to 0.8 percent from 1.3 percent during the previous quarter, and 1.2 percent during the first quarter of last year. Rising assessment income continued to bolster the DIF, but higher loss provisions restrained overall growth. The fund earned assessment income of $448 million in the first quarter, up from $239 million last quarter, as more institutions exhausted the credits that they received under the Federal Deposit Insurance Reform Act of 2005 (Reform

Act). First quarter loss provisions totaled $525 million, including a $459 million increase in the DIF contingent liability for anticipated failures over the next 12 months. By contrast, loss provisions in all four quarters of 2007 totaled $95 million.

After three consecutive quarters of flat or moderate growth, estimated insured deposits rose sharply in the first quarter of 2008, by 3.3 percent (13.8 percent annualized). Quarterly growth outpaced even the strong 2.2 percent rate (9.1 percent annualized) reported in the first quarter of last year. Both large and small banks experienced strong insured deposit growth on average. Retail deposits, such as savings and interest-bearing checking accounts, appeared to drive much of the growth. Significant variation in quarterly insured deposit growth rates is not uncommon, and a large increase is reasonable to expect after a prolonged period of low growth. Furthermore, the safety of federally insured deposits is an attractive feature in periods of economic uncertainty and financial sector difficulties.

The strong growth in insured deposits, together with the increase in loss provisions, pushed down the DIF reserve ratio to 1.19 percent at March 31st from 1.22 percent at year-end 2007. On March 14, 2008, the FDIC Board considered industry requests to lower assessment rates but voted to leave rates unchanged this year. Given the current difficulties stemming from problems in the housing sector, financial markets, and overall economy, the possibility remains that the fund could suffer insurance losses that are significantly higher than indicated by staff projections in March. A significant increase in insurance losses due to failures (or the fund's loss reserve for anticipated

failures) combined with strong deposit growth could push the fund below the 1.15 percent minimum of the statutory range. The Board will act as necessary under the statutory requirements of the Reform Act to maintain the integrity of the DIF.

Risk-Based Deposit Insurance Pricing

The new risk-based assessment system implemented after the enactment of the Reform Act has now been in place for over one year. The FDIC has begun to review how the system is working in order to determine whether changes to the assessment regulations would improve its effectiveness.

For well-managed, well-capitalized smaller institutions (and a small number of larger institutions), the FDIC determines a risk-based assessment rate using five financial ratios and a weighted average of supervisory component ratings. The FDIC selected and combined these measures based on a model that relates them to the probability that an institution's supervisory ratings will decline significantly within one year. To test how well this pricing method is working, the FDIC analyzed recent data available after the model was developed and found that the higher the assessment rate assigned under this method, the higher the percentage of banks whose supervisory ratings declined significantly within one year. This finding provides support that the pricing method is determining risk-based assessment rates as intended. The FDIC still plans to update the model this year in order to incorporate more recent data.

For most well-managed, well-capitalized large institutions (generally, those with over $10 billion in assets), the FDIC determines risk-based assessment rates using supervisory component ratings and long-term debt issuer ratings assigned by the rating agencies. For every large institution, the FDIC, after consulting with the applicable primary federal regulator, also determines quarterly whether to adjust the assessment rate within prescribed limits. These adjustments are intended to ensure consistency, fairness, and consideration of all available information. The FDIC has begun a review of the pricing method for larger institutions to determine whether it is sufficiently responsive to changing conditions. The agency plans to examine, among other issues, whether changes in how long-term debt issuer ratings are used to determine premium rates can improve the assessment system's effectiveness in capturing risks posed by large institutions.

In light of the current difficulties facing insured institutions, including institutions that are on the FDIC problem list, and recent failures, the FDIC also will consider other modifications to improve the risk-based assessment system's ability to account for risks in a timely manner and provide appropriate incentives. For example, the FDIC plans to review whether heavy reliance on brokered deposits (particularly when combined with rapid growth), excessive concentrations of difficult-to-value assets and disproportionate reliance on secured liabilities create risks to the fund that risk-based premium rates should reflect.

Recent Initiatives to Enhance Supervision

Commercial Real Estate

For several years, the FDIC has recognized the risks associated with CRE and C&D lending concentrations, and has made efforts to advise the industry on prudent risk management and oversight for these exposures. As of the end of first quarter 2008, 2,535 insured institutions had C&D concentrations of 100 percent or greater to Tier One capital.

In December 2006, the FDIC joined the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System (FRB) in issuing guidance titled, "*Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*." This guidance advised institutions to implement strong underwriting and risk management practices, and to maintain appropriate levels of capital to support a sound CRE lending program. Although this guidance has been an effective tool to help institutions manage concentrated CRE exposures, the levels of exposures in some banks continue to require that regulators remain vigilant.

On March 17, 2008, the FDIC issued a Financial Institution Letter to bank management on managing CRE concentrations that reinforced the 2006 CRE guidance. The March guidance articulates the FDIC's significant concerns about concentrations of CRE loans, particularly in the construction and development segment. It re-emphasizes that banks must be attentive to capital adequacy, loan loss reserve appropriateness,

portfolio management, and workout functions. Notably, the letter also encourages institutions to continue making CRE loans available -- on *prudent* terms.

In addition to providing guidance, the FDIC is monitoring institutions' CRE concentrations through both on-site examinations and off-site surveillance. Over the past five years, the FDIC has expanded the review procedures used by our examination force. These internal steps have provided examiners with procedural guidance and the necessary tools to expand examination coverage as necessary to effectively monitor and evaluate exposures. In addition, we have used our enforcement authority to address unsafe and unsound conditions regarding CRE exposures, and will use that authority as necessary to effectively discharge our supervisory responsibilities going forward.

Earlier this year the Division of Supervision and Consumer Protection conducted a targeted visitation program at 27 FDIC supervised institutions reflecting elevated concentrations in CRE loans and C&D lending. The purpose of the program was to determine the effect that deteriorating markets are having on institutions with significant concentrations in commercial real estate lending and whether changes to the current supervisory approaches for these institutions are warranted. The visitations found that some institutions with C&D lending concentrations in former high growth markets are experiencing a rapid increase in problem loans that may translate into losses this year. As a result of the visitations, the FDIC will accelerate some on-site reviews, refine our off-site surveillance and stress testing of institutions involved in C&D lending, and revise procedural guidance and examination tools for our staff.

Enhanced Bank Supervision

In March 2007, the FDIC launched a coordinated strategy for supervising and monitoring state nonmember institutions with significant exposure in nontraditional mortgage (NTM) and/or subprime mortgage products. This strategy included targeted visitations of institutions with the highest exposures to these products and follow-up visitations at institutions that present the highest level of supervisory concern.

The visitations identified weaknesses in credit administration practices, underwriting, and credit analyses but found that these areas are being strengthened at most institutions. The visitations also found that institutions were generally adhering to the 2006 *Interagency Guidance on Nontraditional Mortgage Products,* the 2007 *Statement on Subprime Mortgage Lending*, and consumer compliance policies.

The FDIC continues to focus attention on institutions under our supervision with significant NTM and subprime exposures, and we have modified our internal tracking reports to help us accomplish this. In cases where we see increased risk, we accelerate our examination and visitation schedule, change the CAMELS rating, or use appropriate enforcement action, if necessary.

In addition to monitoring bank NTM and subprime exposures in banks, the FDIC is closely monitoring trends in liquidity risk management and bank investments in structured credit products. The recent credit market turmoil has resulted in significant

disruptions in wholesale, credit sensitive funding programs, causing institutions to rapidly seek alternative funding sources, often at a greater cost. Further, some highly rated assets that were considered to be liquid and marketable proved to be problematic when the market seized up, resulting in a strain on liquidity and sizeable realized and unrealized portfolio losses. Much of these problems can be attributed to the lack of transparency in the structured finance market and a failure by investors to ask the basic question: "what is the collateral that serves as my primary source of repayment?" To address these concerns, the FDIC expects to issue guidance to the institutions we supervise on liquidity risk and issues related to investments in structure credit products. Market stress over the past year made shortcomings evident in some institutions' risk management of these areas, and our guidance will address specific areas where risk management efforts should be improved.

The FDIC also recently created an Emerging Issues Section within the Division of Supervision and Consumer Protection, to enhance the Corporation's ability to develop proactive, forward-looking bank supervision policy. The section will augment existing processes for ensuring that the FDIC Board and executives are apprised of developments affecting the safety and soundness of insured institutions and the treatment of bank customers -- and to identify, at the earliest possible time, issues that may merit a consistent policy response.

To address the issues faced by banks that rely on third parties for critical services and activities, the FDIC is issuing *Guidance for Managing Third-Party Risk*. Banking

institutions often rely on third parties for a wide variety of services and activities that are critical to their safe and sound operation. Basic elements of the guidance will include: effective risk assessment and due diligence when selecting a third party, careful contract structuring, and compensation arrangements that avoid encouraging third parties (which could include loan originators and mortgage brokers) to steer consumers into higher cost or other inappropriate products.

Finally, the FDIC is addressing the growing complexity within the banking industry by ensuring that on-site supervisory activity is commensurate with an institution's complexity and risk profile, and by enhancing procedures related to offsite monitoring of large insured institutions. The FDIC's focus on large, complex financial institutions has evolved to meet emerging challenges posed by consolidation and market innovation. For example, the FDIC recently approved and implemented comprehensive changes to its Large Insured Depository Institution Program, which includes 128 institutions with $10.2 trillion in assets. Key among these changes is the centralizing of risk analysis for supervisory, insurance, and resolutions business lines. The FDIC has developed a system to capture critical data elements identified by each business line in a standardized format to allow for effective comparative analysis and risk ranking of insured financial institutions. This enhances the coordination between these functional areas and ensures effective offsite monitoring, resource allocation, insurance pricing, and resolution planning related to complex insured depository institutions.

Basel II

Last December, the U.S. agencies finalized the rules that will allow the largest banks to use their internal models for calculating their risk-based capital requirements. Although I support the concept of a more risk sensitive capital framework, I have been a skeptic of model-based capital regulation. The last quantitative impact study showed capital requirements declining significantly in many categories with declines particularly dramatic in capital held against residential mortgages. Further, many of the recent problems in the credit market can be attributed to a failure of bank and rating agency models to accurately predict the risk and the resultant losses in the mortgage markets.

For those reasons, the FDIC insisted that the final rule require a comprehensive study by the bank regulators on the effectiveness of the Basel II rules. This study must be completed before any institution is permitted to exit the transitional floors that were established to limit unwarranted reductions in risk-based capital requirements. These procedures will permit a careful review of the Basel II framework that addresses the capital and modeling issues before the bank regulators move to full implementation. Given the recent market turmoil, I believe a cautious approach to adopting a model-reliant capital regime will produce a more rigorous and robust set of capital standards.

Most importantly, the bank regulators retain the leverage ratio for all banks. The leverage ratio complements the risk-based capital requirements by ensuring a base level of bank capital exists to absorb losses and protect the deposit insurance fund, even in

situations where the risk-based metrics erroneously indicate risk is minimal and little capital is needed. These safeguards, along with the Prompt Corrective Action framework that provides regulators with the power to step in early to rectify problems and limit losses, will preserve capital and promote a safe and sound banking system for now and for the years to come.

For several years now, community banks have been asking for a more risk-sensitive capital rule that does not hurt their ability to compete with big banks. To address this concern, the FDIC and other federal banking agencies have developed a proposed rule that would allow all banks that are not required to use the Advanced Approaches the option of implementing a risk-based capital framework based on the Standardized Approach contained in the Basel II Accord. A question in the preamble to the proposed rule also will ask for comment on whether all banks, including those that are required to use the Advanced Approaches, should be allowed to use the Standardized Approach. The comments received in support of such an approach in prior rulemakings strongly supported such an option.

The proposed Standardized Approach provides banks with an alternative that is more risk sensitive than the existing framework, while being less reliant on models than the Advanced Approaches. The Standardized Approach introduces a more risk sensitive approach for residential mortgages that bases the capital charges on first and second liens on loan to value measures, and also better captures the risks on negative amortization loans. This rulemaking will include key questions about the use of external ratings to set

capital for complex structured finance instruments as the bank regulators are very interested in alternatives that enhance the ratings based approach and improve the transparency in this market. The Notice of Proposed Rulemaking (NPR) solicits comments on whether enhancements to the capital treatment of off-balance sheet exposures such as Structured Investment Vehicles are needed, given their role in exacerbating the recent credit market turbulence. The OCC and OTS submitted the proposed rule to the Office of Management and Budget (OMB) for review on April 3, 2008. The OMB review is expected to be completed in a few weeks, and the proposed regulation will be published for public comment.

The FDIC is also participating in larger policy initiatives stemming from the recent market stress, most notably those being conducted by the Basel Committee. The Basel Committee is working on several initiatives that would enhance the minimum capital requirements, supervisory review processes, and transparency of complex structured credit products and is very close to updating and improving upon their existing Sound Practices for Liquidity Risk Management which will be issued for public comment.

Staffing

The FDIC is increasing its staffing to address increased supervisory needs and to handle the increase in its current and projected failure-resolution workload. Because of the similarity of skill sets, the FDIC has been engaging in cross training to create a

flexible workforce where examiners can provide support for resolution activities and resolution specialists can provide support for examination activities.

In recognition of the current economic environment, the Board of Directors authorized an increase in bank examination staff levels. As of April 30, 2008, the FDIC has added 178 Financial Institution Specialists and 94 mid-career employees to the supervisory function. In addition, we have added 65 retired annuitants hired under a special authority provided by the U.S. Office of Personnel Management. Notwithstanding these additional steps, the current credit environment is putting stress on all regulators' supervisory activity and we will continue to take steps to ensure appropriate resources are available for this important activity.

To address staffing needs for a potential increase in financial institution failures, the FDIC has placed great emphasis on cross training existing employees to cover certain resolutions functions. The FDIC has approximately 1200 people with the skill sets to work on resolutions who could be called upon if necessary.

In addition, the Division of Resolutions and Receiverships (DRR) recently received approval to increase its authorized 2008 staffing level from 223 to 331. This increase includes a permanent increase of 39 positions as well as a temporary increase of an additional 69 positions for a period of up to two years. Other FDIC divisions also were given approval to fill additional permanent positions to offset a potential high level of retirement attrition in coming years and allow for a transfer of valuable knowledge to a

new group of employees. The FDIC intends to temporarily hire specialists with expertise in asset management, investigations, owned real estate, accounting and marketing, among other qualifications. The complexity of financial products and assets has changed tremendously over the years and the professional skill sets required to handle this work is highly specialized. In addition to these staffing initiatives, the FDIC plans to supplement its staff with contractors, participants in our corporate employee program and mid-career hires to assist with receivership workload.

The FDIC also is using cutting edge technology to assist staff with key functions from marketing failed bank assets to identifying insured depositors. In addition, we have established contingency plans to increase call center and Internet capacity to ensure quality customer service to the public.

Recent Initiatives to Enhance Resolutions Capabilities

Because the rate of bank failures is expected to return to a level above that of recent years, the FDIC is actively engaged in ensuring that we have the capacity and appropriate skills to address the resolution of failed institutions. With the significant consolidation in the banking industry, we are focusing particularly on the unique issues associated with large financial institutions. Even if the probability of such a failure is unlikely, the development of mega-institutions means that the FDIC must ensure that its processes and systems are capable of handling the complex issues such a failure would pose.

Large Bank Claims Rulemaking

The FDIC needs data to make deposit insurance determinations at large banks in the event of failure. Some of these institutions may have millions of deposit accounts and the ability to determine their insured status quickly is essential to a successful resolution of a large failed bank. In January 2008, the FDIC issued an NPR proposing that the largest and most complex banks modify their deposit systems to facilitate the claims process. The NPR represents the culmination of two years of analysis, including public and industry input. The proposed rule includes a process to hold some fraction of large deposit accounts in the event of failure, the ability to produce depositor data for the FDIC in a standard format, and the ability to automatically debit uninsured deposit accounts to share losses with the FDIC.

The FDIC Board will be considering a final rule on this issue at our meeting later this month. Through this rulemaking, the FDIC also proposed using a failed depository institution's ledger balance after the completion of the day's business (by the receiver) to determine the amount of deposits in the failed institution for deposit insurance purposes. Scheduled internal transfers (for example, from one account to another account within the institution) would be completed before the FDIC would determine the extent of deposit insurance coverage. This particular change is meant to provide clarity and legal certainty regarding when the FDIC will make an insured deposit determination and will not require systems changes on the part of banks.

QFC Rule

Another key resolution area where the FDIC has sought to improve its preparedness is in our ability to respond effectively to larger and more complex portfolios of qualified financial contracts (QFC). QFCs are statutorily-defined financial contracts such as swaps and repos. In a bank failure, other parties to QFCs are granted special statutory rights to close-out their contracts in order to avoid cascading defaults in potentially volatile markets and to protect the stability of the financial markets. These special rights are stayed only briefly to allow the FDIC to make decisions about the disposition of these contracts.

In 2005, Congress recognized the importance of the FDIC having quick access to information critical to its decision-making by approving a statutory change that expressly authorizes the FDIC to adopt rules addressing QFC recordkeeping by troubled institutions after consultation with the other banking regulators. To implement this statute and to improve its access to essential information, the FDIC is developing a rule to require troubled institutions to maintain critical information and make it available to the Corporation upon request.

The FDIC has successfully made QFC determinations in small and mid-sized institution failures. However, in the unlikely event of a larger failure, the FDIC will need to have QFC-related information compiled, organized and available for our immediate

use. Most troubled and healthy banks already maintain and use this information as part of their regular and ongoing efforts to manage counterparty credit risk exposure. For example, fundamental elements in counterparty risk management are management of counterparty exposures and the ability to quickly determine net counterparty exposures. However, it may not be organized in the way needed to make QFC determinations within the prescribed one day timeframe. In addition, the information sought in the rule will streamline supervisory assessments of QFC activities and improve our ability to evaluate the riskiness of those activities. To that end, the proposed rule specifies the essential information and defines how the information should be made available in order to facilitate the most effective response by the FDIC.

Contingency Planning

To increase the FDIC's preparedness to address a potential large-bank failure, we have been running bank failure readiness exercises since 2002. These exercises usually target a single hypothetical large, troubled insured institution, although sometimes the exercises involve scenarios with multiple troubled institutions. In each case, we work through the FDIC's preparedness plans and identify areas for improvement. The most recent exercise was held earlier this year, involving the hypothetical failure of a very large commercial bank.

Depositor Education

The current uncertainty in the financial markets has generated concern on the part of the public about the safety of their money and a renewed interest in deposit insurance coverage. Calls to the FDIC's toll free number regarding deposit insurance coverage have increased dramatically in recent years. For example, the FDIC received 7,827 calls in April 2006 regarding coverage issues compared to 20,874 calls in April 2008. Also, in light of the recent changes in the coverage levels for retirement accounts and the continuing existence of disinformation about the safety of insured deposits, the FDIC is increasing our efforts to educate the public about deposit insurance coverage.

As part of our 75th Anniversary this year, the FDIC will launch a series of new initiatives to broaden public awareness of deposit insurance and the FDIC's mission. The foundation of the FDIC's anniversary activities will be a national advertising campaign promoting basic deposit insurance information. The FDIC's campaign will be designed to address the increased public interest in deposit insurance issues and provide the essential information in a straightforward and reassuring manner. The FDIC also will hold a series of events in four cities across the country aimed at sharing ideas about the effectiveness of financial education and leadership while gathering key elements to produce effective financial education tools.

Other elements of the campaign will further promote the important work of the Corporation. Given the current economic environment, it is a unique opportunity to

leverage our anniversary to educate the public about the confidence and stability that the FDIC has been providing for 75 years.

The Housing Market

Promoting Responsible Lending Going Forward

Because the problems surrounding unaffordable mortgages are acute in today's environment, and because I believe things may get worse before they get better, the FDIC is engaged in a wide range of activities to address home ownership and credit concerns. The FDIC has addressed public policy concerns regarding unfair and unsound lending practices by providing comments on the FRB Home Ownership and Equity Protection Act (HOEPA) proposed rule. Further, the FDIC has proposed a rule to make it easier for institutions to use covered bonds as a means to add additional liquidity for funding responsibly underwritten mortgages. In addition, the FDIC has embarked on fact-finding and outreach initiatives, such as an upcoming *Forum on Mortgage Lending for Low- and Moderate-Income Households* (LMI Mortgage Forum).

HOEPA Comment Letter

Earlier this year, the FRB, utilizing its authority under the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA), proposed amendments to Regulation Z. The FDIC strongly commended the FRB for taking this

important step and filed comments to address our views on the numerous consumer protection concerns that have arisen in the context of residential mortgage lending.

In its comment letter, the FDIC recommended significant revisions to the FRB's proposal with regard to several issues, including: providing a straightforward standard requiring mortgage creditors to determine a borrower's ability to repay a loan, and prohibiting underwriting based only on the initial "teaser rate" for all higher priced and nontraditional mortgage loans; requiring disclosure to borrowers and investors of loans with debt-to-income (DTI) ratios greater than 50 percent; prohibiting "stated income" underwriting outright for higher-priced first- and second-lien mortgage loans, as well as for nontraditional mortgage loans; banning or limiting prepayment penalties for higher cost loans; prohibiting the use of yield spread premiums to compensate mortgage brokers; restricting use of the term "fixed," or similar terms, in marketing information for adjustable rate or hybrid mortgage products; and keeping the proposed requirement that higher-priced mortgage loans have escrows for real estate taxes and insurance, but not allowing borrowers to opt out of escrows until longer than the minimum 12-month period proposed.

The FDIC strongly supports efforts to use rulemaking authority to establish consumer protections against abuses that are strong and consistent across industry and regulatory lines. In light of the existing patchwork of state laws, consistency in consumer protection standards through the application of uniform national standards for banks and nonbanks has the potential to raise the bar for all institutions and reduce the incentives for

regulatory arbitrage. However, state laws should not be preempted unless they are inconsistent, since many states have proven to be innovative laboratories for the development of consumer protections in recent years.

Covered Bonds

In order to promote greater liquidity in the mortgage credit markets, some have suggested the broader use of covered bonds as an additional funding source for mortgage lenders. Covered bonds are general obligation bonds issued by a bank that are secured by a pledge of loans that remain on the bank's balance sheet. Proponents argue that covered bonds provide an additional source of funding for mortgages while providing stronger incentives for sound underwriting practices than securitizations. Loans that secure the bank's performance of the covered bonds it has issued remain on the bank's balance sheet, so the bank is required to hold capital to cover the risk in these loans.

Last year, market participants communicated to the FDIC that uncertainty surrounding how we would handle covered bonds in the event of an issuing bank's insolvency was hampering efforts to market covered bonds. In April, the FDIC issued guidance addressing the treatment of covered bonds in receiverships and conservatorships.

The FDIC's guidance clarifies how the FDIC will treat covered bonds in the event of a bank failure and establishes safeguards to permit the prudent and incremental

development of a covered bond market in the United States. For example, the guidance states that in order to obtain favorable treatment by an FDIC receiver, covered bond issuances must be made with the consent of an insured depository institution's primary federal regulator and the total covered bond obligations at issuance cannot comprise more than four percent of the institution's total liabilities. Importantly, the collateral for the covered bonds must be secured by perfected security interests under applicable state and federal law on performing mortgage loans on one- to four-family residential properties, be underwritten at the fully indexed rate and rely on documented income in accordance with existing supervisory guidance governing the underwriting of residential mortgages. The FDIC's guidance should permit the development of a covered bond market in a way that permits bank supervisors to evaluate the growth and risks of this funding mechanism. While not a panacea, a developing covered bond market could provide an additional, importance source of secondary market funding for responsibly underwritten mortgages.

Mortgage Lending for Low- and Moderate-Income (LMI) Households

On July 8, 2008, the FDIC will be hosting an LMI Mortgage Forum. The purpose of the forum is to discuss the elements of a framework for LMI mortgage lending in the future, including identifying market and regulatory incentives for encouraging responsible LMI mortgage lending. Participants will include Secretary Paulson and Chairman Bernanke, as well as prominent private sector participants. The Forum is designed to focus on ways to ensure that LMI lending is properly underwritten and provides a profitable opportunity for lenders. Unfortunately, much of the LMI lending in

recent years has been poorly underwritten or done in ways that are not sustainable for borrowers. The Forum will provide guidance for a return to fundamentals in lending to this important segment of the population. Following the LMI Mortgage Forum, the FDIC will convene a meeting of our Advisory Committee on Economic Inclusion to discuss issues raised at the LMI Forum and to make recommendations to the FDIC regarding how our agency can enhance our efforts to encourage safe and sound lending that is fair to LMI consumers.

Addressing the Needs of the Current Housing Market

In addition to promoting responsible lending going forward, the FDIC has been engaged in efforts to address the current problems in the housing market. The FDIC has issued guidance to foster better reporting of restructured loans by servicers, underscoring the FDIC's ongoing commitment to the HOPE NOW program. The FDIC also has proposed a new initiative, the Home Ownership Preservation (HOP) loan proposal, which would augment the existing or proposed FHA refinancing strategies and has the potential of helping many homeowners weather these difficult times and stay in their homes.

Voluntary Loan Modifications

The FDIC was an early proponent of voluntary industry efforts to systematically modify troubled mortgages into sustainable mortgage obligations. We have strongly supported the HOPE NOW initiative and encouraged banks to work with borrowers

under streamlined loan modification procedures to help prevent unnecessary foreclosures. On March 3, 2008, the FDIC joined the other banking agencies in issuing a Financial Institution Letter on bank reporting of securitized subprime adjustable rate residential mortgages under HOPE NOW's reporting standards. As banks and servicers report this data, the industry and regulators will have a better understanding of how loan modification and foreclosure prevention efforts are progressing and what areas of these efforts can be enhanced.

In addition, the FDIC joined the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators in encouraging servicers to consider the borrower's ability to repay modified obligations taking into account their monthly housing-related payments in relation to gross income. The thrust of this September 2007 Financial Institution Letter was to encourage institutions to apply loss mitigation techniques to achieve long-term, sustainable mortgage loans for homeowners.

Enhancing FHA

As you know, foreclosures keep rising as mortgages reset to higher rates, home prices continue to drop, and millions of families continue to struggle with unaffordable mortgages. I commend the Committee on its recently passed legislation to expand eligibility for loans guaranteed by the FHA, combined with GSE modernization and regulatory reform. This legislation is laudable and will help many borrowers. I have seen hundreds of ordinary homeowners at foreclosure workshops desperately looking for

ways to keep their homes. There is no single solution that can address all types of unaffordable loans.

Home Ownership Preservation Loans

Given the scope of the problem and differing circumstances of troubled borrowers, we encourage Congress to provide multiple tools for addressing rising foreclosures and the self-reinforcing spiral of declining home prices. Specifically, as a complement to FHA refinancings and voluntary loan modifications, we suggest a borrower loan program to meet the needs of homeowners who might not benefit from these other proposals.

Under our Home Ownership Preservation (HOP) loan proposal, the Treasury Department would make loans to borrowers with unaffordable mortgages to pay down as much as 20 percent of their principal. Mortgage investors choosing to participate would be required to restructure the mortgage to ensure an affordable, long-term payment and subordinate their lien interest to the government's claim. Both securitization trusts as well as portfolio lenders would be eligible to participate. To give borrowers time to stabilize their finances and rebuild some equity, repayment of the Treasury loan would be delayed for five years and then amortized over the remaining life of the mortgage. Mortgage investors would pay a subscription fee to cover the government's interest costs during the first five years. To prevent gaming of the system, eligibility could be confined

to loans originated in recent years that were unaffordable at origination, based on a simple debt-to-income ratio.

Importantly, this proposal keeps the risk of re-default on mortgage investors. It allows the government to leverage its lower borrowing costs to reduce foreclosures significantly with no expansion of contingent liabilities and little net cost. Ownership of the loans, with the corresponding risk of declining collateral values and credit risks, remains with the current mortgage investors. As a result, it has built-in incentives for mortgage investors to qualify those borrowers who have a good chance of paying off a restructured loan over the long term.

This strategy would work within existing securitization contracts and would be less administratively complex than loan-by-loan refinancings. In most cases, borrower eligibility could be assessed with information readily available from existing records. Principal write-offs, which can require investor consent, are not required, limiting the prospect of potential conflicts of interest. Most importantly, the proposal does not require the consent of second lien holders, new appraisals or refinancing the loans. Investors benefit by receiving immediate principal payments and from the reduced default risks.

The FDIC developed the HOP loan proposal to serve as an additional tool along with the existing proposals, and is designed to meet some important goals, including the following:

- *No bailout*. The proposal is not a bailout because borrowers are required to fully repay the principal of their loan.
- *No government cost*. The proposal is designed to result in no cost to the federal government.
- *Investors bear risk*. The proposal is designed so that mortgage investors continue to bear the risk of future default.
- *Stabilization*. The proposal would help stabilize high-cost mortgages (which would be good for credit markets) while keeping people in their homes making their payments (thereby, reducing foreclosure-driven reductions in home prices).

The HOP loan proposal would help homeowners who remain committed to their homes the means to stay in their homes with a mortgage that is sustainable over the long term. I believe the HOP loan program could be a valuable additional tool to address the problems created by unaffordable mortgages. It would complement the current FHA proposals recently adopted by this Committee. The FDIC would welcome an opportunity to work with Congress to achieve this result.

Conclusion

In the time since I testified before this Committee in early March, the FDIC has taken a number of specific actions to address current and potential future risks to insured

institutions from the deterioration in the housing and mortgage markets as well as the economy. Some of the FDIC's efforts have focused on mitigating losses on existing mortgages, while others have been geared toward strengthening underwriting standards and consumer protection to prevent today's unprecedented wave of mortgage defaults from recurring in the future. Although nearly all FDIC-insured institutions remain well-capitalized, they face significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices, and disruptions in the credit and capital markets. The FDIC is focused on these risks to ensure that the institutions it supervises maintain their safety and soundness. In addition, the FDIC is prepared to move promptly to resolve any bank failures that may occur.

This concludes my testimony. I welcome any questions that the Committee might have.

For Release Upon Delivery
10 a.m., June 5, 2008

TESTIMONY OF

JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 5, 2008

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to be here today to update the Committee on recent events in the financial markets and the condition of the national banking system. When I testified before this Committee in March, I reported that two powerful and related forces were exerting real stress on banks of all sizes and in many different parts of the country. One was the large and unprecedented series of credit market disruptions that was precipitated by declining house prices and severe problems with subprime mortgages. The other was the slowdown in the economy, which had begun to generate a noticeable decline in credit quality in a number of asset classes.[1] As we assess the impact of these forces today, I would say this: credit markets are better, while credit quality — meaning the performance of loans and other credit extensions to which banks are exposed — is worse.

On the first point, we are beginning to see improvement in several key segments of the credit markets, which several months ago had, essentially, come to a standstill. In particular, there is significantly more liquidity in money markets, and spreads on credit default swaps have narrowed. Financial institutions have raised unprecedented amounts of capital since October 1 of last year — over $100 billion by national banking organizations alone — and this shoring up of their balance sheets has helped restore confidence and liquidity in the interbank market. In addition, the pipeline of hung leveraged loan deals has slowly begun the clearing process.

While these are all good signs of progress, we clearly are not out of the woods. In particular, securitization channels for residential mortgages remain largely closed except

[1] Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, March 4, 2008, p. 3.

for conforming mortgages sold to the GSEs and FHA. This lack of liquidity is severely constraining new originations and refinancings for nonconforming mortgage products. Although banks and other portfolio lenders have taken up some of this slack, they have not and cannot provide the same level of credit to this important part of the mortgage market as was previously provided by securitization markets. In addition, the number of homes in foreclosure continues to rise. In this regard, we support the significant new options that are provided to help borrowers refinance their homes rather than face foreclosure that are contained in the legislation recently passed by this Committee.

Moreover, there continues to be considerable uncertainty among market participants about the underlying strength of the economy and the ongoing effects the recent market disruption and economic downturn are having on financial counterparties, consumers, and commercial borrowers. This uncertainty may lead to continued volatility in the financial markets that we and the institutions that we supervise will need to monitor carefully.

On the second point – credit quality – the downturn in housing and the broader economy is indeed continuing to have an adverse effect on national banks' loan portfolios, with the levels of nonperforming and past due loans increasing. Responding to deteriorating credit quality will continue to be a major focal point for supervisors and bankers in the months ahead. In light of these conditions, we believe the substantial increases that banks have made both to loan loss reserves and to capital in recent quarters are both prudent and warranted. Indeed, should credit performance continue to worsen, as we expect, additional loan loss reserves will be needed, and in some cases, additional

capital. As always, we support maintaining strong, conservative reserves, and we plan to underscore this message to bankers, the accounting standard setters, and bank auditors.

In the context of these two points, my testimony today provides an update on market conditions since the Committee's March hearing and an overview of national banks' performance during the first quarter of this year. I will then discuss some of the areas on which we will focus our supervisory efforts in the months ahead. I conclude with a discussion of some of the policy and supervisory initiatives we are undertaking in conjunction with other domestic and international supervisors to identify and implement lessons learned from recent market events.

II. Update on Market Conditions

In March, when I testified before the Committee, many segments of the credit and capital markets were experiencing very thin trading or transaction volume. Many market participants were choosing to stay on the sidelines until underlying market conditions and the health of key counterparties and monoline insurers became clearer. This was particularly evident in the corporate, leveraged lending, and interbank markets. By early March, modest improvements that we had seen earlier in the year in the leveraged loan and high yield bond markets had largely disappeared.

In recent weeks, we have started to see signs of increased liquidity as investors slowly return to many markets and once again begin to differentiate risk among issuer names. The cost of credit default swaps on most U.S. commercial banks – a barometer of investor concerns about the financial sector – has improved substantially from the levels observed in March. The spreads between U.S. Treasury bills and interbank rates such as LIBOR have declined (even though still high by historical standards), another sign of

improved investor confidence. The leveraged loan market has started showing renewed strength with the launching of several large primary issues and continued firming in secondary market prices. In addition, banks are reporting increased market appetite for high quality credit card securitizations and other non-complex transactions. Asset-backed commercial paper (ABCP) markets continue to show modest improvements. The market for commercial mortgage backed securities, which essentially had shut down in January and February, is also beginning to show signs of renewed activity, albeit at substantially lower volumes than in recent years. And financial institutions' raising of significant amounts of capital has also helped restore investor confidence after the announcement by these same institutions of very significant losses.

All of these are positive developments that, if they continue, can help reduce the overhang of loans that banks have had to fund on their balance sheets and thus free up capacity for additional lending. More stable and liquid markets may also reduce the volume and rapidity of mark-to-market write downs that we saw in the third and fourth quarters of last year and, to a lesser extent, in the first quarter of this year.

Notwithstanding these developments, any near-term return to the volume or pricing of credit that existed before last year's market disruption is unlikely. In addition, it is clear that certain market segments, such as non-conforming residential mortgage loans and some auction rate securities (ARS), particularly student loan ARS, remain severely constrained. In particular, while liquidity has slightly improved in some residential mortgage-related markets, the securitization market remains essentially closed to loans that cannot be sold to the GSEs and FHA. Recent Congressional action to increase the GSE and FHA loan limits should help improve the market for larger eligible

loans. And recent housing legislation that has moved through this Committee and the House of Representatives is intended to help stabilize the housing and mortgage markets. However, until that stabilization occurs and significant liquidity returns to the non-agency market, the origination for sale of subprime, Alt A, and jumbo loans not eligible for GSE and FHA programs is likely to remain severely constrained. As a result, the volume of new and refinanced non-conforming mortgages has declined substantially as banks are tightening underwriting criteria and solely originating these products for balance sheet retention.

All of this suggests the need for continued vigilance by bankers and supervisors.

III. Update on National Banks' Condition and First Quarter 2008 Performance

While the dislocations in the credit and capital markets appear to be abating, the downturn in the housing markets and the broader economy has adversely affected the credit quality of banks' loan portfolios. For some banks and portfolio segments, these adverse effects will likely worsen in the months ahead, as many borrowers now find themselves overextended.

This trend was reflected in recent earnings reports. While national banks' earnings rebounded in the first quarter of 2008 from the fourth quarter of 2007 (4Q:07), they were significantly lower than those reported in 1Q:07. Aggregate net income for 1Q:08 totaled $12.0 billion, compared to $4.8 billion in 4Q:07 and $21.1 billion in 1Q:07. Much of the improvement from 4Q:07 to 1Q:08 stemmed from smaller write-downs and mark-to-market adjustments in banks' trading and held for sale portfolios. Write-downs of collateralized debt obligation (CDO) exposures at the five largest national banks, for example, declined from $27.9 billion 4Q:07 to approximately $9.7

billion in 1Q:08. In contrast, banks' provision expenses continued to increase in 1Q:08, reflecting both the need to cover higher levels of charge-offs and a desire to increase loan loss reserves. Aggregate provisions to net charge-offs climbed to 194 percent in 1Q:08 compared to 111 percent in 1Q:07, while the loan loss reserve coverage as a percentage of total loans increased by 49 basis points from 1.14 percent to 1.63 percent.

The cumulative increase in loan loss reserves by national banks during the last four quarters is consistent with the deterioration in credit quality. National banks' ratio of noncurrent loans – the percentage of bank loans that are 90 days or more past due and on nonaccrual - rose to 1.56 percent in 1Q:08 compared to 0.85 percent a year ago. While this overall level of noncurrent loans remains very low by historical standards, there have been fairly rapid increases within certain portfolio segments, most notably those tied to the real estate sector. In particular, noncurrent loan rates for residential construction loans have jumped from 1.11 percent in 1Q:07 to 8.38 percent in 1Q:08, while those for other construction loans are up 244 basis points from 0.68 percent in 1Q:07 to 3.12 percent in 1Q:08. Noncurrent rates for home equity lines of credit have also risen significantly, from 0.41 percent in 1Q:07 to 1.01 percent in 1Q:08.

Despite the challenging economic and credit environment, the national banking system remains fundamentally sound: virtually all national banks meet or exceed the "well capitalized" regulatory capital requirements, and they continue to serve the needs of their communities by providing credit to creditworthy consumer and commercial borrowers. Indeed, in 1Q:08, total loans on the books of national banks increased by 16.8 percent compared to a year earlier. Adjusting for mergers and charter conversions, the increase was 12.2 percent, a rate of expansion that is actually somewhat above that

experienced in recent years. Net loan growth continued in almost all lending categories for both small and large banks.

As I reported in my March testimony, we have been directing banks to maintain strong capital cushions and adequate loan loss reserves; to develop diversified funding sources supplemented with realistic contingency funding plans; and to restore more discipline in credit underwriting and loan administration practices. A bank's adherence to these fundamentals has and will continue to be critical in determining its ability to weather the current environment.

Indeed, the vast majority of national banks are taking steps to bolster their operations and strengthen their balance sheets. As previously noted, national banks have significantly increased their loan loss reserves over the last four quarters. The largest national banking organizations continue to increase capital and debt levels through both public and private offerings, raising over $100 billion since October 1 of last year—an unmistakable sign of the underlying long-term viability that investors see in these franchises.

In the wake of the market disruptions of last year and, more recently, the experience of Bear Stearns, larger national banks are also working to strengthen their liquidity positions. To do this, they are increasing retail deposits, improving management of collateral that can be pledged for borrowings, and, as market opportunities permit, extending liability maturities. Core deposits, the most stable source of bank funding, have continued to grow. At the five largest national banks, core deposits rose by 7.9 percent in 1Q:08, measured year-over-year.

Our annual underwriting survey, which we will be releasing later this month, shows that after several years of increasingly accommodative credit terms, there is a renewed focus by national banks on credit fundamentals. This year's survey covered the largest 62 national banks, the combined loan portfolios of which represent approximately 83 percent of all outstanding loans in the national banking system. The results indicate that, in response to deteriorating economic and borrower conditions, many banks are strengthening their underwriting standards across an array of credit products.

With respect to commercial credit, examiners reported a net tightening of underwriting standards at approximately half of the surveyed banks; less than ten percent of the banks have eased commercial loan underwriting standards. Not surprisingly, products with the highest incidence of stricter underwriting standards included leveraged loans and commercial and residential real estate construction loans. But tighter standards were generally observed across all commercial loan products. The stricter underwriting standards are being imposed through a variety of mechanisms, including stronger loan covenants, reduced borrower leverage, additional collateral requirements, and adjustments to loan pricing to better reflect risk.

With respect to retail credit, examiners reported stronger underwriting standards at nearly seventy percent of the surveyed banks. No examiners reported an overall easing of retail underwriting standards. Stronger underwriting standards were most prevalent for residential real estate, home equity, and credit card loans -- portfolios that have sustained deterioration in borrower performance. Adjustments to collateral requirements (*e.g.*, lower loan-to-value ratios), credit scorecards, and documentation requirements are methods that banks are using to tighten their retail underwriting standards.

While the vast majority of national banks have the financial capacity and management skills to weather the current environment, some will not. Of these, some will be able to find stronger buyers – in some cases at our insistence – that will enable them to avoid failure and resolution by the Federal Deposit Insurance Corporation. In other cases, that will not be possible. In these other cases, our goal, consistent with the provisions of the Federal Deposit Insurance Incorporation Improvement Act, is to effect early and least-cost-resolution of the institution. We have had three such failures since the beginning of this year. The two most recent involved banks that engaged in significant out of market commercial real estate (CRE) lending to borrowers that were adversely affected by the economic and housing downturn. One of the banks had rapid loan growth and an elevated concentration of residential construction and development loans. Although the banks' boards and management made commitments to address deficiencies that we had identified and directed the banks to correct, they were unable to deal effectively with the banks' asset quality problems in the face of a weakening economy. They were also unable to generate or attract sufficient new capital to restore the banks' financial condition and sound operations.

IV. Areas of Examination Focus

In my March testimony, I observed that, as market conditions began to stabilize, the focus of supervisors and bankers would increasingly turn to the more traditional challenges of identifying and managing problem credits. That shift in focus has begun to occur as our examiners are increasingly drilling down and assessing banks' loan portfolios. One major facet of this assessment, the federal banking agencies' annual Shared National Credit Program (SNC), is currently underway. This program, focused

on our largest institutions, provides on-site reviews by examination teams of large syndicated credits that are shared by three or more banks. The current SNC portfolio totals $3 trillion in commitments to approximately 6,000 borrowers. This year's on-site reviews will encompass approximately 30 percent of this total commitment. Target areas of focus include commercial real estate, leveraged finance for mergers and acquisitions, and non-bank lenders.

A second initiative underway is focused on our smaller banks that have sizable concentrations of CRE loans. As reported in my March testimony, approximately one quarter of the community banks supervised by the OCC now have CRE-related concentrations exceeding one or both of the thresholds contained in the interagency CRE guidance issued in December 2006.[2] The share is even higher in areas that experienced rapid appreciation followed by downward pressures on home prices.

For each community bank that has exceeded one or both thresholds, our district examination staffs have prepared summary reports that identify the bank's exposures; our recent and current supervisory activities; and the examiner's assessment of management's ability to manage the bank's CRE exposures in the current environment. These reports have been reviewed and discussed within our district senior management group to identify those banks that we believe have the highest potential risk, and to ensure that our planned supervisory activities for those banks are appropriate. For all identified high risk banks, we will conduct asset quality reviews targeted on the bank's CRE portfolio by year end.

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[2] The concentration thresholds articulated in the guidance are commercial real estate loans (excluding owner-occupied real estate) exceeding 300 percent of risk-based capital, or construction and development loans exceeding 100 percent of risk-based capital.

Our goal in conducting these reviews is to work with bankers to identify potential problems at an early stage so that bank management can take necessary remedial action. Let me stress, however, that they are not intended to curtail prudent CRE lending. Because the issues and risks associated with CRE lending can vary by geography and product, our reviews are not broad brush in approach. They are tailored to the specific facts and circumstances of each bank, the nature of its CRE lending activity, and its local market. These reviews are already underway and in some cases have been completed.

Because of our concerns about national banks' CRE exposures, on April 18 our senior deputy comptrollers for bank supervision conducted a nationwide conference call with our examiners to discuss our policies and expectations with regard to CRE concentrations. The call also reviewed key policy guidance and issues that examiners may encounter during examinations to ensure that they take a consistent and balanced approach across our districts and lines of business. These issues include determining when a nonaccrual designation may be warranted; evaluating the use of interest reserves; and measuring project performance for construction and development loans.

One of the most controversial practices associated with the significant real estate downturn in the late 1980 arose in circumstances where the sharp decline in markets meant that appraisals had become outdated. In too many instances, because bankers were reluctant to adjust appraisals to reflect current market conditions, examiners were forced to unilaterally make such adjustments.

This time around, we have stressed to bankers, and reiterated to examiners during this call, that our objective is to minimize the need for such action. To achieve this objective, examiners will direct bank management to obtain new appraisals when needed

due to market or project changes, and to take necessary action should those appraisals indicate that loans are no longer adequately supported by collateral values. In many cases, an adjustment by bank management to original appraisal assumptions to reflect current market conditions, rather than a full reappraisal, may be sufficient. We emphasized that examiners should give bankers reasonable time frames for obtaining updated appraisals and making their assessments. We also reiterated the importance of maintaining open and constructive communications with bankers throughout this process.

With regard to retail credit exposures, our monitoring and examination efforts are focused primarily on residential mortgages, home equity lines of credit, and credit card portfolios. With respect to residential mortgages, as I reported in March, we are requiring the largest national bank mortgage servicers to submit comprehensive mortgage data to the OCC on a monthly basis so that we can do something that has not really been done before: collect mortgage data on a loan-level basis using standard data elements and definitions and a prescribed file format. This new approach to mortgage data collection allows the OCC to collect more comprehensive mortgage data and conduct data validation in order to make "apples-to-apples" comparisons between and among banks regarding various aspects of mortgage performance. For example, the data reflects both asset quality and loss and foreclosure mitigation actions using standardized definitions of prime, Alt-A, and subprime loans. The scope of the OCC's data collection covers all mortgages held on national bank balance sheets and those national banks service for others – which in total represents over 40 percent of all mortgages originated in the United States.

We recently received the first data submissions for the six month period ending on March 31 of this year. We have been actively working with servicers to verify the accuracy and reliability of this very substantial amount of loan level data. Our current plan is to issue later this month – perhaps as early as next week – our first public report of key aspects of the data. This will depend, however, on our ability to complete our validation efforts, which have taken a significant amount of time given the large size of this data collection.

Strains in the housing market are also adversely affecting the performance of home equity lines of credit. The home equity loan industry experienced rapid growth over the last six years. Aggregate outstanding lines have doubled since 2002 and currently stand at $1.1 trillion. National banks account for approximately half of this market, with much of this lending concentrated in our largest institutions. As with residential first lien mortgages, competition in the home equity lending market resulted in liberalized underwriting and increased risk layering. As housing prices have fallen and borrowers have become more leveraged, past due levels have accelerated and are expected to increase. While this continued deterioration may place a strain on some banks with sizeable portfolio concentrations, we believe the problem is likely to be manageable.

Mortgage spillover effects, coupled with the strains consumers are experiencing from rising food and gas prices, also are beginning to appear in national banks' credit card portfolios as delinquency and net loss rates have trended upward. The credit card industry began reacting early to the deterioration, with losses just now hovering around historical averages. We do expect some further deterioration in this asset class.

Prompt recognition of losses and the maintenance of strong loan loss reserves and capital buffers are critical during periods of economic stress. Ensuring banks maintain adequate loan loss reserves has been, and will continue to be, a point of emphasis during our examinations. Similarly, we will also continue to evaluate the adequacy of banks' liquidity positions and liquidity risk management processes, especially at those institutions with significant concentrations in their loan or liability portfolios.

Notwithstanding these efforts, we expect to see an increase in the number of problem banks that will require more intensive supervisory focus. In anticipation of this increase, we are taking steps to ensure that we can redeploy resources, as needed, to assist with the supervision of these institutions.

V. Policy Responses – Strengthening Supervision and Risk Management

At the Committee's March hearing, members requested information on initiatives underway to strengthen supervision and promote enhanced risk management practices among financial institutions, drawing upon lessons learned from the recent market disruptions. As the Committee is aware, a number of reports have recently been issued by various domestic and international work groups, discussing key lessons learned and setting forth recommendations for financial institutions and their supervisors. These reports include the March 6th and April 11th reports by the Senior Supervisors Group (SSG) on "Observations on Risk Management Practices during the Recent Market Turmoil" and "Leading-Practice Disclosures for Selected Exposures," respectively; the March 13th "Policy Statement on Financial Market Developments" issued by the President's Working Group on Financial Markets (PWG); and the April 7th report by the Financial Stability Forum (FSF) on "Enhancing Market and Institutional Resilience,"

(collectively referred to as the reports).[3] These reports have been supplemented by a series of papers on credit risk transfers, identification and management of risk concentrations, and customer suitability in the retail sale of financial products and services by the Joint Forum, an international group of senior bank, insurance, and securities supervisors for which I currently serve as chairman.[4]

While the reports have a somewhat different focus, they share several common themes and recommendations for supervisors and institutions. Broadly speaking, their recommendations call on institutions to:

- Strengthen risk management practices. Specific recommendations include ensuring an independent risk management function; managing the pipeline risk associated with "originate-to-distribute" lending and securitization business strategies; conducting appropriate due diligence, rather than relying solely on ratings, when investing in complex structured products; more fully evaluating the reputation and residual risks arising from various off-balance sheet activities, including off-balance sheet conduits and asset management businesses; identifying and managing concentration risks; and strengthening liquidity risk management practices and contingency funding planning.
- Enhance transparency, disclosure, and valuation practices. Specific recommendations in this area include improved disclosures with respect to

[3] Senior Supervisors Group Report, "Observations on Risk Management Practices," at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf; Senior Supervisors Group Report, "Leading-Practice Disclosures for Selected Exposures" at http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf; President's Working Group, "Policy Statement on Financial Market Developments," at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf; Financial Stability Forum, "Enhancing Market and Institutional Resilience," at http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.

[4] Copies of these reports are available at: http://www.bis.org/list/bcbs/index.htm.

off-balance sheet commitments, including commitments to support conduits and other off-balance-sheet vehicles. Improved disclosures should also apply to the underlying distribution of assets and associated risks for various structured products such as CDOs and asset-backed commercial paper conduits. Institutions are also being directed to ensure that they have rigorous valuation processes and to provide robust disclosures on their valuations.

- Improve stress testing and firm-wide capital planning processes. These recommendations focus on ensuring that an institution's stress tests and capital planning process fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm, and that capital planning and estimates of potential credit losses are appropriately forward looking and take account of uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

The reports also highlighted areas for enhanced supervisory oversight by banking supervisors. The recommendations generally fall into three broad categories: 1) providing additional guidance to institutions with regard to the risk management and disclosure practices noted above and monitoring institutions' actions to implement those recommendations; 2) enhancing the various aspects of the Basel II framework; and 3) improving the exchange of supervisory information and sharing of best practices.

On April 16, the Basel Committee on Bank Supervision announced a series of steps that address a number of these recommendations.[5] Consistent with the findings and recommendations by the PWG and FSF, the Basel Committee reiterated the importance

[5] "Basel Committee on Banking Supervision announces steps to strengthen the resilience of the banking system" at http://www.bis.org/press/p080416.htm.

of implementing the Basel II framework and outlined several proposed revisions to more fully capture the risks of certain complex structured credit products and off-balance sheet exposures. Specifically, the Basel Committee plans to establish higher capital requirements for resecuritizations, such as collateralized debt obligations that are comprised of asset-backed securities. These structured securities experienced the most significant losses during the recent market turmoil because of their high degree of leverage and the difficulty in establishing reliable estimates of the correlation of defaults among the exposures in the underlying portfolios. The capital treatment of liquidity facilities that support ABCP conduits will also be enhanced.

In addition to these two proposals, the Basel Committee is working with the International Organization of Securities Commissions to propose revisions to the current market risk capital framework for trading account activities. The planned revision would introduce a capital element for incremental event risk to better reflect potential exposures arising from the larger proportion of complex, less liquid credit products that institutions now hold in their trading portfolios. While this revision to the market risk framework is being developed, the Basel Committee plans to adopt an interim capital charge that would substantially eliminate the difference in required capital for certain structured securities that are held in the trading book relative to the banking book.

In addition to these revisions to the Pillar 1 (explicit capital charge) component of the Basel Framework, the Basel Committee also plans to strengthen guidelines for Pillar 2 (supervisory review) and Pillar 3 (market discipline/disclosure). The Pillar 2 enhancements, aimed at strengthening risk management and supervisory practices, will focus on the management of firm-wide risks, stress testing and capital planning, and off-

balance sheet exposures and associated reputational risks. These enhanced guidelines are expected to be issued later this year.

The Pillar 3 revisions will promote enhanced disclosures for complex securitization exposures, ABCP, and the sponsorship of off-balance sheet vehicles. These revisions are expected to be issued in 2009. The Basel Committee also reiterated its intention to monitor and assess the effect of Basel II on banks' capital levels over the credit cycle and to make further revisions, if needed, to ensure that it provides a sound capital framework for addressing banks' evolving and complex risks.

The Basel Committee also plans to issue for public comment sound practice standards for the management and supervision of liquidity risks. These standards are intended to address many of the issues identified during the recent market disruptions, including the need to fully assess the potential liquidity draws stemming from various off-balance sheet vehicles and other contingent commitments.

The OCC has been actively involved in the various work groups that issued these reports, and we support their recommendations. We are taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations. Many of these institutions already have begun an internal assessment of their practices to identify gaps where improvements are needed.

The OCC has existing guidance that addresses some of the issues and concerns highlighted in the recent SSG, PWG, and FSF reports. We plan to provide examiners at our large banks with a summary and cross reference of these policies to assist them with their on-site evaluations. We also will evaluate whether some of our existing policies

need revisions to incorporate recent market developments and lessons learned. In particular, we plan to update our guidance on derivatives and structured products (OCC Banking Circular 277, "Risk Management of Financial Derivatives") to reflect developments in these markets.

Finally, I would like to bring to the Committee's attention one recommendation in the PWG's report that does not directly involve the OCC but which is of vital interest to us and the institutions we regulate: the need for the Financial Standards Accounting Board (FASB) to evaluate the role that accounting standards played in the current market turmoil. While recent accounting changes, such as the greater application of fair value accounting, may provide benefits, I think we need to carefully review how the application of these standards may have influenced product structures and market behavior, including the market recent disruptions. The OCC would be pleased to provide any assistance the FASB may need as it undertakes this analysis. In this regard, I would also note that many of our larger institutions have begun to disclose the potential impact that the FASB's planned changes to FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* as it relates to qualifying special purpose entities, may have on their balance sheet structures and business lines. Here again, I think we need to carefully evaluate how these changes may affect markets and institutions, and to ensure that appropriate transition periods are provided if significant changes are adopted. We will be working with the other federal banking agencies to assess this impact and plan to provide comments to the FASB on this proposal when its exposure draft is released.

VI. Conclusion

In conclusion, it is clear that current economic and borrower conditions continue to pose challenges to financial institutions. We are closely monitoring these conditions and their potential effects on individual banks and the national banking system as a whole. As I have described in my testimony, we are stressing the need for banks to maintain strong loan loss reserves and capital buffers and to identify and correct weaknesses in their risk management systems that have been revealed by recent market events. We are also working closely with our supervisory colleagues on the Basel Committee to further strengthen the risk-based capital standards and disclosure practices for large internationally active banks.

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Statement of

John M. Reich
Director, Office of Thrift Supervision

concerning

The Condition of the Thrift Industry, Part II

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

June 5, 2008

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

June 5, 2008

I. Introduction

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

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

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

II. Conditions in the Housing Market and Broader Economy

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

[1] Bureau of Economic Analysis

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

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

III. Thrift Industry Performance in the First Quarter of 2008

Summary

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

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

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

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[2] Ibid.
[3] LoanPeformance February 2008.
[4] S&P/Case-Shiller Home Price Index, February 2008.
[5] Ibid.

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

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

Earnings and Profitability

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

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

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

Analysis of ROA

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

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

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

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

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

Mortgage Originations

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

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

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

Asset Quality

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

[6] Data are from the Federal Housing Finance Board's monthly *Mortgage Interest Rate Survey*.

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

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

Assets, Liabilities and Capital

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

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

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

Problem Thrifts

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

Structural Changes

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

IV. Supervisory Concerns

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

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

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

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

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

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

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

V. Underwriting Standards

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

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

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

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

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

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

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

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

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

Regulation of mortgage originators or brokers should contain three ingredients:

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

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

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

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

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

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

VI. Basel II

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

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

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

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

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

VII. Bank Risk Management

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

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

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

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

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

VIII. Foreclosure Prevention

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

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

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

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

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

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

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

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

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

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

IX. Consumer Protection

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

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

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

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

X. Conclusion

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

Thank you again for having me here today.

ATTACHMENT

Office of Thrift Supervision - West Region March 21, 2008

Regional Bulletin: 08-04

Credit Risk Management

Dear Chief Executive Officer:

SUMMARY

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

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

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

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

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

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

DISCUSSION

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

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

For all loans:

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

For loans secured by 1-4 single family residences:

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

For loans secured by income properties:

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

For construction and development projects:

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely,

Darrel W. Dochow
Regional Director

STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"STATE OF THE BANKING INDUSTRY: PART II"

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

THURSDAY, JUNE 5, 2008

I. Introduction

The National Credit Union Administration (NCUA) appreciates this opportunity to provide an update to the March 4, 2008, testimony concerning "The State of the Banking Industry." The federally insured credit union industry continues to comprise a relatively small but important part of the financial institution community, and NCUA's perspective on the financial performance of the institutions the agency regulates and insures will hopefully add to the overall understanding of a wide range of issues. Despite the continued downturn in the credit markets, and the resultant effect on the mortgage industry and now the broader economy, the federally insured credit union industry continues to be financially strong and vibrant. NCUA takes seriously the responsibility for close and diligent regulatory oversight in the context of this difficult environment.

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all federal credit unions, and participating in the supervision of federally insured state chartered credit unions in coordination with state regulators. In its statutory role as the administrator for the National Credit Union Share Insurance Fund, NCUA provides oversight and supervision to 8,049 federally insured credit unions, representing 98 percent of all credit unions and approximately 87.5 million members.[1]

[1] Approximately 166 state-chartered credit unions are privately insured and are not subject to NCUA oversight.

II. Financial Status of the Credit Union Industry

The financial state of the federally insured credit union industry remains strong and healthy with financial trends indicating continued margins of safe and sound growth. As with the previous testimony, the following discussion highlights key operating trends and supports the conclusion that federally insured credit unions have followed NCUA's guidance issued to date, particularly related to the risks associated with real estate lending, and continue to be well positioned to successfully address the current downturn in the economy.

Federally Insured Credit Unions Experience Continued Growth in Assets and Shares

Through the first quarter of 2008, aggregate assets of federally insured credit unions increased $39 billion (annualized rate of 20.57 percent) to a new high of $792.16 billion. Federally insured credit unions continue to place a priority on meeting the lending needs of the membership as total loans comprise 67 percent of total assets. This percentage has diluted somewhat since December 2007 due largely to asset growth outpacing loan growth by a margin of five to one.

Not surprisingly, given the trend cited above, total shares grew at an annualized rate of 22.35 percent through the first three months of 2008 to $668 billion. Nearly all share categories demonstrated strong growth in the first quarter of 2008, with a notable increase in money market and share certificates; these two categories combined for 53

percent of the quarterly dollar increase in total shares. Share certificates continue to represent the largest category of shares.

Federally Insured Credit Unions Continue to Provide Members with a Full Range of Loan Products

Loans continue to be the largest federally insured credit union balance sheet item, representing an industry-wide commitment to providing members with a full range of lending products and services. At the end of the first quarter of 2008, net loans represented 67 percent of aggregate credit union assets. As with 2007, real estate loans accounted for the majority of all loan growth through March 2008, and represented 52.47 percent of total loans. During the first quarter of 2008, fixed rate first mortgages increased $6.3 billion (annualized rate of 24.21 percent), and adjustable rate first mortgages increased $2.3 billion (annualized rate of 12.04 percent).

While Delinquency is Down Slightly, Net Loan Losses Have Increased in the Current Environment

Federally insured credit unions have appropriately positioned themselves to withstand the current economic cycle and related mortgage lending crisis. However, the federally insured credit union industry is not immune to the macroeconomic impact of increasing credit risk exposure created by the current housing market. Aggregate delinquency remained somewhat consistent in the first quarter of 2008, decreasing slightly from 0.93 percent to 0.91 percent of total loans outstanding. In comparing the various categories of delinquent loans (2-6 months, 6-12 months, and greater than 12 months), NCUA

noted an increase in the dollar amount of delinquent loans in longer-term categories (6-12 months and greater than 12 months) in the first quarter, even with an overall increase in net charge-offs during this same time period.

Delinquent real estate loans in federally insured credit unions increased from 0.67 at year-end 2007 to 0.70 percent through the first quarter of 2008. While this represents the highest mortgage delinquency in the last 13 years, it is important to note that federally insured credit unions have demonstrated an ability to manage economic downturns, as they did when mortgage delinquency hit a high of 0.56 percent in 1995.

The largest area of concern within the category of real estate loans continues to be with the category of Other Real Estate Adjustable Rate Loans, consisting primarily of Home Equity Lines of Credit (HELOCs). Delinquency for this category increased from .80 percent as of year-end 2007 to 0.96 percent as of March 31, 2008.

The aggregate net charge-off ratio for all loans also increased 17 basis points during the first three months of 2008, to 0.67 percent of average loans. This trend, coupled with the increasing delinquency with 6-12 months and greater than 12 months cited above, seem to indicate concerns remain in the credit quality of loan portfolios. Looking more closely at the category of real estate loans, NCUA noted an increase in net charge-offs from 0.08 percent at the end of 2007, to 0.19 percent as of March 31, 2008, with the majority of the increase identified as Other Real Estate Loans (HELOCs/Second Deed of Trust).

Federally Insured Credit Unions Reporting Continued Increase in Real Estate Foreclosures

To facilitate better risk identification and monitoring, NCUA began collecting data on foreclosed real estate with the June 2006 Call Report cycle.[2] Call Report data shows foreclosure trends have been increasing each quarter to a high of $407 million as of March 31, 2008. However, this represents a small portion (0.15 percent) of total real estate loans outstanding.

Higher Provision for Loan and Lease Losses Continue to Impact Earnings in the first quarter of 2008

The level of earnings for federally insured credit unions declined further in the first quarter of 2008, to 0.60 percent of average assets. As with the time period covered by the previous testimony, this decline was largely due to an increased Provision for Loan and Lease Losses expense needed to adequately fund for estimated losses in the lending portfolio. This level of return, however, was more than sufficient to cover the cost of operations and to contribute to the already solid level of net worth. This is consistent with NCUA's commitment to focus examination and supervision efforts on a federally insured credit union's ability to build capital to meet members' needs, and not just obtain an arbitrary level of return which may sacrifice service to the membership. This philosophy on evaluating earnings was presented to examiners and federal credit unions in Letter to Credit Unions 06-FCU-04 in August of 2006.

[2] NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from federally insured credit unions on a quarterly basis.

Federally Insured Credit Unions Continue to Have Strong Net Worth

Aggregate net worth increased $1.54 billion (annualized rate of 7.13 percent) through the first three months of 2008 to $87.72 billion, representing a new high dollar level in credit union history and a strong 11.07 percent of total assets. The overwhelming majority of federally insured credit unions remain well capitalized despite a slight dilution in the net worth ratio. This dilution resulted from asset growth exceeding capital growth through the first three months of the year. As of March 31, 2008, 99.09 percent of all federally insured credit unions were at least "adequately capitalized" or better, with 98.3 percent of all federally insured credit unions "well capitalized".[3]

Looking Forward

As reported during the previous state of the banking industry testimony, NCUA is aware of an increasing trend in the activity of consumer credit card loans as well as delinquent credit card loans. This could be an indicator of consumers facing financial difficulties and needing funds, particularly now that access to additional credit through HELOCs has been significantly reduced or eliminated. As of March 2008, credit card loan delinquency was 1.36 percent, representing a high-point since 2003. In addition, annualized credit card net charges-offs through March 31, 2008, represent 2.37 percent of average credit card loans outstanding. NCUA will continue to monitor this trend over

[3] NCUA's Prompt Corrective Action (PCA) framework utilizes a statutory net worth category classification to include: "Well Capitalized" for credit unions with a total net worth ratio of 7 percent or above, "Adequately Capitalized" for credit unions with a total net worth ratio of 6 – 6.99 percent, "Undercapitalized" for credit unions with a total net worth ratio of 4 – 5.99 percent, "Significantly Undercapitalized" for credit unions with a total net worth ratio of 2 – 3.99 percent, and "Critically Undercapitalized" for credit unions with a total net worth ratio of less than 2 percent. NCUA utilizes a modified version of this matrix for newly-chartered credit unions.

the next several Call Report cycles and provide relevant guidance to the industry and agency staff if warranted.

III. Mortgage Lending in the Federally Insured Credit Union Industry

A Closer Look at the Current State of Federally Insured Credit Union Mortgage Lending

As a point of reference, through the first quarter of 2008, first mortgage loan originations throughout the entire mortgage industry were estimated at $558 billion, of which federally insured credit unions originated only 3.26 percent or $18 billion first mortgage loans.[4] First mortgage loans held in federally insured credit unions represent only 6.62 percent of mortgage loans outstanding in all federally insured depository institutions.[5]

Seventy percent of federally insured credit unions offer mortgage loans to their members. As reported during the previous testimony in March, those credit unions not offering mortgage loans are generally smaller in asset size and cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios.[6] Consequently, the majority of federally insured credit union mortgage lending occurs in larger federally insured credit unions, as the following chart illustrates:

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[4] Based on information available at the Mortgage Bankers Association website for 2007 Purchase and Refinance Originations http://www.mbaa.org/files/Bulletin/InternalResource/62590_.pdf.

[5] NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 3/31/2008.* 31 March 2008. Federal Deposit Insurance Corporation. <http://www2.fdic.gov/SDI/SOB>.

[6] In addition, for federal credit unions, loans to a single member are statutorily limited to 10 percent of a federal credit union's total unimpaired capital and surplus (shares plus post-closing undivided earnings. See 12 C.F.R. 701.21(c)(5).

Federally Insured Credit Unions by Asset Size	Number of Mortgage Loans Originated Jan 1 – Mar 31, 2008	% of Federally Insured Credit Union Mortgage Loan Portfolio as of 3/31/2008
Greater than $1 billion	128,301	48.05%
$500 million-$1 billion	51,271	17.33%
$50 million-$500 million	109,401	29.61%
$10 million-$50 million	17,610	4.64%
Less than $10 million	1,319	0.37%

Demand for mortgage loans in federally insured credit unions remains high. As mentioned earlier, mortgage loans led all loan types in growth through the first three months of 2008, increasing $8.49 billion to a new high of 52 percent of total loans. In fact, in the absence of mortgage loan growth, aggregate loan growth for federally insured credit unions would have been negative in 2007 as well as through the first three months of the this year. NCUA continues to closely watch performance indicators in the mortgage lending area through data collection and the examination and supervision process.

As the following chart demonstrates, the majority of mortgage loans in federally insured credit unions are fixed rate, with almost all of the remainder being standard adjustable rate mortgages. Nontraditional mortgages[7] are offered by less than 6 percent of

[7] Consistent with guidance issued by NCUA and the other FFIEC member agencies, the term "nontraditional mortgage" covers a broad category of "exotic" or "alternative" mortgage products, including interest only and payment option loans.

federally insured credit unions and represent only 2.4 percent of mortgage loans outstanding.

Type of Mortgage	Dollar Amount of Mortgage Loan Portfolio (billions) as of 3/31/2008	% of Federally Insured Credit Union Mortgage Loan Portfolio as of 3/31/2008
Fixed Rate	$163	58.2%
Adjustable Rate	$117	41.8%
Interest Only or Payment Option[8]	$6.7	2.4%

Fixed rate mortgage loans accounted for 67.1 percent of the increase in mortgage loans during the first quarter of 2008. Fixed rate mortgages in federally insured credit unions grew at a rate of 14.6 percent (annualized) through March 2008. Adjustable rate mortgage loans accounted for 32.9 percent of the increase in mortgage loans during the first quarter of 2008, and grew at a rate of 9.71 percent (annualized). This data indicates a clear preference by federally insured credit union members for fixed rate mortgage loans in the current economic environment, and likely includes a significant degree of refinancing of adjustable rate mortgages.

[8] NCUA does not capture information relating to the type (fixed or adjustable) of "interest-only" or "payment-option" loans, just the dollar amount outstanding for these loan products. This amount is reflected in the totals for both fixed and adjustable rate mortgage loans outstanding.

Nontraditional Mortgage Lending in Federally Insured Credit Unions

Recognizing the increase in nontraditional mortgage products in the broader market, NCUA amended the 5300 Call Report to collect data on certain nontraditional first mortgage loans. Results for these mortgage products became available with the March 2007 reporting cycle. The data indicates that these mortgage products (specifically "Interest-Only" or "Payment Option" mortgages) are only offered in a small number of federally insured credit unions and comprise a very small portion of the total mortgage portfolio.

As the following table indicates, federally insured credit unions typically grant traditional mortgage loans:

Types of Federally Insured Credit Union Real Estate Loans[9]					
Quarter Ending:	**Mar-07**	**Jun-07**	**Sep-07**	**Dec-07**	**Mar-08**
Total Fixed Rate First Mortgages	37.6%	38.3%	38.2%	38.3%	39.4%
Total Balloon/Hybrid First Mortgages	17.1%	16.9%	17.1%	17.2%	17.4%
Total Adjustable First Mortgages	11.1%	11.0%	10.8%	10.6%	10.4%
Total Other Real Estate	34.2%	33.8%	33.9%	33.8%	32.8%
Total Real Estate Loans	100.0%	100.0%	100.0%	100.0%	100.0%
Non-Traditional: Interest Only/Optional Payment Loans[10]	1.9%	1.8%	2.1%	2.3%	2.4%

The non-traditional loans (Interest Only/Optional Payment Loans) account for only 2.4 percent of total real estate loans outstanding and 0.85 percent of total assets. There

[9] The table reflects the percentage of each real estate loan type to total outstanding real estate loans.
[10] NCUA only captures the balance of Interest Only/Optional Payment Loans and does not distinguish the type of such loans. Therefore, the Interest Only/Optional Payment Loans dollars are intermixed into the various types of loans listed in the table.

are several reasons why these riskier mortgage loans are not prevalent in federally insured credit unions. As earlier addressed, many federally insured credit unions are smaller institutions that lack the sophistication or resources to underwrite these types of loans. Also, as member-owned not-for-profit cooperatives, federally insured credit unions lending motivation is designed to be member-oriented, appropriately concerned with the suitability and impact on the member. In addition, the Federal Credit Union Act prohibits prepayment penalties and establishes a statutory limit for interest rates.[11] Because of these statutory provisions, the regulatory environment for federal credit unions is not conducive to some of the features that make the cost of underwriting non-traditional loans more tenable to other types of institutions.

Mortgage Loan Performance

Over the last decade, aggregate federally insured credit union mortgage delinquency has been very low, averaging approximately 0.38 percent. Mortgage loan losses have been equally low at 0.05 percent even with the increased numbers associated with these trends throughout 2007 and the first three months of 2008. Real estate delinquency continued to increase to 0.70 percent during the first quarter of 2008; however, it still remains at a very manageable level.

[11] The Federal Credit Union Act establishes a limit of 15% per annum inclusive of all service charges, with authority for the NCUA Board to establish a higher ceiling when certain economic conditions are met. The ceiling is currently set at 18%. 12 U.S.C. §§1757(5)(A)(vii) and 1757(5)(A)(viii).

Real Estate Loan Delinquency > 2 Months					
Quarter End:	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
1st Mortgage Fixed/Total 1st Mtg Fixed Loans	0.28%	0.36%	0.44%	0.48%	0.46%
1st Mortgage Adjustable Rate/Total 1st Mtg Adjustable Rate Loans	0.31%	0.33%	0.46%	0.69%	0.87%
Interest Only & Payment Option First Mortgage/Total Int Only and Pmt Opt First Mtg Loans	0.34%	0.34%	0.88%	1.66%	1.98%

As noted in the table above, nontraditional loans experienced an increase in delinquency. NCUA will continue to monitor the levels of delinquency and losses associated with these loans to ensure the additional risks are being properly measured and controlled. These levels, however, do not represent a threat to the safety and soundness of the federally insured credit union industry.

Federally insured credit unions typically continue to experience low real estate foreclosure rates as demonstrated in following table:

Foreclosed Real Estate (By Quarter)					
Quarter Ending:	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Amount (in Millions)	190.2	213.4	271.8	331.9	406.9
Percentage Increase	15.93%	12.17%	27.40%	22.11%	21.65%
Percentage of Total Real Estate Loans Outstanding	0.08%	0.08%	0.10%	0.12%	0.15%

Over the last 12 month period (March 2007 – March 2008), foreclosed real estate held by federally insured credit unions has more than doubled. A state-by-state breakdown of foreclosed real estate based on credit union location shows three states alone (California, Michigan, and Virginia) account for over a third of total foreclosure dollars

and nearly a quarter of the number of credit unions reporting foreclosures. Further analysis, however, shows that the actual dollar amount of $407 million in foreclosed real estate continues to represent only a small fraction, 0.15 percent, of the $280 billion in total real estate loans outstanding in federally insured credit unions, and does not represent a threat to the safety and soundness of the credit union industry. NCUA has also identified other geographical areas which warrant enhanced supervisory oversight, and has reallocated resources to ensure a proper level of staff are available to monitor credit unions' efforts through this particularly distressed economy.

NCUA's Demonstrated History of Mortgage Lending Guidance to the Industry

In the late 1970s, legislation expanded services to federally insured credit union members to include mortgage lending. This added another option for consumers who found it difficult to obtain real estate loans from commercial banks and savings institutions. Over the last thirty years or so, mortgage lending by federally insured credit unions has been considered a relatively safe product, subject more to interest rate risk exposure than the credit risk typically associated with lending products. As emerging risks have been identified, NCUA has provided written guidance to federally insured credit unions in the form of Letters to Credit Unions. Many of these pieces of guidance, some dating back to the 1970s, have been either cancelled or superseded by more relevant guidance to address emerging risks.

The written statement submitted for the previous testimony illustrated an established history of guidance related to mortgage lending dating back to 1991. Further, since the

previous testimony NCUA has issued additional guidance to the industry on this important issue.

Shortly after the last testimony, NCUA issued Letter to Credit Unions 08-CU-05 to encourage federally insured credit unions servicing subprime adjustable rate residential mortgages to utilize the HOPE NOW Alliance's loan modification standards to report foreclosure prevention efforts. The message conveyed in this letter built on previous statements issued by NCUA and the other FFIEC member agencies; working constructively with residential borrowers who are financially unable to make contractual payments on their home loans can be in the best interest of both the credit union and the borrower when done prudently.

Just last month, NCUA and the other FFIEC member agencies jointly released finalized Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products to assist credit unions with implementing the guidance contained in the Interagency Statement on Subprime Mortgage Lending issued last July.

IV. CONCLUSION

The federally insured credit union system remains financially sound. These institutions have effectively implemented guidance issued by NCUA related to real estate lending and have positioned the industry to weather this current economic downturn. Since the last "state of the industry" testimony in March, federally insured credit unions have

continued to demonstrate sound financial performance. While the data shows the industry is not entirely insulated from the adverse impact of the real estate lending crisis, it also supports the strong risk management principles effectively implemented by federally insured credit unions nationwide.

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Statement of

Donald L. Kohn

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

June 5, 2008

Chairman Dodd, Ranking Member Shelby and members of the Committee, it is my pleasure to appear today to discuss the condition of the U.S. banking system, as a follow-up to the testimony I gave at a hearing held by your Committee in early March. In my remarks today, I will provide an updated view of the health of the U.S. banking system, discuss some key lessons learned from recent events, and then outline a few important areas in which the Federal Reserve is responding in its role as banking supervisor.

Within the past year, we have seen a number of banking institutions suffer losses, some quite substantial. These and other institutions have been facing a range of risk management challenges, some of them relatively fundamental in nature and others associated with the increased use of complex and relatively new products. Fortunately, bank managers are acting on lessons learned from recent events and taking steps to rectify identified problems. Supervisors are also taking steps to respond to lessons being learned from recent events and, where appropriate, enhancing supervisory processes. Some of these steps include enhancing our understanding of the adverse implications of greater complexity in financial products and markets, stepping up our continuing efforts to address the challenges associated with supervising large, complex consolidated entities by multiple regulatory agencies, and ensuring that we continue to send strong supervisory messages, in good times and bad.

Condition of the Banking System

As you know, the Federal Reserve is responsible for supervising bank holding companies, working together with the primary supervisors of the banks and their affiliates. We ourselves are the primary supervisors of state-chartered banks that choose to join the Federal Reserve System. My update on banking conditions will focus on these two groups of banking organizations.

As the U.S. housing market has weakened and the economy has slowed over the past year, banking organizations have recognized significant losses stemming both from higher credit charges against residential mortgage-related loans held on their books and sharp asset value write-downs of securitized mortgage-related positions and leveraged loans. Indeed, the 50 largest bank holding companies, which represent more than three-fourths of all bank holding company assets, reported losses of more than $9 billion in the fourth quarter of 2007. Overall, bank holding companies in aggregate generated a loss of more than $8 billion during the difficult fourth quarter of 2007.

The largest 50 bank holding companies performed better in the first quarter of 2008, reporting profits of $5.2 billion and reduced trading losses. Consequently, bank holding companies overall reported net income of nearly $10 billion for the quarter, down substantially from the $36.5 billion in income they reported for the first quarter of 2007 but a considerable improvement over the prior quarter's losses. Nonetheless, the headwinds of heavy trading book losses proved difficult to overcome for some firms and seven of the fifty largest bank holding companies still recorded net losses for the quarter. Moreover, as economic conditions have softened, these large companies have reported increasing problems in mortgage loan portfolios, particularly home equity lines of credit, and in loans to residential real estate developers. In some cases, broker-dealer subsidiaries of bank holding companies have suffered valuation losses on their holdings of mortgage-related assets. Reflecting this deterioration in mortgage-related exposures, nonperforming assets more than doubled over the past year from $37 billion to $81 billion and, as of March 31, 2008, nonperforming assets as a share of overall assets reached the highest level since 2002.

Loan loss provisions rose sharply during the first quarter to $32 billion, exceeding net charge-offs by more than $14 billion, as the institutions were building their loan loss reserves in advance of expected further deterioration in loan quality. Increased concern over the potential for more losses from traditional lending activities has also been evident in the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which in recent quarters has shown banks tightening their lending standards and terms.

The 50 largest bank holding companies continue to work at improving their liquidity positions in the wake of recent market turmoil. Several of these companies had brought on balance sheet substantial assets that were originally securitized or otherwise held off balance sheet, forcing alterations in funding strategies and increasing pressures in the term funding market. As the Committee is aware, the Federal Reserve has taken a number of steps with its liquidity facilities to address the difficulties in term funding markets.

In order to bolster equity positions diminished by recent writedowns, U.S. bank holding companies--some at the urging of supervisors--have raised more than $80 billion in capital so far in 2008. In addition, some have reduced dividends to further shore up their capital base. Reflecting these steps, aggregate tier 1 leverage, tier 1 risk-based, and total risk-based capital ratios for the largest 50 bank holding companies increased over the first quarter, expanding the margins above regulatory minimums. We expect bank holding companies to continue to report weak earnings and further asset valuation writedowns and/or significant credit costs in coming quarters. Indeed, despite higher provisioning during the past several quarters, coverage of nonperforming loans by loan loss reserves has not kept pace with growth in problem assets and bank holding companies may likely face the need to further bolster loan loss reserves. In view of this uncertain outlook, additional capital injections and the consideration of dividend cuts are still

warranted for some of these companies and we have strongly encouraged supervised bank holding companies to enhance their capital positions. Stronger capital positions also will allow banking institutions to participate in and support the rebound in lending that will accompany the strengthening of the U.S. economy.

Consistent with trends in commercial banks overall, conditions at state member banks have weakened over the past year. Problems in residential mortgage, home equity, and loans to home builders have pushed the nonperforming assets ratio at these banks to 1.57 percent, more than twice the level of one year ago and the highest rate since 1993. Loan loss provisions have also accelerated, rising to a high of 1.14 percent of average loans during the first quarter of 2008 in large part reflecting the deterioration in residential real estate-related loan portfolios. Despite this deterioration, state member banks still reported aggregate net income of $3.7 billion and a return on assets of about one percent for the first quarter of 2008. Moreover, more than 98 percent of these banks reported risk-based capital ratios consistent with a "well-capitalized" designation under prompt corrective action standards.

Over the coming months, we expect banking institutions to continue to face deteriorating loan quality. House prices are still declining sharply in many localities and losses related to residential real estate--including loans to builders and developers--are bound to increase further. In addition, weak economic conditions could well extend problems to other segments of lending portfolios including consumer installment or credit card loans, as well as corporate loan portfolios. Moreover, banking organizations must be prepared for the possibility that liquidity conditions become tighter if uncertainties in the capital markets fail to subside or if credit conditions deteriorate significantly. Accordingly, we anticipate that the number of banks with less than satisfactory supervisory ratings will continue to increase from the relatively low levels

that have existed in recent years and we are monitoring developments at all supervised institutions closely.

Risk Management Lessons for Financial Institutions

Recent market events point to a number of risk management lessons for financial institutions. I will highlight just a few key points; many of these lessons have been documented more fully by recent public reports and discussed in speeches by Chairman Bernanke, myself, and other Federal Reserve officials.[1]

The period leading up to the recent market turbulence was an unusually good one for the banking system, characterized by high profits, strong balance sheets, rapid innovation, business growth, and relatively few bank failures. Unfortunately, the extended period of good times in the banking system bred a sense of overconfidence among many bankers and other market participants, causing them to underestimate risks and not fully consider the potential for those good times to end. Most notably, many market participants expected housing prices to continue their upward trend and did not properly consider what might happen if prices leveled off or fell. In order to be good risk managers, bankers need to understand that overconfidence and complacency must be continually battled, especially during an extended period of good times.

Another key lesson is that if risks are to be successfully managed, they must first be properly identified, measured and understood. Unfortunately, recent events have revealed significant deficiencies in these areas. Notable examples are the underestimation by many firms of the credit risk of subprime mortgages and certain tranches of structured products, as well as

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[1] President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf
Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf;
Senior Supervisors Group (2008). "Observations on Risk Management Practices during the Recent Market Turbulence" March 6, www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

poor understanding of particular market risk characteristics of structured credit products. In a number of cases, bank managers did not exercise proper due diligence in valuing their positions and assessing their risks, relying solely on third-party assessments of risk that turned out to be overly optimistic. Other firms did not fully consider the linkages and correlations between credit risk and market risk, leading to mismeasurement of their overall exposure.

Some institutions took an excessively narrow perspective on risk with insufficient appreciation of the need for a range of risk measures, including both quantitative and qualitative metrics. For example, some firms placed too much emphasis on the mechanical application of value-at-risk or similar model-based indicators. Sophisticated quantitative tools and models play an important role in good risk management, and they will continue to do so. But no model, regardless of sophistication, can capture all of the risks that an institution might face. Those institutions faring better during the recent turmoil generally placed relatively more emphasis on validation, independent review, and other controls for models and similar quantitative techniques. They also continually refined their models and applied a healthy dose of skepticism to model output. Stress tests and scenario analysis are tools through which institutions can gain perspective on risks that fall outside those typically captured by statistical models.

Another crucial lesson from recent events is that financial institutions must understand their liquidity needs at an enterprise-wide level and be prepared for the possibility that market liquidity may erode quickly and unexpectedly. As is now widely recognized, many contingency funding plans did not adequately prepare for the possibility that certain off-balance-sheet exposures might have to be brought onto the firm's balance sheet. Nor did they adequately account for the possibility of widespread and protracted declines in asset market liquidity.

Unexpected balance sheet expansions subsequently added to funding pressures as well as to pressures on capital ratios.

Effective oversight of an organization as a whole is one of the most fundamental requirements of prudent risk management. Senior managers at successful firms are actively involved in risk management, which includes determining the firm's overall risk preferences and creating the incentives and controls to induce employees to abide by those preferences. Often those incentives and controls must provide a counterweight to the incentives to seek short-run profits that can be inherent in prevailing compensation practices. Strong oversight requires access to a variety of high-quality information on a timely basis. Successful senior managers also work to ensure that critical information is transmitted horizontally as well as vertically; during recent events, some firms' business lines did not share vital information relevant to risk positions and business tactics, with adverse implications for profitability.

The leaders of well-managed institutions of all sizes generally seek to have strong and independent risk functions. Such functions support clear, dispassionate thinking about the entire firm's risk profile. In addition, the institution benefits when senior managers encourage risk managers to dig deep to uncover latent risks and to point out cases in which individual business lines appear to be assuming too much risk. The lessons I just noted emphasize the importance of risk management fundamentals, which means that they apply not only to those institutions suffering substantial losses recently, but also to institutions faring better during recent events.

Supervisory Consideration of Lessons Learned

Risk management shortcomings at financial institutions highlighted by recent events also present policy and operational challenges for supervisors. The primary responsibility for risk management appropriately rests with the management of each institution, and our supervisory

efforts are not aiming to prevent individual banks from suffering losses, which is part of the banking business. However, we are working to make sure that financial institutions have a better understanding of their potential for loss and that there are not broader breakdowns in risk management that can affect the financial system and the economy. While events continue to unfold, some key lessons for supervisors, in addition to bankers, are coming into focus. I would first like to highlight a few key lessons, and then in the next section will describe corresponding supervisory actions.

For one, the increased complexity and linkage within and among increasingly globalized markets presents greater challenges not just for bankers but also for supervisors. Supervisors need to enhance their understanding of the direct and indirect relationships among markets and market participants, and the associated impact on the banking system. Supervisors must also be even more keenly aware of the manner in which those relationships within and among markets and market participants can change over time and how those relationships behave in times of stress--not just at banking institutions, but also at other financial firms that play prominent roles in financial markets and whose actions and condition can have an impact on financial stability.

Before the recent market turbulence, the Federal Reserve--in many cases along with the other U.S. banking agencies--acted on a number of fronts to alert financial institutions about emerging risks, for example by issuing supervisory guidance on nontraditional mortgages, home equity lending, commercial real estate, and subprime lending. We must continue to be vigilant about emerging risks, not just in these more turbulent times, but also when good times return--and we must be insistent that banking organizations factor these risks into their own risk management practices. It is also clear that supervisors need to enhance their focus on consumer compliance issues at the point of contact between lenders and households and on the linkages

between weaknesses in consumer lending practices and safety and soundness, such as occurred with subprime mortgages.

The current U.S. regulatory structure, with multiple supervisory agencies, has a number of strengths and benefits, but challenges can arise in assessing risk profiles of large, complex financial institutions operating across financial sectors, particularly given the growth in the use of sophisticated financial products that can generate risks across various legal entities. Congress established a consolidated supervisory framework for bank holding companies in recognition that some risks cross legal entities and are managed on a consolidated basis. Accordingly, monitoring those properly requires a supervisory approach directed at more than one, or even several, of the legal entity subdivisions within the overall organization. Recent events have highlighted the fundamental importance of enterprise-wide risk management; both supervisors and bankers need to understand risks across a consolidated entity and assess the risk management tools being applied across the firm.

The implementation of consolidated supervision in the United States generally works well, with strong, cooperative relationships between the Federal Reserve and other relevant bank supervisors and functional regulators. Information sharing among relevant supervisors and regulators is essential to ensure that a banking organization's global activities are effectively supervised on a consolidated basis, and we have worked over the years to develop and enhance interagency coordination and information sharing. But as institutions grow larger and more complex, we need to ensure that our system of consolidated supervision keeps pace.

Supervisory Actions Going Forward

We are acting in response to lessons from recent events to ensure the continuing safety and soundness of the U.S. banking system. Of course, we also continue to study recent and ongoing events to gain additional information and insights.

As a first step, supervisors are redoubling their efforts to help organizations improve their risk-management practices, given the challenges some banks are facing today. Accordingly, we have increased supervisory attention to this issue. For instance, supervisors are reinforcing and strengthening their focus on assessments and testing of fundamental risk management processes, requiring vigorous corrective action when weaknesses are identified. We are also ensuring that institutions take a more forward-looking approach to risk management; for example, our examiners are reviewing due diligence around commercial real estate valuations and ensuring that bankers make appropriate adjustments based on market conditions. This approach is consistent with recent lessons we have all learned from residential real estate. Additionally, we are more intensely verifying assertions made by bank management about the robustness of their risk management capabilities. Naturally, we have focused first on the institutions in most need of improvement, but we will continue to remind stronger institutions of the need to remain vigilant against potential weaknesses.

Supervisors are also enhancing their understanding of the full spectrum and the scale of the risks inherent in increasingly complex banking activities and the potential for risks to crystallize in times of stress. In particular, we are focusing on the inter-relationships among risk types, not just with respect to those areas that precipitated recent events, but more broadly. These forward-looking risk identification processes include a more comprehensive understanding of institutions' main and emerging business lines and the full range of risks they

generate. We are also counseling institutions to improve their own risk identification processes and to emphasize the importance of stress testing and scenario analyses.

Better risk management at banking organizations must be accompanied by more robust liquidity and capital cushions. As developments of the past months clearly demonstrate, the difficulty in identifying complexity and linkages--and their potential impact during times of stress--requires institutions to maintain sizable and more reliable liquidity and capital cushions, given the inherent uncertainty in financial markets. This is a key point supervisors are reinforcing strongly.

The Federal Reserve is nearing completion of enhancements to its supervisory guidance to clarify our role as consolidated supervisor of bank and financial holding companies--often known as our "umbrella supervisor" role. The updated guidance is primarily intended to provide greater clarification to our own examination staff. For example, it provides for more consistent Federal Reserve supervisory practices and assessments across institutions with similar activities and risks, detailing expectations for understanding and assessing primary governance functions and risk controls, material business lines, nonbank operations, funding and liquidity management, consumer compliance, and other key activities and risks. Again, from a financial stability perspective the Federal Reserve has an interest not just in identifying the risks within an individual organization, but also understanding the broader set of risks affecting all key market participants.

The updated consolidated supervision guidance, which will be made publicly available, naturally reiterates the importance of coordination with, and reliance on, the work of other relevant supervisors and functional regulators. The consolidated supervision guidance under development is being updated based on the lessons from recent events noted above. We need to

continue to work closely with other supervisors and regulators as we implement the enhanced consolidated supervision guidance, with focus on improving interagency coordination of supervisory activities across all bank holding companies, particularly the largest and most complex organizations.

We are also considering new or augmented supervisory guidance on other aspects of risk management, including further emphasis on the need for an enterprise-wide perspective when assessing and managing risk. For example, we are developing supervisory guidance to clarify expectations surrounding compliance risk, focusing particularly on firm-wide compliance risk management for large, complex organizations. Another example is our participation in the development of enhanced guidance on the management of liquidity risks, which is being developed by the Basel Committee on Banking Supervision.

As you know, the U.S. federal banking agencies are also in the process of implementing the Basel II framework, which is intended to enhance the quality of risk management by tying regulatory capital more closely to institutions' underlying risks and by requiring strong internal systems for evaluating credit and other risks. We understand that Basel II must be implemented carefully and so have established an extended transition process with multiple safeguards. Indeed, findings from recent supervisory reviews on the use of economic capital have direct application to the evaluations we will make under Pillar 2, where banks are required to have their own robust internal process to ensure that they have adequate capital for their entire risk profile. Importantly, Pillar 2 underscores the current supervisory authority to require institutions to hold additional capital if the agencies are not satisfied with the levels chosen by bank management. We are also working with the Basel Committee to ensure that the Basel II framework appropriately reflects the lessons of recent events, such as by strengthening the capital treatment

of off-balance-sheet vehicles and assessing the use of external credit ratings to determine capital charges.

Conclusion

The Federal Reserve plays an important role in the strong supervisory structure we have here in the United States. And we are committed to making our supervisory and regulatory processes as strong as possible, improving them when necessary. Going forward, we must continue to send strong supervisory messages to senior management at financial institutions--perhaps with more force and frequency than in the recent past--particularly since during extended periods of good times institutions can lose their focus on the importance of sound risk management fundamentals. We continue to review our supervision practices to identify and act on potential areas for improvement in light of recent events.

TESTIMONY OF

TIMOTHY J. KARSKY

NORTH DAKOTA COMMISSIONER OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"THE CONDITION OF THE BANKING INDUSTRY: PART II"

Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

June 5, 2008, 10:00 a.m.

Room 538, Dirksen Senate Office Building

Introduction

Good morning Chairman Dodd, Ranking Member Shelby, and other distinguished members of the Committee. My name is Timothy J. Karsky, and I am the Commissioner of the North Dakota Department of Financial Institutions. I serve as the Chairman of the Conference of State Bank Supervisors (CSBS) and am pleased to testify today on behalf of CSBS.

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's over 6,000 state-chartered commercial and savings banks. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities, to develop regulatory policy, to provide training to state officials, and to represent state officials before Congress and the federal financial regulatory agencies.

In addition to regulating banks, most state banking departments also supervise the residential mortgage industry. In the past few years, CSBS has expanded its mission beyond traditional commercial bank supervision and has been working closely with the American Association of Residential Mortgage Regulators (AARMR)[1] to enhance state supervision of the mortgage industry. All 50 states and the District of Columbia provide regulatory oversight of the residential mortgage industry. States currently manage over 88,000 mortgage company licenses, over 68,000 branch licenses, and approximately 357,000 loan officer licenses.

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[1] AARMR is the organization of state officials responsible for the administration and regulation of residential mortgage lending, servicing, and brokering.

Thank you for the opportunity to discuss the state of the nation's banking industry today, and specifically the challenges and conditions facing the state banking system.

Condition of the Banking Industry

As we reported to the Committee in March, our nation's banks are operating in a challenging economic environment. A downturn in economic conditions often results in a weakening of the banking sector and an increase in bank failures. The declining real estate market, rising foreclosures, slower economic growth, and rising energy prices have both exposed and contributed to weaknesses in the portfolios of numerous banks. The industry now has to manage these risk exposures in a weaker economy. Our job as regulators is to ensure the risks are identified in a timely manner and proactively managed to minimize any loss to the institution.

Unfortunately, we are seeing and will continue to see some banks fail. Based on current conditions and trends, state banking regulators do not expect these failures to be widespread or beyond our capacity to manage. While we strongly believe that it is not—and should not be—our goal to attempt to regulate risk out of our banking system, failures are obviously undesirable and can be very disruptive to local economies. However, we have created a regulatory system to identify problem institutions, anticipate failures, and orchestrate an orderly receivership, and sale to another institution. As the recent failures have demonstrated, the banking industry is strong enough to absorb failed institutions, providing stability to the local market. This largely market-based solution can be managed with limited losses to the Deposit Insurance Fund and without the government having to provide direct support to provide market stability.

Given current economic trends, we should reasonably expect a continued weakening in the banking industry. However, in the whole, the industry is prepared to face this downturn from a position of strength. As the FDIC's Quarterly Banking Profile shows, while earnings are down primarily due to increased loan loss provisions, 86% of banks remain profitable and overall capital is strong. As we contemplate regulatory or legislative responses, we must consider the economic and regulatory environment which fostered a strong and diverse industry as the economy changed and our excesses were exposed. The strength of the majority of banks will aide us greatly in managing our current challenges.

Undoubtedly, strong capital requirements had a major impact on the strength of the banking industry. In this regard, we must take stock of our current capital framework and the direction we are headed with the implementation of the advanced approaches of Basel II. The models and assumptions which drive the calculation of capital under Basel II were developed during a period of extraordinary economic growth and asset value appreciation. Given the historic low level of risk for residential mortgage loans, it is highly likely that most models would generate a lower level of required capital. The data from the Quantitative Impact Study-4 revealed significant declines in minimum required capital for residential mortgages and home equity lines of credit. Obviously, these asset categories have become a tremendous source of loss for the financial system. Without the ability to detect and measure soft information impacting credit quality (i.e. changes in underwriting practices), it is likely that Basel II banks would be holding less capital heading into the current economic environment.

State supervisors believe it is critical to evaluate Basel II in the context of the current crisis. We need to be confident the banking industry will be as strong going into

the next crisis after operating under the Basel II framework and that there will be sufficient transparency in our largest institutions to make this assessment.

If we are to look for "lessons learned" from the ongoing housing and capital markets crisis and the ongoing economic downturn, I believe that "strength through diversity" should be at the top of the list. "Diversity" does not just refer to variation within an institution's lending portfolio or lines of business, but also diversity in the number of institutions. It has not been an historic accident, but rather conscious policy decisions that have fostered the breadth of banks in the United States.[2] At critical points in the evolution of banking and the financial markets, Congress and the States supported a decentralized rather than consolidated model of banking based on a state and federal system of chartering and regulation.

The challenges facing the industry at this point are widely known. We still have a long way to go to work through the issues related to residential mortgage finance. The poor mortgage underwriting, declining home values, and the rapidly increasing cost of energy is taking its toll on the American consumer. We all understand the impact consumer spending has on our economy. This will likely continue to be the source of challenges for the banking system and will undoubtedly spread to other areas.

Commercial real estate exposures have been the focus of regulatory scrutiny for some time. Weakness in this sector is pronounced in certain areas of the country. This is a cyclical change in the market following a period of tremendous growth. As market absorption of developed property slows, future development will slow or cease. As this

[2] As of March 31, 2008, there were 8,504 insured depository institutions operating in the United States. These institutions ranged in size from $1,000,000 in assets to $1,407,568,000,000 in assets. Source: FDIC Statistics on Depository Institutions.

impacts employment, it will only add to the economic stress of consumers. This sector is demanding significant regulatory resources.

In periods of market turmoil and uncertainty, liquidity can become a significant issue. While FDIC insurance provides market stability for retail deposits, as some banks expand their funding options with wholesale borrowings, this presents an additional risk management challenge and enhanced regulatory scrutiny.

As my colleague, Tom Gronstal from Iowa, discussed in his testimony before this Committee in March, we are closely watching the agricultural sector. Current agricultural conditions are reminiscent of conditions experienced in the 1970s, which led to the economic and financial collapse of the 1980s. Currently, we are witnessing a combination of high oil and high commodity prices. The value of farm land is directly correlated to the prices of commodities grown on it. The dramatic increase of farmland value in the last few years makes the agricultural sector look strong. In the future, should the price of corn, soybeans, and other commodities decrease, the price of farm land would most likely also fall. If there has been too much leveraged or loaned against the inflated value of farm land, the bubble will burst and we will once again experience an economic crisis similar to that of the 1980s. The continuing disappearance of manufacturing jobs from the rural mid-west will make it harder to recover from a future agricultural slump. I am pleased to see that since Superintendent Gronstal's testimony, this issue has received greater attention.

One additional issue of concern in this area is the mission creep of the Farm Credit System and its direct competition with community banks in rural areas. Community banks are the cornerstones of these communities and they are facing increasing competition from Farm Credit Banks. Given their status, tax and pricing advantages, this creates an unlevel

playing field that favors Farm Credit Banks. We believe this disparity could eventually result in safety and soundness issues. Community banks have a real stake in the economic success of the rural communities they serve that a government sponsored enterprise could never have.

Reviewing Our Regulatory Structure

The U.S. economy is eternally cyclical in nature. Our unique financial structure has sustained market booms and busts for over two centuries. The diversity of our nation's dual banking system has created the most dynamic and powerful economy in the world. It is worth repeating that a great strength of our banking system is that it is comprised of thousands of financial institutions of vastly different sizes. Since this Committee's hearing in early March, the Treasury Department released its blueprint for financial regulatory modernization and the failure of Bear Stearns prompted historic action from the Federal Reserve.

Again, from our perspective that our strength comes from our diversity, I would caution that legislative and regulatory decisions that alter our financial regulatory structure or financial incentives should be carefully considered against how those decisions affect the competitive landscape for institutions of all sizes. We must acknowledge that failures and resolutions take on a variety of forms based upon the type of institution and its impact upon the financial system as a whole.

We recognize that extraordinary events require extraordinary actions. To provide market stability, the Federal Reserve has provided a tremendous amount of liquidity to the market through various lending facilities and access to the discount window by investment banks. As we evaluate our regulatory structure, we must examine the linkage between the

capital markets and the traditional banking sector. Depository institutions are heavily regulated. Going forward, we believe that the capital markets and investment banks in particular, require enhanced regulatory scrutiny.

State Initiatives to Improve Supervision of the Residential Mortgage Industry

While state supervisors are leery of a complete overhaul of the banking system, we have long recognized the need for changes to the residential mortgage system. As a result, CSBS has been working diligently to improve cooperation and coordination among state regulators and between state and federal authorities. Much progress has been made towards enhancing supervision of the residential mortgage industry as federal and state regulators have engaged in an unprecedented number of cooperative initiatives and agreements to ensure seamless supervision of the industry. The numerous initiatives detailed below provide a model of financial regulation in a federalist system of government.

State and federal financial regulators have developed—and continue to develop—guidelines, best practices, and regulations to prevent abusive lending practices in the mortgage industry. Congress and state legislatures have passed or are debating legislative initiatives designed to change industry standards and protect consumers. An array of market participants—regulators, attorneys general, and servicers, among them—are engaged in loan modification strategies to help homeowners avoid foreclosure.

We congratulate this Committee on the recent passage of the S.A.F.E. Mortgage Licensing Act of 2008. As we have outlined for this Committee in previous testimony, the states have adopted numerous initiatives to enhance the supervision of the mortgage

industry. As recognized in the bill passed by this committee, the cornerstone of these initiatives is the development of the Nationwide Mortgage Licensing System.

CSBS-AARMR Nationwide Mortgage Licensing System

The CSBS-AARMR Nationwide Mortgage Licensing System (NMLS) went live, as scheduled, on January 2, 2008. This system is more than a database. It serves as the foundation of modern mortgage regulation by providing transparency for regulators, the industry, investors, and consumers. Seven inaugural participating states started using the system on January 2, and eighteen states will be on the system by the end of the year. To date, 42 state agencies representing mortgage regulators in 40 states have signed the Statement of Intent, indicating their commitment to participate in the NMLS. Eventually, we expect all 50 states to transition onto the System. I have attached, as Exhibit A, a map which indicates when states will begin using the NMLS.

In the first five months of operation, the NMLS:

- Is currently managing over 4,800 companies;
- Is currently managing over 3,100 branches; and
- Is currently managing over 23,000 individuals.

The NMLS creates a single record for every state-licensed mortgage company, branch, and individual that is shared by all participating states. This single record allows companies and individuals to be tracked across state lines and over any period of time. Additionally, consumers and the industry will eventually be able to check on the license status and history of the companies and individuals with which they wish to do business.

The NMLS provides profound benefits to consumers, state supervisory agencies, and the mortgage industry. Consumers will have access to a central repository of licensing

and publicly adjudicated enforcement actions. Each state regulatory agency will retain its authority to license and supervise, but the NMLS eliminates unnecessary duplication and implements consistent standards and requirements across state lines. Honest mortgage bankers and brokers will benefit from the removal of fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications.

The NMLS is part of an extensive effort to improve regulatory expectations, supervision and enforcement of the mortgage industry. We appreciate this Committee's recognition of this powerful tool and the revolutionary impact it will have on the supervision of the mortgage industry.

CSBS is pleased that we have been able to initiate many programs in collaboration or consultation with our Federal counterparts.

Pilot Programs with Federal Regulatory Agencies

Late in 2007, CSBS, the Federal Reserve System (Fed), the Office of Thrift Supervision (OTS), and the Federal Trade Commission (FTC) engaged in a pilot program. Under this program, state examiners have joined examiners from the Fed, OTS, and FTC to conduct simultaneous examinations of mortgage companies whose separate charters cross federal and state jurisdiction. While the examinations are in their final stages and are not yet complete, we have already learned a great deal from the process. This pilot is truly the model for coordinated state-federal supervision.

Uniform Standards for Testing and Education

CSBS and AARMR are spearheading a cooperative project with the mortgage industry called the Mortgage Industry Nationwide Uniform Testing and Education

Standards (MINUTES). The project involves regulatory representatives from five states (Louisiana, North Carolina, Oregon, Pennsylvania, and South Carolina) cooperating on a task force with representatives from three mortgage industry associations (Mortgage Bankers Association, American Financial Services Association, and National Association of Professional Mortgage Women).

The initiative, begun in early 2007, provides model language establishing uniform standards for mortgage professional testing and education, and streamlines the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers and their loan originators are held to the same standards and expectations, regardless of the state in which they make loans. Once implemented, MINUTES will provide an Internet portal connecting state approved educators with mortgage professionals and then connecting testing and education satisfaction with the NMLS for a seamless interface of licensing and continuing education requirements. Users of the NMLS will be able to identify mortgage professionals who have successfully passed a test and are current on their education requirements for each state in which they are licensed to conduct business.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

In October 2006, the federal financial agencies issued the *Interagency Guidance on Nontraditional Mortgage Product Risks* which applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Recognizing that the interagency guidance did not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and

AARMR developed parallel guidance in November 2006 to apply to state-supervised residential mortgage brokers and lenders. As of May 31, 2008, 44 states plus the District of Columbia have adopted the guidelines developed by CSBS and AARMR.[3] Ultimately, we expect all 50 states to adopt the guidance.

CSBS-AARMR-NACCA Statement on Subprime Mortgage Lending

The federal financial agencies also issued the *Interagency Statement on Subprime Mortgage Lending*. Like the *Interagency Guidance on Nontraditional Mortgage Product Risks*, the Subprime Statement applies only to mortgage providers associated with an insured depository institution. Therefore, CSBS, AARMR, and the National Association of Consumer Credit Administrators (NACCA)[4] developed a parallel statement that is applicable to all mortgage providers.

Released in July 2007, the Subprime Statement has been adopted by 38 states and the District of Columbia.[5] Again, we expect all 50 states to adopt the Statement to encourage seamless and consistent supervision of the mortgage industry.

CSBS believes the Nontraditional Mortgage Product Guidance and the Subprime Statement strike a fair balance between encouraging growth and free market innovation and draconian, stern restrictions.

AARMR-CSBS Model Examination Guidelines

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[3] To track state adoption of the CSBS-AARMR *Guidance on Nontraditional Mortgage Product Risks*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM_State_Implement.htm.

[4] The National Association of Consumer Credit Administrators represents the officials of the states and territories of the United States of America and of the Dominion of Canada, or their associates, who, by law, are vested with authority and duty to administer laws which require regulation or supervision of consumer credit agencies in the United States of America and the Dominion of Canada.

[5] To track state adoption of the CSBS-AARMR-NACCA *Statement on Subprime Mortgage Lending*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Sub_prime_State_Impl.htm.

In addition, CSBS and AARMR developed state Model Examination Guidelines (MEGs) for field implementation of the *Guidance on Nontraditional Mortgage Product Risks* and the *Statement on Subprime Mortgage Lending*.

Released on July 31, 2007, the MEGs enhance consumer protection by providing state regulators with a uniform set of examination tools for conducting examinations of subprime lenders and mortgage brokers. In addition, the MEGs were designed to provide consistent and uniform guidelines for use by lender and broker in-house compliance and audit departments to enable them to conduct their own review of their subprime lending practices. These enhanced regulatory guidelines present a new and evolving approach to mortgage supervision.

To prepare state examiners, as well as industry compliance personnel for an approach designed specifically for subprime lending platforms, CSBS and AARMR released a comprehensive Internet based MEGs User School on March 1, 2008. This school was developed to give both regulators and industry the tools needed to comprehensively examine the institution under the MEGs.

Nationwide Cooperative Protocol and Agreement for Mortgage Supervision

In December of last year, CSBS and AARMR launched a Nationwide Protocol and Agreement for Mortgage Supervision to assist state mortgage regulators by outlining a basic framework for the coordination and supervision of Multi-State Mortgage Entities (those institutions conducting business in two or more states). The goals of this initiative are to protect consumers; to ensure the safety and soundness of the institutions; to identify and prevent mortgage fraud; to supervise in a seamless, flexible and risk-focused manner;

to minimize regulatory burden and expense; and to foster consistency, coordination and communication among state regulators.

To date, thirty states have signed the agreement with an additional six states indicating a commitment to join. CSBS and AARMR expect all state regulators to sign the protocol and agreement in 2008.

CSBS contends that an enhanced regulatory regime for the residential mortgage industry is absolutely necessary to ensure legitimate lending practices, provide adequate consumer protections, and to once again instill both consumer and investor confidence in the housing market. The vast majority of mortgage bankers, brokers, and lenders are honest, law-abiding mortgage providers. And many of the problems we are experiencing are not the result of "bad actors" but rather bad assumptions by the architects of our modern mortgage finance system. Enhanced supervision and industry practices can successfully weed out both the bad actors and address the bad assumptions. If regulators and the industry don't address both causes we will only have the veneer of reform and we risk repeating our mistakes.

One lesson we should learn from this crisis is that consolidation and nationalization of supervision and preemption of applicable state law is not the answer. For those who were listening, the states provided plenty of warning signs of the problems to come. The flurry of state predatory lending laws and laws to create new regulatory structures for lenders and mortgage brokers that banks and the capital markets were funding were indicators that things were not right in our mortgage lending industry. To respond to this lesson by eliminating the early warning signs that the states provide seems incongruous. Just as checks and balances are a vital part of our democratic government, they serve an

equally important role in our financial regulatory structure. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Most importantly, it serves the consumer interest that the states continue to have a role in financial regulation. While CSBS recognizes that the mortgage market is a nationwide industry that ultimately has international implications, local economies and individual homeowners are most affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies, and our ability to react quickly and decisively to protect consumers. To that end, the states, through CSBS and AARMR, are working to improve mortgage supervision through enhanced cooperation and coordination with one another and our federal regulatory counterparts.

State Efforts Regarding Foreclosure Prevention

In addition to our efforts to prevent a future mortgage crisis, the states have acted to offer relief to homeowners who are suffering in today's crisis. State banking and mortgage regulators have been working together formally with State Attorneys General during the past year to develop a comprehensive strategy to address increasing foreclosure rates. The partnership between state regulators and attorneys general is long-standing, and had led to the largest consumer protection settlements in our nation's history, including most recently the $325 million settlement with Ameriquest.

In July 2007, representatives of 37 state attorney general offices and state banking regulators gathered in Chicago for a summit meeting on the growing crisis in subprime mortgage foreclosures. The news was alarming: nearly two million subprime mortgages

with an adjustment feature, such as hybrid adjustable rate mortgages (ARMs) and option ARMs, were set to adjust between the latter part of 2007 and the end of 2008. These loans had been made with an expectation that borrowers could refinance before the rate adjusted, an expectation that is no longer justified in light of the rapid decline in home values. Many of these loans had been made based on incorrect stated incomes and/or inflated appraisals, with little if any underwriting having been done to assure that borrowers could afford to make monthly payments after the initial "teaser" rate had adjusted upward. The likely outcome of this situation was an unprecedented flood of foreclosures.

A State Foreclosure Prevention Working Group, chaired by Iowa Attorney General Tom Miller, formed out of this summit meeting, to gather more information and to attempt to work with participants in the subprime mortgage industry to find ways to modify loans on a mass scale so that as many borrowers as possible could retain their homes with affordable mortgages. The Working Group consists of representatives of the attorneys general of 11 states (Arizona, California, Colorado, Iowa, Illinois, Massachusetts, Michigan, New York, North Carolina, Ohio, and Texas), two state banking departments (New York and North Carolina), and CSBS.

Since September 2007, this Working Group has met with representatives of the 20 largest servicers of subprime mortgages. Collectively, these top 20 companies service approximately 93 percent of the nation's subprime loans. The Working Group has asked the servicers to work collaboratively to start identifying and implementing collective and consistent solutions to prevent foreclosure. The Working Group's guiding principle is simple: any solution must be in the interests of both the borrower and the investor. There

are ample opportunities for improvement that will lead to benefits for investors and homeowners alike.

Beginning in November of last year, the State Foreclosure Prevention Working Group collaborated with industry and federal regulators to develop a uniform data reporting format to collect data to measure the extent of the foreclosure problem and the servicers' efforts to respond to it. This is the only regulatory data to capture information on loss mitigation efforts. While we have been unable to collect data from some federally regulated institutions, we are hopeful the OCC's data collection announced in March will allow for consolidation with our data to provide a comprehensive view of the servicing industry. As state officials, CSBS believes that objective data is necessary to make informed policy decisions and to promote initiatives that could reduce foreclosures. In addition, we believe the public has a right to know how servicers are managing the foreclosure crisis. In April 2008, the State Foreclosure Prevention Working Group issued its second data report.[6] The key findings are:

1. **Seven out of ten seriously delinquent borrowers are still not on track for any loss mitigation option.** The lack of interaction between mortgage servicers and homeowners remains a major problem. While servicers have developed creative outreach efforts and increased staffing, the data shows a large gap between the number of homeowners needing loss mitigation and the number currently receiving assistance. The data suggests that a rising

[6] The "Analysis of Subprime Mortgage Servicing Report" can be viewed at: http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.

number of loan delinquencies are outpacing the increase in loss mitigation efforts.

2. **Data suggests that loss mitigation departments are severely strained in managing the current workload.** Almost two-thirds of all loss mitigation efforts started are not completed in the following month. Without access to loss mitigation programs, the ever increasing level of seriously delinquent loans are heading toward foreclosure.
3. **For homeowners receiving loss mitigation assistance, more are receiving loan modifications.** Two-thirds of home retention solutions started in January were directed to loan modifications, showing a continued shift to longer-term solutions. Many servicers are replacing their use of repayment plans in favor of loan modifications.
4. **Payment resets on hybrid ARMs have not *yet* been a driving force in foreclosures.** A significant percentage of subprime adjustable rate loans are delinquent before they experience payment shock from their first adjustment, reflecting weak underwriting or fraud in the origination of the loan. With so many homeowners struggling to stay afloat prior to rate resets, we need to act quickly to address these hybrid ARM loans before the payment shock due to the rate reset triggers further foreclosures.

The Working Group will continue to collect monthly data from servicers in order to provide public information on trends in the servicing industry as we move through the foreclosure crisis. The Working Group has also formed an Analytics Subcommittee to work with individual servicers to improve data integrity, to understand success strategies

for loss mitigation, and to share those successes with other servicers. It is my sense that many servicers are making positive efforts to avert foreclosures, but that we are still losing the larger battle to stop unnecessary foreclosures and stem the foreclosure crisis. The servicing industry was not designed for this type of activity and it is a difficult process to develop the capacity to manage the ever increasing workload. At this stage of the cycle, there are three specific areas which deserve our attention and focus:

1. **We are increasingly concerned with the length of loan modifications.** We must ensure that debt modifications are more than just temporary adjustments, further delaying the problem and betting on an improved real estate market.
2. **Second liens have become a serious impediment to sustainable solutions.** It is very difficult to identify the servicer, engage them in the modification process, and obtain their subordination where necessary. In many cases, these lien holders are unsecured and are essentially holding the process hostage. This is an area which requires the attention of state and federal policymakers.
3. **The process for negotiating "short sales" must be improved.** For homeowners with no other option, selling the home with the lender accepting the proceeds for less than the loan value is a way to avoid the time, cost and stigma of foreclosure. We consistently hear that the slow decision process of the lenders makes this solution unworkable in the market.

Last week, the National Governors Association held a forum to highlight the numerous initiatives undertaken by state agencies to prevent foreclosures and provide for market stability. Given the local nature of this crisis, state officials are well positioned to be an integral part of the solution. State efforts include:

- Establishing foreclosure prevention hotlines to provide counseling resources or assist with contacting servicers;
- Hosting "road shows" of servicers in hard-hit economic areas, such as Ohio, Michigan, and California to promote face-to-face contact between servicers and struggling homeowners;
- Meeting directly with servicers in states such as Maryland, California, Ohio, and Texas, to determine if there are solutions to local problems; and
- Enactment of legislation to improve servicing practices.

Conclusion

The banking industry is eternally cyclical. A downward turn in banking always reveals bad practices and structural flaws of both institutions and supervision. As regulators we must, with an unbiased eye, collectively and collaboratively acknowledge and address the weaknesses that a turn in the industry identifies. Our highly diverse financial system is the envy of the world and allows our markets to be flexible and responsive. Thanks to our decentralized regulatory system, our financial institutions are competitive internationally and locally. However regulators and legislators address the current market failings, it should be in a way that preserves the diversity of financial institutions and supervision that has made our economy both nimble and strong.

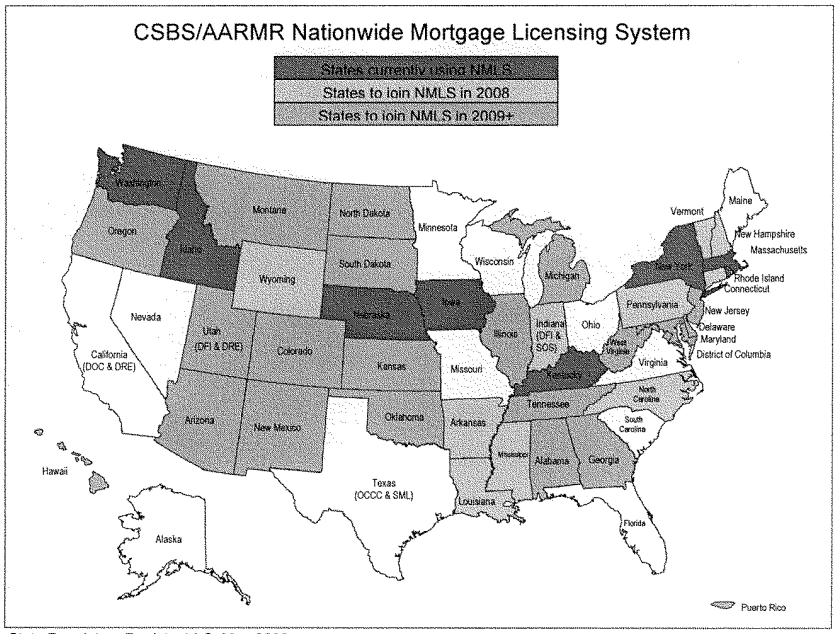
We recognize that our regulatory structure at both the state and federal level is sometimes complex for both the industry and consumers to navigate. There is a need for improved coordination and cooperation among functional regulators. CSBS has been actively engaged in efforts to enhance coordination as we all work to develop a system of supervision that ensures safety, soundness, and consumer protection, but still provides economic stability and industry innovation.

CSBS looks forward to continuing to work with the federal regulators and Congress to address the needs and regulatory demands of an ever evolving financial system in an environment that fosters the strongest economy possible while protecting consumers, minimizing regulatory burden, and ensuring access to the broadest range of financial opportunity.

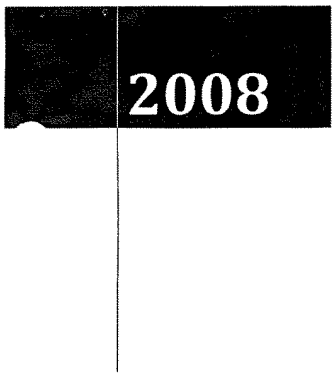
I thank you for the opportunity to testify today, and look forward to any questions you may have.

Appendix

Exhibit A—Schedule of State Participation in the CSBS/AARMR NMLS



State Regulatory Registry LLC, May 2008



ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE

DATA REPORT NO. 2
APRIL 2008

STATE FORECLOSURE PREVENTION WORKING GROUP

Executive Summary

In February 2008, the State Foreclosure Prevention Working Group published its first data report on performance of subprime mortgage servicing, based on data from October 2007 provided by 13 of the 20 largest subprime mortgage servicers. The State Foreclosure Prevention Working Group, composed of state attorneys general and state banking regulators, published this data to provide the public with information to shed light on how servicers are managing the unprecedented level of homeowners struggling to make their mortgage payments.

The first report found that, while servicers had increased their use of loan modifications, a large percentage of seriously delinquent loans (7 out of 10) were not in any sort of work-out process. The first report also revealed that a significant proportion of adjustable rate subprime loans were entering into delinquency prior to the first reset date, reflecting the extent of weak underwriting and mortgage origination fraud present in subprime loans in recent years.

This second report provides information on servicing performance from October 2007 through and including January 2008. The additional data allow us to assess performance trends, in addition to providing a static snapshot of recent performance.

Based on our analysis, the collective efforts of servicers and government officials to date have not translated into meaningful improvement in foreclosure prevention outcomes. In major respects, the subprime servicing data for January 2008 is nearly *unchanged* from October 2007. In normal times, one would not expect a significant change in a four-month period; however, this time period involved a dramatic increase in public attention to the subprime mortgage crisis, a ramping up of efforts by the HOPE NOW Alliance, and the initiation of new creative outreach efforts by servicers and government officials.

Specific Findings:

1. **Seven out of ten seriously delinquent borrowers are *still* not on track for any loss mitigation outcome.** While the number of borrowers in loss mitigation has increased, it has been matched by an increasing level of delinquent loans. The number of home retention solutions (forbearance, repayment plan, and modification) in process, as compared to the number of seriously-delinquent loans, is unchanged during the four month period. The absolute numbers of loss mitigation efforts and delinquent loans have increased, but the relative percentage between the two has remained the same. Given creative servicer outreach efforts and increased public awareness of the HOPE Hotline during this time period, this large gap suggests a more systemic failure of servicer capacity to work out loans.

2. **Data suggests that loss mitigation departments are severely strained in managing current workload.** For example:

    a. Almost two-thirds of all loss mitigations efforts started are not completed in the following month. Most loss mitigation efforts do not close quickly. This consistent trend over the last three months suggests that many proposed loss mitigations fail to close, rather than simply take longer than a month to work through the system. Based on anecdotal reports of lost paperwork and busy call centers, we are concerned that servicers overall are not able to manage the sheer numbers of delinquent loans.

    b. Seriously delinquent loans are "stacking up" on the way to foreclosure. The primary increases in subprime delinquency rates are occurring in very seriously delinquent loans or in loans starting foreclosure. This suggests that the burgeoning numbers of delinquent loans that do not receive loss mitigation attention are clogging up the system on their way to foreclosure. We fear this will translate to increased levels of vacant foreclosed homes that will further depress property values and increase burdens on government services.

3. **For those homeowners receiving loss mitigation assistance, more are receiving loan modifications.** Two-thirds of home retention solutions started in January were directed to loan modification, showing a continued shift to longer-term solutions for homeowners that receive loss mitigation assistance. Many servicers are replacing their use of repayment plans in favor of loan modifications.

New approaches are needed to prevent millions of unnecessary foreclosures. Without a substantial increase in loss mitigation staffing and resources, we do not believe that outreach and unsupervised case-by-case loan work-outs, as used by servicers now, will prevent a significant number of unnecessary foreclosures. In our first report, we renewed our call for more systematic, long-term solutions to efficiently deal with subprime loans originated in recent years. While we support industry-led efforts to implement broader-based programs such as the ASF "fast track" program and Project Lifeline's 30-day breathing period, we still see a tremendous gap between the need for loan work-outs and the options in place today.

The State Working Group believes more robust approaches to avoid preventable foreclosures are necessary. Servicers, investors, and state officials have opportunities to work together on the following:

- Developing a more systematic loan work-out system to replace the intensive "hands-on" loss mitigation approach. The continued reliance on intensive individual interaction to identify alternatives to foreclosure misses out on opportunities to implement solutions that can reach more homeowners facing foreclosure. A more systematic approach would benefit homeowners and investors by reaching more people with more streamlined solutions. Such an approach would build on the initial effort of the ASF Framework, but cover many more loans.
- Slowing down the foreclosure process to allow for more work-outs. Many states have passed or are considering legislation to slow down the foreclosure process and to increase notice to delinquent homeowners. Targeted efforts to slow down subprime foreclosures may give homeowners and servicers more time to find solutions to avoid foreclosure.

In addition to these efforts, the State Working Group recognizes that federal officials have proposed or are considering legislation, such as permitting judicial modification of loans in bankruptcy and expanding FHA refinancing of subprime loans, that would mark a significant change to the current mortgage servicing dynamics. While we do not endorse any specific federal approach, we support the development of innovative approaches that recognize the extent and scale of the foreclosure crisis.

Updates and Trends between October 2007 and January 2008

Our first report,[1] issued in February 2008, included an extensive discussion of the purposes and formation of the State Foreclosure Prevention Working Group, the development of our "call report" format to collect data from subprime mortgage servicers, and the participation of 13 of the largest 20 subprime servicers.

We also provided a detailed discussion of the first monthly submission of servicing data covering the month of October 2007. This second report will highlight trends between the October 2007 data and the subsequent three months through and including January 2008. As with our first report, we have included as Appendix A the consolidated state report data for the most recent month (in this case, January 31, 2008). We have also included (as Appendix B) a trend analysis to cover each month between October 2007 and January 2008.

A. Summary of Servicing Activity

The composition of the Reporting Servicers did not change from the first report. We continue to have data from 13 of the largest subprime servicers, accounting for approximately 57% of the subprime servicing market. After the first report, several servicers revised data to improve the accuracy of their reporting and understanding of data definitions. With one exception, discussed in Section B below, these revisions did not create a material change from the initial data included in our first report.

Payment Resets

In our first report, we highlighted the high level of delinquency for adjustable rate subprime loans *before* any "reset" of their interest rate to a higher level. The most recent data identifies a worsening of this trend, as more subprime loans are delinquent prior to any payment change. For instance, the percentage of loans facing reset in the 3rd Quarter of 2009 that are currently delinquent jumped from 21.4% to 28.5%. While delinquency rates increase during the early life of a loan pool, this worsening trend confirms our initial assessment that very weak underwriting and mortgage origination fraud, and not simply payment resets, has been the primary cause for elevated subprime loan delinquencies for loans originated through at least the middle of 2007.

While rate resets have a potential to create payment shock, recent cuts in interest rates have somewhat reduced the potential impact of payment shock to accelerate the rate of delinquency and foreclosure.[2] As our first report found, only about 3% of currently delinquent loans entered delinquency as a direct result of an initial payment reset.

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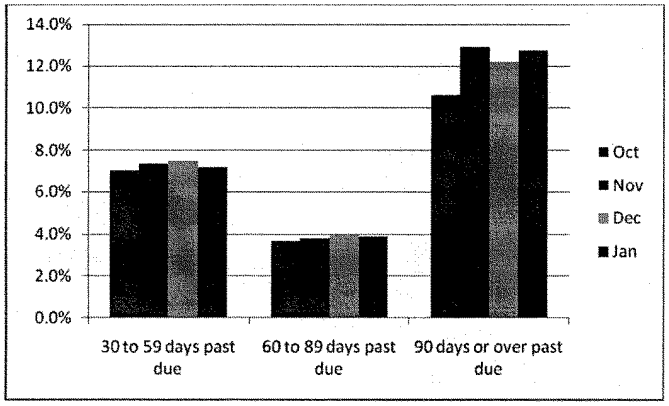
[1] *Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1*, State Foreclosure Prevention Working Group (Feb. 7, 2008), available at http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.

[2] *See Fed's Interest Rate Cuts Limit Subprime ARM Reset 'Shock'*, Inside B&C Lending, March 28, 2008 at 6 (referring to S&P report on impact of interest rate cuts on subprime adjustable rate mortgages).

Delinquency and Default

At the end of January 2008, nearly a quarter of subprime and Alt-A loans were reported delinquent. The servicers reported more than 630,000 subprime and Alt-A loans delinquent by 90 days or more. As shown in Figure 1 below, the delinquency rate for 30-day and 60-day delinquencies remained relatively constant, while the 90-day delinquency rate increased by 16%. This conveys that servicers are pushing the 30-day delinquent files to the next category, then the 60-day delinquent files to the 90 days or over category. Unfortunately, this lack of loan delinquency resolution at the first signs of problems for the borrower is only leading to a pile-up of seriously-delinquent files and ultimately, foreclosure.

Figure 1. Subprime and Alt-A Delinquency Rates



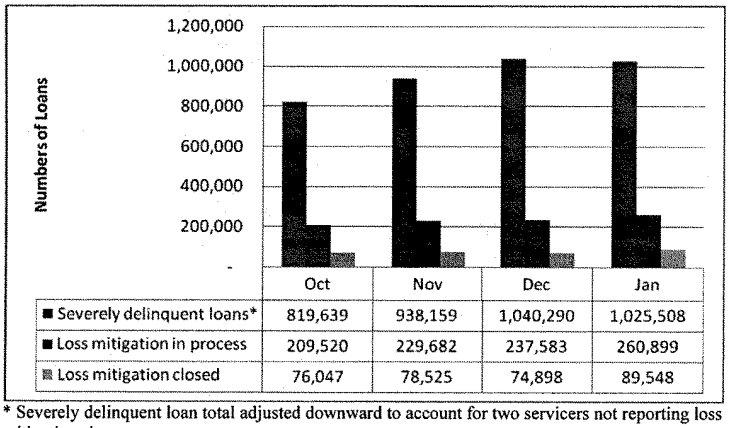
Nearly 300,000 loans are currently in some stage of foreclosure, up 8% between October and January. Furthermore, 133,000 foreclosures were completed in January, a 30% increase from October 2007. In our initial report, we expressed concern about a build-up of foreclosed home inventory on local home prices. We reiterate that concern based on the trends in foreclosures and increases in loans 90 days or more past due.

Finally, although not the focus of our efforts, we note with concern the increasing level of prime delinquencies in our data, and in other publicly available data. Weakness in prime loan quality will further strain the capacity of the larger servicers that manage both prime and subprime servicing portfolios.

B. Loss Mitigation and Loan Modification Efforts

The most troubling finding from our first report was the sheer number of seriously delinquent borrowers -- 7 out of 10 borrowers – that were not in any loss mitigation process to work out their situation. This finding has remained consistent over the subsequent three months of data.

Figure 2. Comparison between seriously delinquent (60+) loans and loss mitigation in process



	Oct	Nov	Dec	Jan
■ Severely delinquent loans*	819,639	938,159	1,040,290	1,025,508
■ Loss mitigation in process	209,520	229,682	237,583	260,899
■ Loss mitigation closed	76,047	78,525	74,898	89,548

* Severely delinquent loan total adjusted downward to account for two servicers not reporting loss mitigations in process.

The data through January confirms the finding from our first report that servicers have increased their use of loan modifications as a tool to enable homeowners to avoid foreclosure. While loan modifications in process increased 56% between October and January, repayment plans in process decreased 17% over the same time period, but overall, the percentage of "home retention" efforts in process remained unchanged (20% of seriously delinquent loans) between October 2007 and January 2008. Thus, servicers appear to be replacing short-term repayment plans with longer-term loan modifications.

In our first report, we divided loss mitigation efforts into three broad categories: 1) those where borrower loses the home (short sale and deed in lieu); 2) those where borrower retains the home (forbearance, repayment plan, or modification); and 3) those where borrower efforts lead to resolving the delinquency (refinance or reinstatement). The trend data, as seen in Table 1 below, show no change in the relative proportions of these efforts over this four-month period.

Table 1. Loss mitigation efforts, as a percent of total loans 60 or more days delinquent

Loss Mitigation Efforts	Jan 2008	Oct 2007
Total in process with borrower losing home	3.42%	3.42%
Total in process of home retention	20.06%	20.17%
Total in process of being resolved by borrower	1.95%	1.97%
Total loans in loss mitigation	25.44%	25.56%

In short, while more loans are in loss mitigation and more are working toward loan modifications, the level and dispersion of loss mitigation efforts in January is nearly identical to that of October 2007.

Closed Loss Mitigations

As noted above, after the publication of our first report, various servicers revised their data to improve consistency of the reporting or to correct for errors in initial reporting. As a result, the number of closed modifications due to reinstatement was dramatically reduced. While our first report highlighted the disparity between the "in process" and "closed" categories, the revised data in Table 2 show a much smaller gap between the two categories.

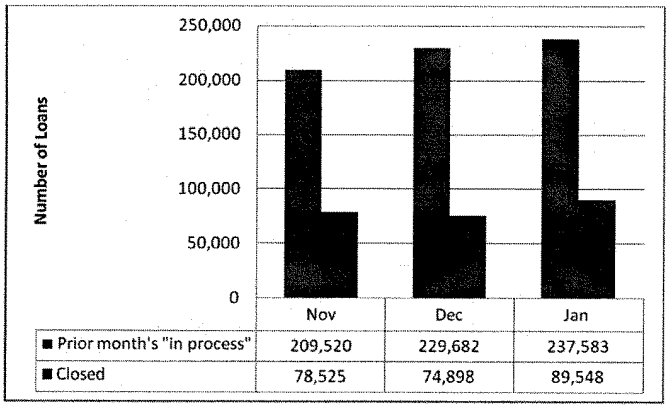
Table 2. Loss mitigation efforts in process versus loss mitigation efforts closed for month of January 2008.

Loss Mitigation Effort	In Process	Closed
Deed in lieu	1.4%	0.4%
Short sale	12.1%	4.4%
Forbearance	6.5%	3.9%
Repayment plan	19.0%	26.9%
Modification	53.4%	27.1%
Refinance or paid in full	2.0%	12.9%
Reinstatement	5.7%	24.4%
Total	100.0%	100.0%

While not as stark as our first report, the data still shows that a quarter of loss mitigation cases are closed due to borrowers catching up on past payments.

One explanation for the proportional differences between "in process" and "closed" modifications is the numbers of loss mitigations in process that fail to close. Through January 2008, closed loss mitigation efforts accounted for less than 40% of loss mitigations in process in the prior month. See Figure 3.

Figure 3. Comparison between loss mitigations closed and prior month's loss mitigations in process.



	Nov	Dec	Jan
Prior month's "in process"	209,520	229,682	237,583
Closed	78,525	74,898	89,548

This rate of fall-out is a significant concern. Loss mitigation proposals do not close for a variety of reasons; one reason is the level of paperwork required to close a loan modification. Servicers have told us that borrowers simply do not return the required documentation to complete the modification, and borrowers and counselors have reported that servicers lose paperwork they have sent in to the servicer. Regardless of where the problem arises, it appears that the level of paperwork required is a barrier to preventing unnecessary foreclosures.

Types of Loan Modifications

We are still working toward better reporting on types and duration of loan modifications, but we are able to make some general observations. First, we see a fairly even split between loan modifications that are permanent, life-of-loan changes and modifications that have a shorter duration. Freezing the interest rate at the starter/initial rate on an adjustable rate loan is the most common loan modification. There are significant numbers of interest rate modifications that fall below the starter/initial rate and a larger number that are above the starter rate (but below the reset rate). The majority of servicers are not reporting significant levels of modifications that reduce principal alone, although principal reductions may be combined with other modifications and therefore may not evidenced in our reporting.

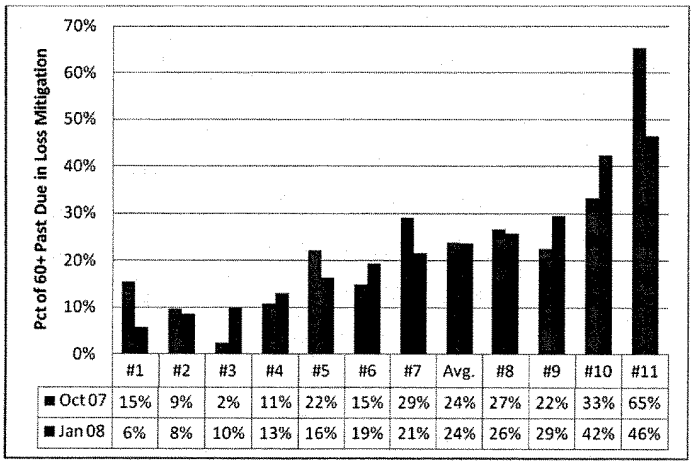
C. Variations Among Servicers

As noted in the first report, subprime servicing is not a monolith. Servicers differ as to their size, their level of specialization in subprime servicing, and their affiliations with mortgage originators. Our report found a significant variation among servicers in the types of modifications offered and the percentage of seriously delinquent borrowers in loss mitigation.

In January 2008, loan modifications were the most used loss mitigation technique for five of the 13 Reporting Servicers, closely followed by repayment plans by 4 of the 13 and reinstatement by 3 of the 13. This shows a slight shift toward loan modifications from the former use of repayment plans.

The data continue to show a wide disparity among levels of loss mitigations in process (Figure 4 below); however, there has been some compression of the disparity. Higher-performing servicers from October have some deterioration in their metrics and other servicers have raised their level of loss mitigation.

Figure 4: Loss mitigations in process for 11 Reporting Servicers in October 2007 versus January 2008, as a percentage of 60+ days past due



	#1	#2	#3	#4	#5	#6	#7	Avg.	#8	#9	#10	#11
Oct 07	15%	9%	2%	11%	22%	15%	29%	24%	27%	22%	33%	65%
Jan 08	6%	8%	10%	13%	16%	19%	21%	24%	26%	29%	42%	46%

Trends in Key Metrics Among Individual Servicers

With individual company data over this four month period, the State Working Group can begin to identify trends occurring at individual servicers.

Six of 11 servicers reporting loss mitigations in process saw a decline in seriously delinquent loans in loss mitigation between October 2007 and January 2008, with most of these being double-digit declines. At the same time, five servicers had impressive increases in their rates of loss mitigation. We have encouraged servicers to increase their loss mitigation capacity and it appears that some have made strides forward.

While almost every servicer saw an increase in subprime and Alt-A loans 90 or more days delinquent, the ones that had the largest increases in delinquency rates tended to show the biggest deterioration of borrower contact over this period.

Ten of the 11 servicers reporting loss mitigations in process showed increases in their use of loan modifications. Some of these increases were dramatic, with five servicers demonstrating increases of over 100% in loan modifications over the four month period.

Conclusion

Between October 2007 and January 2008, the mortgage industry established the HOPE NOW Alliance and devoted significant effort to increase public awareness of the resources to prevent foreclosures, to reach borrowers that had been difficult to reach, and to develop new approaches to modify loans more quickly. In addition, the HOPE NOW Alliance has developed a series of data collection projects that we hope will improve the ability to analyze servicer performance.

As of the end of January, these efforts have not yet made a major difference in preventing unnecessary foreclosures. The vast majority of homeowners with seriously delinquent loans are not on track for a loan work-out of any type. These loans are moving through the system toward foreclosure, leaving investors with increasing inventories of foreclosed homes. Servicers are increasing their use of loan modifications, but this increase is matched by increases in delinquency. Initial efforts to develop systemic approaches are far too limited to make a difference in preventable foreclosures.

In our previous report, we discussed the refusal of some national banks to provide servicing data, with two citing the advice of the Office of the Comptroller of the Currency (OCC). We called on the OCC to encourage national bank servicers to work voluntarily with the states in this foreclosure crisis. On February 29, 2008, the Comptroller announced that some of the largest national banks will be providing mortgage servicing data to the OCC on a monthly basis. We encourage the OCC to aggregate and publish data collected from national banks to complement the State Working Group's efforts.

The State Working Group will continue to work with servicers to promote systematic solutions to modify loans in a more streamlined and efficient manner. Without a systematic approach, we see little likelihood that ongoing efforts will make a serious dent in the level of unnecessary foreclosures.

APPENDIX A

CONSOLIDATED STATE REPORT FOR MORTGAGE SERVICERS
DATA AS OF JANUARY 31, 2008

Consolidated State Report for Mortgage Servicers

Consolidated Report as of January 31, 2008 for 13 Companies

All dollar amounts are the unpaid principal balance (UPB) and are in thousands (000's).
All numbers of loans are the actual number.

OPERATIONAL PROFILE	Number	%	UPB	%
Total Loans Serviced	15,470,743	100.00%	2,426,570,587	100.00%
Serviced loans originated and funded by an unaffiliated party	8,407,090	54.34%	1,369,435,887	56.44%
Serviced loans where originator or funder is affiliated with the servicer	7,063,653	45.66%	1,057,134,700	43.56%
Serviced loans secured by owner-occupied residence*	12,949,454	83.70%	2,080,500,681	85.74%
Serviced loans for investment or second residence property*	2,520,653	16.29%	344,452,211	14.20%
Loans which are secured by a first mortgage only*	11,390,558	73.63%	2,110,826,723	86.99%
Loans which are secured by a second mortgage only*	1,459,966	9.44%	75,538,990	3.11%
Loans which you service both the first and second mortgage*	2,706,156	17.49%	260,177,860	10.72%
*Reported data reconciles within 2%.				
Prime Loans (8 servicers reporting)	10,266,475	100.00%	1,674,789,279	100.00%
Fixed rate, fully amortizing	7,288,708	71.00%	1,032,976,592	61.68%
Hybrid ARMs (2/28, 3/27s, or similar)	1,237,967	12.06%	324,340,123	19.37%
Adjustable rate, fully amortizing	919,100	8.95%	45,831,400	2.74%
Loans with interest only feature	435,318	4.24%	126,633,983	7.56%
Payment Option ARMs and other loans with negative amortization feature	384,111	3.74%	144,756,400	8.64%
Other	1,271	0.01%	250,780	0.01%
Subprime & Alt-A Loans (13 servicers reporting)	4,959,707	100.00%	781,393,399	100.00%
Fixed rate, fully amortizing	2,538,045	51.17%	300,620,148	38.47%
Hybrid ARMs (2/28, 3/27s, or similar)	1,527,204	30.79%	282,402,876	36.14%
Adjustable rate, fully amortizing	76,131	1.53%	16,399,259	2.10%
Loans with interest only feature	348,955	7.04%	96,367,730	12.33%
Payment Option ARMs and other loans with negative amortization feature	127,967	2.58%	47,591,008	6.09%
Other	341,405	6.88%	38,012,377	4.86%

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Prime Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	27,560	6,167	22.38%	24.23%	14.08%	20.39%
1st Quarter 2008	19,890	3,003	15.10%	15.59%	11.11%	14.34%
2nd Quarter 2008	24,110	2,343	9.72%	10.11%	5.00%	8.56%
3rd Quarter 2008	30,683	3,436	11.20%	21.74%	7.35%	13.75%
4th Quarter 2008	22,472	1,829	8.14%	8.15%	6.67%	8.08%
1st Quarter 2009	17,350	1,251	7.21%	16.67%	7.12%	7.68%
2nd Quarter 2009	31,476	1,540	4.89%	20.00%	3.06%	5.27%
3rd Quarter 2009	31,930	1,863	5.83%	8.33%	2.56%	4.80%
Eight Quarter Total	205,471	21,432	10.43%			
Percent of Total Serviced	2.00%					
Percent of non-fixed rate products	6.90%					

UPB of Prime Loans

		30+ Days Past Due		Individual Company %		
		UPB	%	High	Low	Median
4th Quarter 2007	7,829,075	1,706,244	21.79%	22.88%	16.40%	20.86%
1st Quarter 2008	5,045,128	815,638	16.17%	17.19%	7.91%	15.06%
2nd Quarter 2008	5,713,169	601,882	10.54%	11.06%	4.08%	9.30%
3rd Quarter 2008	7,243,717	881,514	12.17%	16.94%	7.88%	11.45%
4th Quarter 2008	5,121,770	454,590	8.88%	8.93%	6.85%	8.87%
1st Quarter 2009	3,929,751	317,272	8.07%	15.10%	7.87%	9.24%
2nd Quarter 2009	7,890,879	395,877	5.02%	28.07%	3.13%	5.39%
3rd Quarter 2009	7,653,209	484,401	6.33%	6.85%	2.15%	3.74%
Eight Quarter Total	50,426,698	5,657,418	11.22%			
Percent of Total Serviced	3.01%					
Percent of non-fixed rate products	7.86%					

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	87,903	40,148	45.67%	61.28%	36.34%	48.44%
1st Quarter 2008	111,720	45,520	40.74%	54.36%	27.76%	41.32%
2nd Quarter 2008	141,486	52,256	36.93%	47.29%	26.34%	36.14%
3rd Quarter 2008	184,154	71,823	39.00%	48.97%	26.95%	38.88%
4th Quarter 2008	187,610	73,762	39.32%	52.95%	23.50%	38.49%
1st Quarter 2009	141,849	51,447	36.27%	45.91%	17.58%	36.42%
2nd Quarter 2009	93,161	27,955	30.01%	52.95%	17.96%	29.09%
3rd Quarter 2009	62,886	17,935	28.52%	45.32%	17.36%	30.05%
Eight Quarter Total	1,010,769	380,846	37.68%			
Percent of Total Serviced	20.38%					
Percent of non-fixed rate products	41.74%					

UPB of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	19,225,767	8,674,663	45.12%	63.45%	33.81%	51.10%
1st Quarter 2008	23,048,468	9,697,710	42.08%	57.57%	29.05%	43.85%
2nd Quarter 2008	28,787,426	11,145,312	38.72%	50.53%	25.92%	39.65%
3rd Quarter 2008	38,987,971	16,140,159	41.40%	52.53%	28.98%	40.72%
4th Quarter 2008	41,059,172	17,371,524	42.31%	56.42%	24.57%	41.33%
1st Quarter 2009	31,631,116	12,521,084	39.58%	59.45%	18.59%	39.29%
2nd Quarter 2009	20,601,372	6,552,705	31.81%	56.08%	18.83%	31.78%
3rd Quarter 2009	14,441,681	4,000,876	27.70%	46.55%	17.43%	26.94%
Eight Quarter Total	217,782,972	86,104,033	39.54%			
Percent of Total Serviced	27.87%					
Percent of non-fixed rate products	45.30%					

DELINQUENCY & DEFAULT

Number of Prime Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	271,804	39.97%	0.22%	2.29%
60 to 89 days	104,091	18.95%	0.72%	1.01%
90 days or over	176,893	80.00%	1.22%	1.89%
Total	552,788			
Percentage of Prime Loans Serviced	*5.38%*	*132.04%*	*0.22%*	*4.70%*
Loans from above which were modified in the last 12 months.	5,822			
Percentage of total past due	*1.05%*	*6.28%*	*0.03%*	*1.68%*
Loans which entered delinquency within 3 payments of initial rate reset	362			
Percentage of total past due	*0.07%*	*3.87%*	*0.29%*	*2.08%*
Loans where notice of default sent	9,029			
Loans where formal foreclosure proceedings started	31,733			
Total Loans in Process of Foreclosure	40,762			
Percentage of total past due	*7.37%*	*79.23%*	*0.11%*	*16.61%*
Loans where foreclosure proceeding completed (ORE)	27,510			

UPB of Prime Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	39,279,638	4.29%	0.15%	1.39%
60 to 89 days	15,300,461	1.58%	0.20%	0.88%
90 days or over	19,921,597	75.87%	0.26%	1.32%
Total	74,501,696			
Percentage of Prime Loans Serviced	*4.45%*	*75.87%*	*0.15%*	*3.74%*
Loans from above which were modified in the last 12 months.	900,883			
Percentage of total past due	*1.21%*	*5.46%*	*0.00%*	*0.77%*
Loans which entered delinquency within 3 payments of initial rate reset	126,846			
Percentage of total past due	*0.17%*	*3.42%*	*0.15%*	*0.81%*
Loans where notice of default sent	3,546,386			
Loans where formal foreclosure proceedings started	6,499,468			
Total Loans in Process of Foreclosure	10,045,854			
Percentage of total past due	*13.48%*	*90.33%*	*0.27%*	*17.45%*
Loans where foreclosure proceeding completed (ORE)	5,980,112			

DELINQUENCY & DEFAULT

Number of Sub-Prime & Alt-A Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	355,422	9.77%	4.04%	7.56%
60 to 89 days	190,795	5.70%	2.47%	3.65%
90 days or over	630,967	22.37%	3.89%	15.95%
Total	1,177,184			
Percentage of Sub-Prime & Alt-A Loans Serviced	*23.73%*	*37.84%*	*13.14%*	*27.95%*
Loans from above which were modified in the last 12 months.	32,148			
Percentage of total past due	*2.73%*	*25.67%*	*0.05%*	*1.10%*
Loans which entered delinquency within 3 payments of initial rate reset	37,072			
Percentage of total past due	*3.15%*	*11.74%*	*0.09%*	*2.61%*
Loans where notice of default sent	135,996			
Loans where formal foreclosure proceedings started	161,962			
Total Loans in Process of Foreclosure	297,958			
Percentage of total past due	*25.31%*	*59.33%*	*0.81%*	*24.27%*
Loans where foreclosure proceeding completed (ORE)	133,540			

UPB of Sub-Prime & Alt-A Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	54,936,175	10.21%	3.96%	6.88%
60 to 89 days	31,212,143	6.39%	2.56%	3.94%
90 days or over	100,543,239	25.99%	3.01%	18.09%
Total	186,691,556			
Percentage of Sub-Prime & Alt-A Loans Serviced	*23.89%*	*41.94%*	*12.07%*	*29.69%*
Loans from above which were modified in the last 12 months.	5,506,175			
Percentage of total past due	*2.95%*	*25.39%*	*0.05%*	*1.19%*
Loans which entered delinquency within 3 payments of initial rate reset	7,485,477			
Percentage of total past due	*4.01%*	*12.57%*	*0.14%*	*3.37%*
Loans where notice of default sent	23,982,676			
Loans where formal foreclosure proceedings started	28,664,809			
Total Loans in Process of Foreclosure	52,647,485			
Percentage of total past due	*28.20%*	*63.61%*	*0.75%*	*31.92%*
Loans where foreclosure proceeding completed (ORE)	27,138,584			

LOSS MITIGATION & MODIFICATIONS

Number of Loans In-Process	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	3,670	1.41%	2.47%	0.02%	0.55%
Short sale	31,450	12.05%	34.50%	3.39%	9.09%
Total in process with borrower losing home	35,120	13.46%			
*Percent of past due 60 days+**	*3.42%*		*7.02%*	*0.35%*	*1.72%*
Forbearance	16,947	6.50%	47.23%	0.31%	3.57%
Repayment plan	49,615	19.02%	54.49%	2.22%	17.93%
Modification (principal reduction, interest rate &/or term of debt)	139,191	53.35%	81.47%	9.14%	33.97%
Total in process of home retention	205,753	78.86%			
*Percent of past due 60 days+**	*20.06%*		*42.48%*	*1.80%*	*13.79%*
Refinance or paid in full	5,279	2.02%	48.10%	1.94%	2.45%
Reinstatement/Account to be made current	14,747	5.65%	69.74%	2.19%	2.76%
Total in process of being resolved by borrower	20,026				
*Percent of past due 60 days+**	*1.95%*		*7.70%*	*0.49%*	*2.26%*
Total loans in loss mitigation	260,899	100.00%			
*Percent of past due 60 days+**	*25.44%*		*46.46%*	*5.54%*	*19.30%*

UPB of Loans In Process	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	884,842	1.73%	2.90%	0.01%	0.56%
Short sale	7,320,986	14.33%	37.81%	4.01%	10.73%
Total in process of borrower losing home	8,205,828	16.06%			
*Percent of past due 60 days+**	*5.19%*		*10.20%*	*0.48%*	*2.40%*
Forbearance	2,563,158	5.02%	46.61%	0.39%	3.15%
Repayment plan	8,866,965	17.35%	49.80%	3.11%	15.99%
Modification (principal reduction, interest rate &/or term of debt)	28,185,048	55.16%	81.21%	10.05%	36.47%
Total in process of home retention	39,615,171	77.54%			
*Percent of past due 60 days+**	*25.07%*		*46.52%*	*2.33%*	*14.90%*
Refinance or paid in full	1,008,996	1.97%	31.01%	0.06%	2.81%
Reinstatement/Account made current	2,262,896	4.43%	37.18%	1.38%	4.69%
Total in process of being resolved by borrower	3,271,891	6.40%			
*Percent of past due 60 days+**	*2.07%*		*8.41%*	*0.01%*	*2.34%*
Total loans in loss mitigation	51,092,890	100.00%			
*Percent of past due 60 days+**	*32.34%*		*52.48%*	*8.83%*	*24.03%*

**Denominator adjusted to remove two companies which do not currently track modifications in process.*

LOSS MITIGATION & MODIFICATIONS

Number of Loans Closed	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	339	0.38%	2.79%	0.03%	0.41%
Short sale	3,943	4.40%	24.87%	0.18%	4.26%
Total closed with borrower losing home	4,282	4.78%			
Forbearance	3,459	3.86%	11.65%	0.39%	2.92%
Repayment plan	24,096	26.91%	76.19%	1.31%	22.70%
Modification (principal reduction, interest rate &/or term of debt)	24,264	27.10%	88.95%	4.30%	23.74%
Total closed solutions with home retention	51,819	57.87%			
Refinance or paid in full	11,579	12.93%	48.10%	0.67%	2.79%
Reinstatement/Account made current	21,868	24.42%	69.74%	2.19%	7.87%
Total closed with resolution by borrower	33,447	37.35%			
Total	89,548	100.00%			
Prepayment penalty waived (from any of the above)	335				

UPB of Loans Closed	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	75,852	0.55%	2.67%	0.03%	0.51%
Short sale	581,695	4.24%	26.85%	0.05%	4.01%
Total closed with borrower losing home	657,547	4.79%			
Forbearance	516,953	3.77%	13.64%	0.55%	2.60%
Repayment plan	3,901,565	28.42%	76.26%	0.95%	26.40%
Modification (principal reduction, interest rate &/or term of debt)	4,469,054	32.56%	90.47%	6.22%	25.65%
Total closed solutions with home retention	8,887,572	64.74%			
Refinance or paid in full	1,512,944	11.02%	44.85%	0.14%	2.07%
Reinstatement/Account made current	2,668,982	19.44%	68.29%	1.12%	6.42%
Total closed with resolution by borrower	4,181,926	30.46%			
Total	13,727,046	100.00%			
Prepayment penalty waived (from any of the above)	44,320				

PROFILE OF MODIFICATIONS BY NUMBER OF LOANS

Time horizon for **closed** loan modifications
Modification effective for less than life of loan (e.g. 2 years)
Modification effective for life of loan
Did not report

Types of modifications **closed**
Modification by freezing interest rate at the initial/start rate
Modification by reducing the interest rate below the initial/start rate
Modification by reducing the interest rate below scheduled reset rate, but above start rate
Modification with extension of term
Modification with reduction in principal balance
Modification using two or more of above modifications (e.g. rate reduction and term change)
Other modification

PROFILE OF MODIFICATIONS BY UPB OF LOANS

Time horizon for **closed** loan modifications
Modification effective for less than life of loan (e.g. 2 years)
Modification effective for life of loan
Did not report

Types of modifications **closed**
Modification by freezing interest rate at the initial/start rate
Modification by reducing the interest rate below the initial/start rate
Modification by reducing the interest rate below scheduled reset rate, but above start rate
Modification with extension of term
Modification with reduction in principal balance
Modification using two or more of above modifications (e.g. rate reduction and term change)
Other modification

	Individual Company		
Number	High	Low	Median
This data is in process of being collected and will be available in future releases.			

Notes
For the individual company data, the Low and Average do not include companies which reported a zero value.

Number of Companies reporting a zero value in the following significant reporting items:

Delinquent sub-prime/Alt-A loans which entered delinquency within 3 payments of initial rate reset		2
In Process:	Deed in lieu	3
	Short sale	2
	Forebearance	5
	Repayment plan	2
	Modification	2
	Refinance or paid in full	6
	Reinstatement / account made current	4
Closed:	Deed in lieu	4
	Short sale	0
	Forebearance	2
	Repayment plan	1
	Modification	0
	Refinance or paid in full	0
	Reinstatement / account made current	0

APPENDIX B

CONSOLIDATED STATE REPORT FOR MORTGAGE SERVICERS
TREND DATA FROM OCTOBER 2007 TO JANUARY 2008

Trend Data from Consolidated State Report for Mortgage Servicers

All dollar amounts are the unpaid principal balance (UPB) and are in thousands (000's).
All numbers of loans are the actual number.

					Percentage Change			
Number of Servicers Reporting	January 13	December 13	November 13	October 13	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Initial Rate Reset & Delinquency								
Percentage of loans scheduled for initial rate reset in the next 8 quarters which are currently 30+ days delinquent								
Prime	10.43%	9.65%	8.45%	7.36%				
Sub-Prime & Alt- A	37.68%	36.57%	34.13%	30.74%				
DELINQUENCY & DEFAULT								
Number of Prime Loans								
30 to 59 days	271,804	297,434	245,242	238,446	13.99%	-8.62%	21.28%	2.85%
60 to 89 days	104,091	110,043	88,619	88,202	18.01%	-5.41%	24.18%	0.47%
90 days or over	176,893	185,104	128,608	62,073	184.98%	-4.44%	43.93%	107.19%
Total	552,788	592,581	462,469	388,721	42.21%	-6.72%	28.13%	18.97%
Percentage of Prime Loans Serviced	5.38%	5.78%	4.60%	3.78%				
Loans from above which were modified in the last 12 months.	5,822	6,659	5,848	5,348	8.86%	-12.57%	13.87%	9.35%
Percentage of total past due	1.05%	1.12%	1.26%	1.38%				
Loans which entered delinquency within 3 payments of initial rate reset	362	378	304	310	16.77%	-4.23%	24.34%	-1.94%
Percentage of total past due	0.07%	0.06%	0.07%	0.08%				
Loans where notice of default sent	9,029	11,269	8,921	9,538	-5.34%	-19.88%	26.32%	-6.47%
Loans where formal foreclosure procedings started	31,733	35,502	31,616	28,433	11.61%	-10.62%	12.29%	11.19%
Total Loans in Process of Foreclosure	40,762	46,771	40,537	37,971	7.35%	-12.85%	15.38%	6.76%
Percentage of total past due	7.37%	7.89%	8.77%	9.77%				
Loans where foreclosure preceding completed (ORE)	27,510	26,707	27,293	23,944	14.89%	3.01%	-2.15%	13.99%

DELINQUENCY & DEFAULT

UPB of Prime Loans	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
30 to 59 days	39,279,638	43,111,094	38,996,319	36,413,811	7.87%	-8.89%	10.55%	7.09%
60 to 89 days	15,300,461	16,357,821	14,720,023	14,258,173	7.31%	-6.46%	11.13%	3.24%
90 days or over	19,921,597	22,873,507	19,863,859	9,125,764	118.30%	-12.91%	15.15%	117.67%
Total	74,501,696	82,342,422	73,580,201	59,797,748	24.59%	-9.52%	11.91%	23.05%
Percentage of Prime Loans Serviced	4.45%	5.10%	4.64%	3.73%				
Loans from above which were modified in the last 12 months.	900,883	1,043,653	905,780	813,347	10.76%	-13.68%	15.22%	11.36%
Percentage of total past due	1.21%	1.27%	1.23%	1.36%				
Loans which entered delinquency within 3 payments of initial rate reset	126,846	134,092	106,337	112,468	12.78%	-5.40%	26.10%	-5.45%
Percentage of total past due	0.17%	0.16%	0.14%	0.19%				
Loans where notice of default sent	3,546,386	4,345,082	3,531,460	3,802,116	-6.73%	-18.38%	23.04%	-7.12%
Loans where formal foreclosure procedings started	6,499,468	7,351,150	6,465,924	5,783,470	12.38%	-11.59%	13.69%	11.80%
Total Loans in Process of Foreclosure	10,045,854	11,696,232	9,997,384	9,585,585	4.80%	-14.11%	16.99%	4.30%
Percentage of total past due	13.48%	14.20%	13.59%	16.03%				
Loans where foreclosure preceding completed (ORE)	5,980,112	6,011,207	5,922,818	5,165,182	15.78%	-0.52%	1.49%	14.67%

DELINQUENCY & DEFAULT	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Sub-Prime & Alt-A Loans								
30 to 59 days	355,422	379,068	374,411	356,849	-0.40%	-6.24%	1.24%	4.92%
60 to 89 days	190,795	199,286	192,709	186,695	2.20%	-4.26%	3.41%	3.22%
90 days or over	630,967	618,158	660,203	542,723	16.26%	2.07%	-6.37%	21.65%
Total	1,177,184	1,196,512	1,242,292	1,086,267	8.37%	-1.62%	-3.69%	14.36%
Percentage of Sub-Prime & Alt-A Loans Serviced	23.73%	23.60%	24.00%	21.25%				
Loans from above which were modified in the last 12 months.	32,148	35,722	26,762	22,522	42.74%	-10.01%	33.48%	18.83%
Percentage of total past due	2.73%	2.99%	2.18%	2.07%				
Loans which entered delinquency within 3 payments of initial rate reset	37,072	33,047	31,857	30,986	19.64%	12.18%	3.74%	2.81%
Percentage of total past due	3.15%	2.76%	2.60%	2.85%				
Loans where notice of default sent	135,996	135,325	121,366	135,024	0.72%	0.50%	11.50%	-10.12%
Loans where formal foreclosure procedings started	161,962	160,104	153,181	140,203	15.52%	1.16%	4.52%	9.26%
Total Loans in Process of Foreclosure	297,958	295,429	274,547	275,227	8.26%	0.86%	7.61%	-0.25%
Percentage of total past due	25.31%	24.69%	22.37%	25.34%				
Loans where foreclosure preceding completed (ORE)	133,540	125,402	115,233	102,538	30.23%	6.49%	8.82%	12.38%

DELINQUENCY & DEFAULT

UPB of Sub-Prime & Alt-A Loans	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
30 to 59 days	54,936,175	57,991,375	57,715,248	54,777,258	0.29%	-5.27%	0.48%	5.36%
60 to 89 days	31,212,143	32,280,167	31,269,978	30,275,397	3.09%	-3.31%	3.23%	3.29%
90 days or over	100,543,239	97,393,169	103,140,085	82,763,152	21.48%	3.23%	-5.57%	24.62%
Total	186,691,556	187,664,711	192,125,312	167,815,807	11.25%	-0.52%	-2.32%	14.49%
Percentage of Sub-Prime & Alt-A Loans Serviced	23.89%	23.43%	23.87%	20.91%				
Loans from above which were modified in the last 12 months.	5,506,175	6,041,625	4,338,864	3,562,013	54.58%	-8.86%	39.24%	21.81%
Percentage of total past due	2.95%	3.22%	2.26%	2.12%				
Loans which entered delinquency within 3 payments of initial rate reset	7,485,477	6,356,556	5,846,870	5,378,363	39.18%	17.76%	8.72%	8.71%
Percentage of total past due	4.01%	3.39%	3.04%	3.20%				
Loans where notice of default sent	23,982,676	23,458,517	21,168,389	25,219,053	-4.90%	2.23%	10.82%	-16.06%
Loans where formal foreclosure procedings started	28,664,809	28,201,039	31,512,264	28,715,404	-0.18%	1.64%	-10.51%	9.74%
Total Loans in Process of Foreclosure	52,647,485	51,659,556	52,680,654	53,934,457	-2.39%	1.91%	-1.94%	-2.32%
Percentage of total past due	28.20%	27.53%	27.42%	32.14%				
Loans where foreclosure preceding completed (ORE)	27,138,584	25,128,957	22,022,922	19,080,954	42.23%	8.00%	14.10%	15.42%

LOSS MITIGATION & MODIFICATIONS	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Loans In-Process								
Deed in lieu	3,670	4,711	4,451	3,663	0.19%	-22.10%	5.84%	21.51%
Short sale	31,450	31,009	29,475	24,365	29.08%	1.42%	5.20%	20.97%
Total in process with borrower losing home	35,120	35,720	33,926	28,028	25.30%	-1.68%	5.29%	21.04%
Percent of past due 60 days+	3.42%	3.43%	3.62%	3.42%				
Forbearance	16,947	17,855	18,102	16,222	4.47%	-5.09%	-1.36%	11.59%
Repayment plan	49,615	49,059	59,447	59,991	-17.30%	1.13%	-17.47%	-0.91%
Modification (principal reduction, interest rate &/or term c	139,191	117,051	99,692	89,147	56.14%	18.91%	17.41%	11.83%
Total in process of home retention	205,753	183,965	177,241	165,360	24.43%	11.84%	3.79%	7.18%
Percent of past due 60 days+	20.06%	17.68%	18.89%	20.17%				
Refinance or paid in full	5,279	6,414	7,167	3,206	64.66%	-17.70%	-10.51%	123.55%
Reinstatement/Account to be made current	14,747	11,484	11,348	12,926	14.09%	28.41%	1.20%	-12.21%
Total in process of being resolved by borrower	20,026	17,898	18,515	16,132	24.14%	11.89%	-3.33%	14.77%
Percent of past due 60 days+	1.95%	1.72%	1.97%	1.97%				
Total loans in loss mitigation	260,899	237,583	229,682	209,520	24.52%	9.81%	3.44%	9.62%
Percent of past due 60 days+	25.44%	22.84%	24.48%	25.56%				

LOSS MITIGATION & MODIFICATIONS

UPB of Loans In Process	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Deed in lieu	884,842	1,143,585	1,078,053	883,044	0.20%	-22.63%	6.08%	22.08%
Short sale	7,320,986	7,122,576	6,504,175	5,260,935	39.16%	2.79%	9.51%	23.63%
Total in process of borrower losing home	8,205,828	8,266,161	7,582,228	6,143,980	33.56%	-0.73%	9.02%	23.41%
Percent of past due 60 days+	5.19%	5.15%	5.16%	4.73%				
Forbearance	2,563,158	2,842,774	2,992,909	2,618,905	-2.13%	-9.84%	-5.02%	14.28%
Repayment plan	8,866,965	8,830,697	10,517,134	10,139,747	-12.55%	0.41%	-16.04%	3.72%
Modification (principal reduction, interest rate &/or term c	28,185,048	23,632,958	19,274,083	16,080,207	75.28%	19.26%	22.62%	19.86%
Total in process of home retention	39,615,171	35,306,428	32,784,125	28,838,858	37.37%	12.20%	7.69%	13.68%
Percent of past due 60 days+	25.07%	21.98%	22.31%	22.18%				
Refinance or paid in full	1,008,996	1,144,067	1,239,074	704,512	43.22%	-11.81%	-7.67%	75.88%
Reinstatement/Account made current	2,262,896	1,804,164	1,756,235	2,052,634	10.24%	25.43%	2.73%	-14.44%
Total in process of being resolved by borrower	3,271,891	2,948,231	2,995,310	2,757,146	18.67%	10.98%	-1.57%	8.64%
Percent of past due 60 days+	2.07%	1.84%	2.04%	2.12%				
Total loans in loss mitigation	51,092,890	46,520,821	43,361,663	35,589,060	43.56%	9.83%	7.29%	21.84%
Percent of past due 60 days+	32.34%	28.96%	29.51%	27.37%				

LOSS MITIGATION & MODIFICATIONS	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Loans Closed								
Deed in lieu	339	317	275	356	-4.78%	6.94%	15.27%	-22.75%
Short sale	3,943	3,960	3,449	3,456	14.09%	-0.43%	14.82%	-0.20%
Total closed with borrower losing home	4,282	4,277	3,730	3,812	12.33%	0.12%	14.66%	-2.15%
Forbearance	3,459	3,413	3,124	3,136	10.30%	1.35%	9.25%	-0.38%
Repayment plan	24,096	19,564	19,625	21,843	10.31%	23.16%	-0.31%	-10.15%
Modification (principal reduction, interest rate &/or term of debt)	24,264	19,935	22,154	19,082	27.16%	21.72%	-10.02%	16.10%
Total closed solutions with home retention	51,819	42,912	44,903	44,061	17.61%	20.76%	-4.43%	1.91%
Refinance or paid in full	11,579	9,327	11,186	8,573	35.06%	24.14%	-16.62%	30.48%
Reinstatement/Account made current	21,868	18,382	18,712	19,601	11.57%	18.96%	-1.76%	-4.54%
Total closed with resolution by borrower	33,447	27,709	29,898	28,174	18.72%	20.71%	-7.32%	6.12%
Total	89,548	74,898	78,525	76,047	17.75%	19.56%	-4.62%	3.26%
Percentage of the previous month's in-process	37.69%	32.61%	37.48%					
Prepayment penalty waived (from any of the above)	335	344	279	236	41.95%	-2.62%	23.30%	18.22%
UPB of Loans Closed								
Deed in lieu	75,852	74,832	56,470	71,679	5.82%	1.36%	32.52%	-21.22%
Short sale	581,695	513,220	433,173	618,663	-5.98%	13.34%	18.48%	-29.98%
Total closed with borrower losing home	657,547	588,052	489,643	690,343	-4.75%	11.82%	20.10%	-29.07%
Forbearance	516,953	495,766	421,588	443,615	16.53%	4.27%	17.60%	-4.97%
Repayment plan	3,901,565	3,017,291	3,031,761	3,358,630	16.17%	29.31%	-0.48%	-9.73%
Modification (principal reduction, interest rate &/or term of debt)	4,469,054	3,569,723	4,217,612	3,340,759	33.77%	25.19%	-15.36%	26.25%
Total closed solutions with home retention	8,887,572	7,082,780	7,670,960	7,143,004	24.42%	25.48%	-7.67%	7.39%
Refinance or paid in full	1,512,944	1,273,470	1,152,006	1,814,769	-16.63%	18.80%	10.54%	-36.52%
Reinstatement/Account made current	2,668,982	2,387,497	2,399,345	2,521,715	5.84%	11.79%	-0.49%	-4.85%
Total closed with resolution by borrower	4,181,926	3,660,967	3,551,351	4,336,484	-3.56%	14.23%	3.09%	-18.11%
Total	13,727,046	11,331,800	11,711,954	12,169,830	12.80%	21.14%	-3.25%	-3.76%
Percentage of the previous month's in-process	29.51%	26.13%	32.91%					
Prepayment penalty waived (from any of the above)	44,320	37,821	19,691	14,500	205.65%	17.18%	92.07%	35.80%

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM SHEILA C. BAIR

There was an article in the June 4, 2008, *Financial Times* that said banks could be forced to bring up to 5 trillion of assets currently held off their books onto their balance sheets. This raises many questions, but I will start with three.

Q.1. First, in the current markets can the banks raise the capital they need to hold against these assets?

A.1. The June 4, 2008 *Financial Times* article addresses lingering concerns with off-balance sheet exposures. Firms have used loopholes in off-balance sheet accounting for years in order to enhance their financial statements without shedding risk. Capital and accounting rules need to reflect the economic reality of the transactions that our large financial institutions engage in on a daily basis.

Financial institutions have shown a remarkable ability to raise capital even in this stressed market, which I view as a positive reflection on the long-term prospects for the U.S. banking system. Bloomberg reports that the ten U.S. bank holding companies with the largest write-downs and credit losses since second quarter 2007 raised $114.5 billion in capital during this same time period. This amount more than offsets the $100.2 billion in write-downs and losses that these institutions reported. To shore up their capital bases, institutions have reduced and in some cases eliminated cash dividends and have raised common stock and preferred shares from a wide range of sources.

While their ability to continue to access the capital markets for funding is not assured, institutions have taken the right steps to adequately plan for their capital needs. However, several market participants have indicated that continued losses are expected as we work through the credit market turmoil, which could place additional pressure on bank capital levels.

We are continuing to evaluate the potential impact of any FASB action on off-balance sheet accounting on regulatory capital and on the securitization business in general, and will be in a better position to consider changes once the FASB proposals are issued for public comment.

Q.2. Second, since you are their regulators, do you know and have you known all along what those assets are?

A.2. U.S. regulators have three important tools at our disposal for identifying and evaluating the risk present in bank operations: on-site examination, off-site surveillance, and public disclosures. While these tools provide us with a significant amount of information necessary to assess the safety and soundness of our banks, the financial innovations that have transpired over the past several years have made it more difficult to fully understand the risks present in off-balance sheet structures such as securitized investment vehicles (SIVs) and collateralized debt obligations (CDOs). These vehicles were used to transfer a wide variety of exposures to investors without a sufficient degree of transparency and disclosures. However, the opacity in these structures served to exacerbate problems since investors and, in some instances, regulators were not able to quickly identify the assets placed in these vehicles.

The work underway in the Basel Committee to improve the disclosures governing off-balance sheet vehicles should address many of these concerns. In addition, I have been a strong advocate of requiring banks that invest and manage securitization exposures to fully understand the risk characteristics present in the securitization vehicles and the underlying collateral supporting these structures before they can take any capital relief from external ratings. These are bare minimum due diligence standards that serve as the foundation of prudent investment management.

Q.3. And third, why were they allowed to move trillions of dollars of what turned out to be the riskiest assets off their books to avoid capital charges?

A.3. The accounting and capital rules have provided banks with the ability and incentive to remove assets from their balance sheet. I believe that the accounting standards and the capital rules need to be reassessed in order to ensure that they provide the right incentives for managing risks at our largest financial institutions. Securitization in general has provided several benefits to the financial markets—it has enhanced credit availability and has provided market participants with another asset class in which to invest. At the same time, the off-balance sheet rules were abused in some cases. I am pleased to see that the Financial Accounting Standards Board is reviewing their off-balance sheet accounting standards with an eye towards eliminating any loopholes. The Basel Committee and U.S. regulators need to consider these issues as well in conjunction with any revisions to our capital rules.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM SHEILA C. BAIR

Q.1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser requirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?

A.1. The New York Attorney General, Fannie Mae, Freddie Mac, and the Office of Federal Housing Enterprise Oversight (OFHEO) have proposed a Home Valuation Code of Conduct that would overlay the long-standing set of federal banking agency appraisal regulations and Uniform Standards of Professional Appraisal Practice (USPAP) guidelines. The FDIC provided a comment to OFHEO on the proposal on June 20, 2008, which is attached. Our comment letter strongly supports the concept of appraiser independence and USPAP standards, but articulates our belief that the use of in-house or affiliated appraisers may be appropriate if managed prudently.

The Dole amendment would direct OFHEO to devise appraisal rules for mortgages purchased or guaranteed by government-sponsored enterprises in a way that is consistent with appraisal regulations issued by the federal banking agencies. This would have the advantage of establishing a common set of appraisal standards for insured depository institutions and other mortgage lenders nationwide. As indicated in our comment letter, the FDIC supports an interagency rulemaking process to establish comprehensive appraisal and appraiser standards.

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

June 20, 2008

The Honorable James B. Lockhart III
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Lockhart:

Thank you for the opportunity to comment on the Home Valuation Code of Conduct ("Code") and the Home Valuation Protection Program and Cooperation Agreements ("Agreements") entered into by the New York Attorney General, Fannie Mae, Freddie Mac, and the Office of Federal Housing Enterprise Oversight (OFHEO). As federal deposit insurer, receiver, and supervisor of state nonmember banks, the FDIC has significant interest in changes to standards for real estate appraisals that affect the banking industry.

The FDIC believes that an effective, independent appraisal process is in the best interest of financial institutions to ensure quality collateral valuations and implementation of successful real estate lending programs. Since 1990 (pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989), insured depository institutions have been subject to minimum federal real estate appraisal standards for approaches to value, professional competency, appraiser independence, and the Uniform Standards of Professional Appraisal Practice (USPAP). These rules promote effective appraisal processes for mortgage underwriting and can be enforced by the federal banking agencies if institutions fail to comply. Appraisers employed by financial institutions or their affiliates are also subject to these directives and federal oversight. The Code and Agreements would overlay this long-standing set of federal regulations and professional appraiser practice.

The FDIC strongly supports the concept of appraiser independence and believes that lenders should ensure that appraisers adhere to federal banking requirements and USPAP. The Code proposes strict new limitations on bank-affiliated appraisers at insured depository institutions and on appraisers selected, retained, and compensated by third parties. There may well be benefits to these new limitations, but there could also be unintended costs and consequences. We believe that both bank-affiliated and independent appraisal firms can be subject to undue influence; therefore, it is not clear that forcing business along rigid organizational demarcations is more suitable. It is also important to note that most depository institutions also do portfolio lending and the inherent financial and safety and soundness considerations that attach to their underwriting processes provide strong incentives to receive high-quality valuations, regardless of the provider. The use of bank-affiliated appraisers should not be tainted because of abuses observed in individual enforcement cases. Accordingly, we recommend permitting flexibility for

appraiser independence that would accommodate professional practice standards and could be appropriately scaled to correspond with the wide variety and size of mortgage lending institutions.

Finally, although we understand OFHEO's need to act expeditiously in executing the Agreements and adopting the Code, we believe that the best way to establish comprehensive appraisal and appraiser standards that affect both insured depository institutions and other mortgage lenders nationwide is through notice-and-comment rulemaking. The FDIC would be supportive of such an interagency rulemaking process. We very much appreciate, however, the opportunity for comment you afforded for the Code and Agreements, as well as the recent public comments by your General Counsel indicating that OFHEO takes the comment process seriously and may pursue amendments to the Code and Agreements based on the comments received.

Sincerely,

Sandra L. Thompson
Director

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN C. DUGAN

Q.1. There was an article in the June 4, 2008, *Financial Times* that said banks could be forced to bring up to 5 trillion dollars of assets currently held off their books onto their balance sheets. This raises many questions, but I will start with three. First, in the current markets can the banks raise the capital they need to hold against these assets?

A.1. The accounting changes referenced in the article relate to work of the Financial Accounting Standards Board (FASB) to revise two accounting pronouncements. One is FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, which is the primary accounting standard for securitization transactions. The other is FIN 46(R), Consolidation of Variable Interest Entities, which is the primary accounting guidance for the consolidation of special purpose entities. FIN 46(R) often affects whether banks have to consolidate asset-backed commercial paper conduit programs including structured investment vehicles. While proceeding separately, the International Accounting Standards Board (IASB) is also undertaking work to enhance the accounting and disclosure standards for off-balance sheet entities.

While the article you cited claims that $5 trillion could be brought onto bank balance sheets as a result of FASB's actions, the precise amount is difficult to gauge. A major reason for the uncertainty is that the proposed accounting changes have yet to be fully articulated and subjected to public comment. We understand that the FASB intends to issue the proposed FAS 140 and FIN 46(R) amendments contemporaneously in the coming weeks, for formal public comment prior to a final standard being released and becoming effective. While we do not know for certain which current off-balance sheet entities would be consolidated under revised accounting standards, many people following the FASB project believe that certain structured finance entities (e.g., ABCP conduits) and revolving securitization trusts (e.g., credit card receivables) will be required to be consolidated by the sponsoring entities. It is less certain whether securitized residential mortgages and money market funds would be affected significantly by the proposal.

In relation to your first question, while investors have shown strong willingness to provide capital to U.S. banks, a change in generally accepted accounting principles (GAAP) that would add a large amount of assets onto bank balance sheets and a related increase in the need for regulatory capital would place additional strain on the banking system. As I noted in my written testimony, the OCC believes policy makers and accounting standard setters need to carefully evaluate how these proposed accounting changes may affect markets and institutions and ensure that appropriate transition periods are provided if significant changes are adopted. Specifically, we believe any effective date and transition period should provide time for financial institutions to review their existing transactions and respond to the final FAS 140 and FIN 46(R) amendments. This would allow U.S. banks an opportunity to raise capital, shed assets, or make other adjustments to their balance sheets to prepare for the influx of off-balance sheet exposures. Moreover, enhanced coordination between FASB and IASB could

minimize international competitive issues resulting from differing accounting standards governing these activities.

We are considering the extent to which these accounting changes should flow through to regulatory capital requirements, which would also affect whether banks need to raise more capital. As is discussed in more detail below, our regulatory capital rules already require capital against many off-balance sheet exposures. Once the details of the proposed accounting changes are available, we will evaluate how our capital requirements might need to be altered.

Q.2. Second, since you are their regulators, do you know and have you known all along what those assets are?

A.2. As touched on above, off-balance sheet exposures that might be affected by the accounting changes include a wide array of assets, including residential mortgage loans, auto loans, and credit card receivables that have been sold through securitization transactions. The accounting changes might also affect asset-backed commercial paper programs used by banks to provide financing to bank customers for assets such as trade receivables. As part of our supervisory process, we are actively engaged in evaluating our banks' activities and risk exposures, including an in-depth understanding of bank exposures not shown on the balance sheet.

Q.3. And third, why were they allowed to move trillions of dollars of what turned out to be the riskiest assets off their books to avoid capital charges?

A.3. It is important to note that the assets that might be brought onto bank balance sheets if accounting changes are enacted can often be of relatively high credit quality. The fact that assets are off-balance sheet does not imply that those assets are riskier than assets kept on the balance sheet. For example, credit card receivables and prime mortgage loans that have been securitized and sold to third-party investors generally do not appear on bank balance sheets but could be brought on as a result of accounting changes. Although the loss rates on these types of exposures are increasing due to the effects of the housing and economic downturn, we do not expect the losses to approach those experienced in the collateralized debt obligation (CDO) market. Similarly, we anticipate that loss rates for home equity loans, which typically are not securitized, will be substantially higher than loss rates for securitized prime mortgages.

The ability to move assets off the balance sheet is dictated by GAAP, which are governed in the United States by FASB. While the regulatory capital rules build off of the accounting framework, bank regulatory capital requirements take into account exposures beyond just the assets appearing on the balance sheet. In particular, the agencies' risk-based capital rules include charges for off-balance sheet risks. These risk-based capital requirements attempt to look at the economic risks of a given transaction, as opposed to being driven solely by the accounting decision of whether the assets can be removed from the balance sheet. For example, unfunded portions of liquidity facilities, as well as credit guarantees that banks provide to asset-backed commercial paper programs, are generally off-balance sheet, but they are captured under the risk-based capital rules.

With that said, the banking agencies readily acknowledge that our existing regulatory capital rules warrant review and enhancement. Recent events have revealed some shortcomings in our capital rules, and we are considering changes to these rules to better reflect risks. One of the motivations of developing the recently finalized Basel II-based capital rules was to further enhance risk sensitivity of the regulatory capital framework. We believe that, once implemented, the Basel II-based rules will better reflect risks—both on and off the balance sheet.

Furthermore, we have not stopped considering how to improve the rules with the adoption of Basel II. Recent events have led the Basel Committee on Banking Supervision to examine making refinements to various aspects of the securitization framework of the international Basel II Accord. Changes to the Accord could affect the minimum regulatory capital required for off-balance sheet exposures, such as bank exposures to asset-backed commercial paper conduits. Changes could also affect on-balance sheet exposures, such as certain CDOs and other structured finance transactions that have contributed significantly to large losses at banks in recent months. We will consider the changes to the Accord developed by the Basel Committee for adoption by U.S. banks through our notice and comment process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM JOHN C. DUGAN

Q.1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser requirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?

A.1. As we understood Senator Dole's amendment, it would require the Director of OFHEO to issue a final regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie Mae and Freddie Mac. In doing so, the Director would be required to ensure that the regulation is consistent and does not conflict with the regulations and guidelines issued by the Federal banking agencies and the NCUA. Finally, the regulation would supersede the terms of "any agreement relating to appraisal standards" (including the agreement with the New York Attorney General (NYAG) referred to in this question) to the extent of any inconsistency between the regulation and any such agreement. The Director would have the authority to determine whether or not such an inconsistency exists. ("Consistent" provisions of any such agreement would not take effect until one year after issuance of the Director's final regulation.)

In the opinion of the OCC, Senator Dole's amendment would further the crucial objective of ensuring that appraisal standards ap-

plicable to the GSEs do not run counter to the standards that already have been established by the Federal banking agencies and the NCUA to implement the framework for appraisal regulation that Congress provided in the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). The FIRREA appraisal provisions provided the foundation upon which an extensive regulatory scheme for appraisal standards and oversight for appraisers and depository institutions has been built. The imposition of new and inconsistent standards on mortgages purchased by the GSEs is unnecessary and could add additional, unwarranted impediments to the availability of mortgage credit and an unnecessary new and potentially disruptive factor in the mortgage marketplace. In two recent letters to the Director of OFHEO, the OCC has described its serious concerns in these respects.[1] If enacted, the Dole amendment would prevent these problems. The OCC supports that result.

Two modifications to the Dole amendment would further promote consistency in the appraisal standards that apply to federally supervised lenders and to the GSEs. (1) The Director of OFHEO should be required to consult with the Federal banking agencies and the NCUA in two instances to ensure such consistency: first, consultation should occur prior to the Director's promulgation of the regulation required by the amendment; second, consultation should occur when the Director determines whether there is inconsistency between the regulation and any agreement relating to appraisal standards. (2) The provision at the end of the amendment that makes "consistent" agreement provisions effective one year after the Director issues the regulation can be eliminated. To the extent the OFHEO regulation is "consistent" with an agreement, it would be unnecessary for the agreement to continue in effect at all.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN M. REICH

Q.1. There was an article in the June 4, 2008, Financial Times (attached) that said banks could be forced to bring up to 5 trillion dollars of assets currently held off their books onto their balance sheets. This raises many questions, but I will start with three. First, in the current markets can the banks raise the capital they need to hold against these assets? Second, since you are their regulators, do you know and have you known all along what those assets are? And third, why were they allowed to move trillions of dollars of what turned out to be the riskiest assets off their books to avoid capital charges?

A.1. The Financial Times article was referring to structured investment vehicles (SIVs). SIVs were primarily an off-balance sheet financing tool or arrangement used by large money center banks.

Typically a large bank utilizing a SIV would also provide a line of credit to the investor/lender that was used to help guarantee the credit rating of the underlying collateral. Only the largest banks have both the wherewithal and credit rating necessary to provide these guarantees that would be acceptable to investors/lenders.

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[1] *See* Letter from John C. Dugan to James B. Lockhart III (May 27, 2008) (OCC Letter); Letter from Randall S. Kroszner, John C. Dugan, John M. Reich, and JoAnn M. Johnson to James B. Lockhart III (June 19, 2008) (Interagency Letter).

Thrifts did not utilize this type of financing.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM JOHN M. REICH

Q.1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser requirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?

A.1. The Office of Thrift Supervision (OTS) welcomes congressional efforts to promote quality appraisals and appraiser independence for secondary mortgage market transactions. OTS is very interested in this amendment because of the potential effect of any new appraisal requirements on federal housing and mortgage markets and the institutions we regulate. OTS supervises an industry whose primary activity is mortgage lending.

We support requiring, among other provisions, that the Office of Federal Housing Enterprise Oversight (OFHEO) issue a regulation establishing appraisal standards for mortgage transactions that are guaranteed or purchased by the Federal Home Loan Mortgage Corporation or Federal National Mortgage Association (collectively, the GSEs). This provision would ensure that appraisal requirements adopted by the GSEs are established through a process that follows procedural and other laws applicable to a federal agency rulemaking.

This open and public process would provide federally regulated institutions and other interested parties the opportunity to provide meaningful input and to question the assumptions upon which proposed requirements are based. In contrast, the requirements imposed by the Home Valuation Code of Conduct and the Home Valuation Protection Program and Cooperation Agreements (the Code and Agreements), as executed by OFHEO, the Attorney General of the State of New York (NYAG), and the GSEs, are not the result of a federal agency rulemaking. In our view, the Code and Agreements are the products of a flawed process that would implement sweeping changes in the industry without adequate notice and public comment.

More importantly, we are very concerned that certain requirements imposed by the Code and Agreements would unnecessarily undermine the safe and sound extension of credit, reduce the availability of mortgage credit to many consumers, and ultimately lead to less reliability and accuracy in appraisals as explained in our attached correspondence.[1] Such requirements would conflict with the

[1] OTS issued the attached comment letters concerning the legal and policy issues presented by the Code and Agreements. See letter dated April 30, 2008, from T. Ward, Deputy Director for OTS, and the joint letter dated June 19, 2008 from Randall Krozner, Governor, Board of Governors of the Federal Reserve System, John M. Reich, Director for OTS, John C. Dugan,

existing regulatory framework for appraisal standards and appraiser oversight that implements the Financial Institutions Reform Recovery and Enforcement Act of 1989 and other legislation. To address these concerns, the amendment ensures that OFHEO's appraisal regulation would supersede any agreement entered into by OFHEO or the GSEs to the extent that any such agreement is inconsistent with the regulation.

Finally, the amendment directs OFHEO to issue an appraisal regulation that (i) would be consistent with appraisal regulations and guidelines issued by OTS and other federal banking agencies, including regulations related to the independence and accuracy of appraisals and (ii) would not conflict with any other banking regulations. While we support this provision, it is important that OFHEO's appraisal regulation not create unnecessary regulatory burden for federally regulated institutions or otherwise adversely affect mortgage credit availability. Our concern is that a new set of appraisal requirements could be "consistent" and yet impose additional standards already addressed by our current regulations. If this were to occur, we would address the specific requirement with OFHEO well in advance of a final regulation.

Comptroller of the Currency, and JoAnn M. Johnson, Chairman for the National Credit Union Administration.

Office of Thrift Supervision
Department of the Treasury

Timothy T. Ward
Deputy Director, Examinations, Supervision, and Consumer Protection

1700 G Street, N.W., Washington, DC 20552 • (202) 906-5666

April 30, 2008

Home Valuation Code of Conduct Response
Attn: Senior Vice President, Credit Risk Oversight
Freddie Mac
1551 Park Run Drive, Mail Stop D2Z
McLean, VA 22102-3110

To Whom It May Concern:

The Office of Thrift Supervision (OTS) submits this comment letter regarding the Home Valuation Code of Conduct ("Code") and the Home Value Protection Program and Cooperation Agreements ("Agreements") entered into by the New York Attorney General, Fannie Mae, Freddie Mac, and the Office of Federal Housing Enterprise Oversight (OFHEO) (respectively, and collectively, the "Parties") on March 3, 2008. The OTS is interested in the Code and the Agreements given their potential for economic consequences on the federal housing and mortgage markets. In OTS's unique role as the federal regulator of savings associations and savings and loan holding companies, the OTS supervises an industry comprised primarily of mortgage lenders.

OTS regulated institutions are subject to appraisal standards of independence and minimum appraisal requirements, all of which are described in the OTS Appraisal Regulation at 12 C.F.R. Part 564. This regulation is consistent with the appraisal regulations adopted by the other federal banking agencies. The federal banking agencies have issued joint guidance to be read in conjunction with each agency's appraisal regulation.[1] Moreover, licensed appraisers are subject to industry standards such as the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP is incorporated in the OTS Appraisal Regulation and constitutes a minimum appraisal requirement for our supervised institutions.

Our Appraisal Regulation and Interagency Guidance cause an appraisal program to be isolated from influence by loan production staff. Reporting lines for staff who order, accept, perform or review appraisals should be independent of loan production. Similarly, individuals who oversee the appraiser selection process must be independent of the loan production area.

The Code would preclude many federally regulated institutions from using in-house appraisers, as well as appraisers employed by certain affiliates or subsidiaries, to perform appraisals on transactions that are eligible for sale to Freddie Mac and Fannie Mae. OTS disagrees that corporate structure and ownership considerations alone would dictate whether an appraisal was prepared with proper independence.

Imposing a requirement that all lenders must outsource appraisals will not ensure appraiser independence and may make regulatory enforcement more difficult. As I noted earlier, sufficient laws, regulations, and

[1]Specifically, OTS has issued Thrift Bulletin 55a, Interagency Appraisal and Evaluation Guidelines, dated October 27, 1994, (http://www.ots.treas.gov/docs/8/84042.pdf), CEO Letter #184, Independent Appraisal and Evaluation Functions, dated October 27, 2003, (http://www.ots.treas.gov/docs/2/25184.pdf, and CEO Letter #213, Frequently Asked Questions (FAQ) on the Agencies' Appraisal Regulations and Related Guidance, dated March 22, 2005, (http://www.ots.treas.gov/docs/2/25213.pdf) (collectively "Interagency Guidance").

guidance exist to achieve the universal goal of appraisal independence, irrespective of whether the appraisal process is conducted in-house or through outside vendors.

The Code's provisions would require financial institutions to revise their internal operations, including related compliance functions and technology, to sell loans to Fannie Mae and Freddie Mac. Savings associations with in-house appraisers will likely incur significant internal operating costs to comply with the Code. These potential costs include: restructuring of internal operations; terminating existing contracts and business relationships; updating technology for the Code's provisions; testing for compliance; managing terms of new representations or warranties; and selecting new appraisal service providers.

Moreover, the Code as currently drafted could have a significant impact on savings associations utilizing subsidiary or affiliate companies engaged in the appraisal business. If unable to utilize qualified appraisers employed by these entities, savings associations could be forced to close or sell their ownership interest in subsidiary or affiliate companies engaging in appraisal or real estate settlement activities. The costs associated with such actions could be significant. As long as the independence of the appraisal process is ensured, there is no reason to prohibit such affiliations or subsidiary business arrangements.

Additionally, the Code raises several questions as to its enforceability. The Code does not define how Fannie Mae and Freddie Mac will enforce the provisions in the context of representations and warranties or under what standards Fannie Mae and Freddie Mac may "put back" loans to a savings association. For example, the provisions addressing "appraiser coercion" are quite broad. Absent any details around how these new provisions will be interpreted and applied by Fannie Mae and Freddie Mac, institutions could face enormous exposure to the extent, for example, that an appraiser's claims of coercion cause Fannie Mae and Freddie Mac to invoke representations and warranties resulting in loans being "put back" to a savings association. Accordingly, OTS believes that institutions that it regulates will not be able to fully identify, manage, and monitor their credit risk under the ambiguous terms of the Code and could force our institutions into an "unsafe or unsound operation".

If Fannie Mae and Freddie Mac, two of the largest purchasers of home mortgages in the United States, are truly serious about improving the appraisal process, we suggest they develop and adopt certification and qualification standards for appraisers performing appraisals of properties securing loans they purchase and incorporate testing and review procedures to ensure the adequacy and integrity of the appraisal process.

Although OTS and the other federal banking agencies were consulted about the Agreements and the Code by OFHEO, this occurred on an expedited basis immediately prior to the formal announcement of the Code and Agreements by the New York Attorney General. The consultations were initiated at a point when it did not appear to encourage any meaningful collaboration or changes based on industry practice and our long supervisory experience. The financial institutions OTS regulates did not have an opportunity to fully comment on how these documents may directly or indirectly affect them or to explain their possible consequences.

The Agreements and the Code, in OTS's view, are the products of a flawed process. The documents, which purport to address a problem that affects the entire mortgage lending industry, are the result of a process that did not appropriately or adequately identify the problems for which the Code is intended to rectify and/or alternative remedies to address any identified problems. The Code and the Agreements would effectuate sweeping changes in the industry and do not allow for a case-by-case approach. The documents were prepared without the benefit of appropriate industry or regulator input and do not take into account the actual and potential effects and consequences upon OTS-regulated lenders.

OTS recommends that the Parties carefully consider all comments received during this period and delay efforts to improve the appraisal process through implementation of the Code until the impact on regulated lenders can be more fully examined, explained, and understood. The Parties should not make any assumptions as to OTS's views on the provisions in the Code or Agreement that are not addressed in this letter, as we reserve the right to supplement this comment with future submissions, as deemed necessary.

Sincerely,

Timothy T. Ward

Timothy T. Ward
Deputy Director

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Office of Thrift Supervision
National Credit Union Administration

June 19, 2008

Mr. James B. Lockhart, III
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Lockhart:

The Federal Reserve Board ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration (collectively, the "Agencies") appreciate the opportunity to convey our concerns about the Home Valuation Protection Program and Cooperation Agreements ("Agreements") between your agency, the New York State Attorney General, and the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the "GSEs").[1] The Agreements require mortgage lenders, including federally regulated financial institutions and organizations ("federally regulated lenders"), seeking to sell single-family mortgage loans to the GSEs to adopt the Home Valuation Code of Conduct ("Code") attached to the Agreements and to comply with certain practices imposed by the Code.

We strongly support the goals of protecting appraisers from coercion or other undue influence by lenders, borrowers, brokers, or others involved in the mortgage lending and securitization process. Appraiser independence and reliable valuations of real estate collateral for loans in the primary and secondary residential mortgage markets are a necessary part of the foundation to protect lenders in making safe and sound residential mortgage credit decisions, consumers in their borrowing decisions, and investors in their decisions to purchase mortgage-backed securities.

We are very concerned, however, that the requirements imposed by the Agreements and Code would unnecessarily undermine the safe and sound extension of mortgage credit, reduce the availability of mortgage credit to many consumers, and ultimately lead to less reliability and accuracy in real estate appraisals. Moreover, issues regarding appraiser independence and protection from coercion are already adequately addressed by current and pending rules and guidance of the Agencies. In addition, we believe that insufficient information has been collected and inadequate analysis has been performed to permit confidence that the

[1] The OCC and the OTS have previously submitted separate comment letters concerning the legal and policy issues presented by the Agreements and the Code. See letter dated April 30, 2008, from Timothy T. Ward, Deputy Director, OTS, to Senior Vice President, Credit Risk Oversight, Freddie Mac; and letter dated May 27, 2008, from John C. Dugan, Comptroller of the Currency, to James B. Lockhart, Director, OFHEO.

Code will appropriately address the issue of potential coercion and other undue influence of appraisers without causing other significantly adverse, unintended consequences. We believe, therefore, that the Agreements and Code should be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed.

The Code conflicts in material ways with the rules and guidance established by the Agencies and undermines appropriate risk-management and consumer protection practices at federally regulated lenders. The Code inappropriately attempts to regulate the corporate structure and internal operations of federally regulated lenders in connection with their mortgage lending operations. In addition, the Code contravenes appropriate risk-management practices of federally regulated lenders by banning the use of appraisals prepared by in-house appraisers, appraisers employed by affiliates, or appraisers at entities that also provide loan settlement services. The Code also hinders the ability of federally regulated lenders to perform other types of quality controls necessary to ensure the accuracy and quality of appraisals used in lending decisions and, thereby, protect the safety and soundness of such institutions and organizations. For example, the Code overly restricts lenders from ordering or using a second or subsequent appraisal to ensure the reliability of the collateral valuation. Such appraisals are an important quality control tool for lenders, particularly when markets are turning and public data updates are delayed, as recently demonstrated in various declining markets.

The Agencies have significant concerns that compliance with overly restrictive requirements in the Code will materially disrupt mortgage lending processes and raise costs to consumers without enhancing protections for consumers, lenders, or the mortgage markets. Implementation of the Code will result in higher loan origination costs for federally regulated lenders and other mortgage lenders and thereby increase costs to consumers. For example, the Code's unwarranted restriction on a lender using any appraisal performed by an in-house appraiser or ordered by a broker will likely result in loan application processing delays and require the consumer frequently to pay for multiple appraisals for a loan. Higher costs and disruptions in mortgage lending processes also will result from the Code's restrictions on using appraisals from appraisal management companies that are affiliates of lenders or that provide both appraisal and settlement-related services for institutions. The unwarranted loss of the significant efficiencies these companies can provide to mortgage lenders that provide loans to consumers where the lender has few, if any, loan underwriting offices, and particularly to small financial institutions, is likely to result in loan processing delays, higher costs for consumers, and reductions in the availability of mortgage credit in many areas. We believe that the Code's draconian approach sacrifices quality, efficiency, and cost for a result that would not materially enhance protections against undue influence on appraisers.

The Agencies have issued and proposed appraisal regulations and supervisory guidance, applicable to federally regulated lenders, that promote sound appraisal practices; require lenders to originate, purchase, and sell mortgage loans based on reliable appraisals; and protect appraisers from inappropriate influence by loan production staff, borrowers, or other third

parties.[2] The Agencies require separation of the appraisal function from the loan production, investment, and collection functions to prevent the threat of coercion or other undue influence on appraisers. This measured approach recognizes that staff appraisers can provide the lender with impartial, independent and reliable appraisals. Importantly, staff appraisers can provide effective reviews of appraisals performed by unaffiliated appraisers to verify that such appraisals are accurate, supportable, and comply with the Agencies' appraisal regulations and guidance and the lender's appraisal standards. The Agencies already require that these quality control functions be performed independently and without any influence by the lender's loan production staff. The constraints on the role of staff appraisers imposed by the Code would inhibit these quality control functions and impose increased costs for verifying and ensuring the quality and accuracy of appraisals on mortgage lenders and ultimately on consumers without any demonstrable benefit.

The appraisal regulatory framework established by the rules and guidance of the Agencies is based on balanced requirements to help ensure that federally regulated lenders use reliable appraisals that were prepared independently by competent appraisers who are separated, and protected from coercion or other undue influence, from the lender's loan production, investment, and collection functions or any third party. The Agencies' appraisal regulations and supervisory guidance reflect our belief that the reliability of appraisals is not dependent on a blanket prohibition that requires that lenders use only appraisals prepared by third parties that do not provide settlement services. The key to promoting reliable appraisals is that the appraisal function be separated from the loan production function, whether those functions reside in one organization, affiliated organizations, or unaffiliated third parties. Federally regulated lenders must couple the independence of those functions with robust credit and compliance risk-management systems to ensure appraiser impartiality, appraiser independence, and the reliability of the appraisals used in underwriting residential real estate loans.

The Agencies' appraisal regulatory framework is monitored and enforced through examinations that review the operations of the federally regulated lenders' mortgage lending functions. Such entities are instructed to establish adequate internal controls to ensure appraiser independence through separation of the appraisal ordering, preparation, and quality control processes from the institution's and organization's loan production staff and lending processes, including separation of responsibilities and reporting lines between the appraiser and the lending function. Under the Agencies' appraisal regulations and supervisory guidance, an appraisal ordered or prepared by a third party also must meet these impartiality and independence

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[2] 12 CFR part 208, subpart E (Board); 12 CFR part 34, subpart C (OCC); 12 CFR part 564 (OTS); and 12 CFR part 722 (NCUA). See Interagency Appraisal and Evaluation Guidelines, SR letter 94-55 (Board), Comptroller's Handbook, Commercial Real Estate and Construction Lending (Appendix E) (1998) (OCC), and Thrift Bulletin 55a (OTS). See also Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (2005), SR Letter 05-5 (Board), OCC Bulletin 2005-6 (OCC), CEO Memorandum No. 213 (OTS), and NCUA Letter to Credit Unions 05-CU-06 (NCUA); and Interagency Statement on Independent Appraisal and Evaluation Functions (2003), SR Letter 03-18 (Board), Advisory Letter 2003-9 (OCC); CEO Memorandum No. 184 (OTS), and NCUA Letter to Credit Unions 03-CU-17 (NCUA).

requirements, and lenders are instructed to review any broker-ordered appraisals thoroughly to ensure that the appraisal complies with the Agencies' regulations and guidance and the institution's appraisal policies.

A federally regulated lender must demonstrate that its appraisal process complies with our requirements to protect appraiser impartiality and independence, and requires quality, independent opinions of collateral market value through appraisals that conform to minimum regulatory appraisal standards, including the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisals also must be prepared by appropriately credentialed and competent appraisers protected from coercion. The real estate appraisal and evaluation policies and procedures of federally regulated entities are reviewed by examiners, and the Agencies require corrective action when deficiencies are discovered.

In addition, the Board is currently considering revisions to its Regulation Z to enhance further the protection of consumers from improperly influenced real estate appraisals.[3] The Regulation Z proposal prohibits all creditors and mortgage brokers from pressuring an appraiser to misrepresent a dwelling's value and prohibits all creditors from extending credit if the creditor knows or has reason to know that an appraiser has been coerced to misstate a dwelling's value. The proposed amendment to Regulation Z would cover all mortgage lenders (both federally and non-federally regulated lenders) and would apply to all consumer credit transactions secured by the consumer's principal dwelling, whether the mortgage is guaranteed by the GSEs or not.

The GSEs recently invited interested persons to submit their concerns regarding the Agreements and the Code. The new requirements to be imposed by OFHEO and the GSEs through the Agreements and the Code, with their far-reaching and burdensome effects on federally regulated lenders and other mortgage lenders across the nation, are the type of federally-imposed requirements that should be subject to the full panoply of laws designed to protect the procedural and other rights of citizens and corporate entities from improper governmental action. The comment process employed, however, does not confer the protections or rigor required by the Administrative Procedures Act and other applicable laws. Use of requirements set by the GSEs to impose obligations on the entire mortgage lending industry and on consumers is tantamount to government agency action and strongly implies that the GSEs are acting as governmental agencies that should be subject to all the procedural and other laws applicable to agency action.

OFHEO requested comment from the Agencies on the implementation timetable for the Agreements and the Code to ensure that no disruption in the marketplace would occur. We believe that the time available for carefully considering the extensive number of comments and obtaining concurrence on changes needed to the Code to address the many serious concerns identified by the Agencies and the commenters will require substantial delay and revision to the content and process for the implementation of the Code, if the Agreements and Code are not

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[3] Regulation Z--Truth in Lending, 73 Fed. Reg. 1672, 1726 (proposed January 9, 2008) (to be codified at 12 CFR pt. 226). The proposal was released for comment on January 9, 2008. The proposal's comment period ended on April 2, 2008, and Board staff is analyzing the more than 4,000 comment letters received on the proposal to determine what modifications, if any, to make to the draft regulation.

withdrawn. Under the Agreements, the new requirements will apply to all single-family mortgage loans (except government-insured loans) that are originated on or after January 1, 2009, and delivered to a GSE. The actual effective date of the restrictions, however, will of necessity precede that date by a number of months due to the length of time for completion of the origination process, particularly with the new requirements. We expect that the significant number of concerns and adverse consequences identified by the Agencies and commenters will, in fact, result in further disruption of the residential mortgage lending market.

We strongly encourage that the Agreements and the Code be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed. The Agreements' and Code's overly burdensome restrictions and mandates on such a significant segment of the mortgage market would constrain the ability of our regulated institutions and organizations to provide mortgage credit to creditworthy consumers on a safe and sound and timely basis, without increased costs. The Agencies are committed to addressing any weaknesses and deficiencies in mortgage lending practices, including appraisal practices, at any of our regulated lenders through our regulatory and supervisory processes, as necessary. Moreover, the Agencies would be willing to work with OFHEO and the GSEs to identify and address any unresolved issues regarding appraiser coercion.

Sincerely,

Randall S. Kroszner
Governor
Board of Governors of the
Federal Reserve System

John M.Reich
Director
Office of Thrift Supervision

John C. Dugan
Comptroller
Office of the Comptroller
of the Currency

JoAnn M. Johnson
Chairman
National Credit Union Administration

cc: Federal National Mortgage Association
Federal Home Loan Mortgage Corporation

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CORKER FROM JOHN M. REICH

Q.1. In an earlier hearing in front of this committee, an OTS plan was outlined which would have created negative equity certificates for 2nd lienholders in refinancing troubled or underwater mortgages. This was of particular interest to me because I believed that the incentive for 2nd lienholders to work out their obligations with servicers and borrowers was not there if they would be required to forfeit the entire lien at a loss. However, I am told, that this would actually have cost the U.S. government and the taxpayers a great deal more than the plan we recently passed out of committee because the uptake would have been higher. I am also told that we will have a better picture of what our housing situation looks like in September when we are able to see how much of the inventory was "cleared" during the typically busy spring and summer months. In the state foreclosure working group report that was just released on seriously delinquent loans, it indicates that 2nd liens are a growing problem and a tremendous obstacle in getting servicers to do what needs to be done in refinancing. Do you think that the Banking Committee's passed legislation strikes the right balance between market based solutions and government intervention in this unprecedented housing situation?

A.1. The OTS proposal includes the idea of creating a certificate in which the borrower, servicer and perhaps the second lien holder may be entitled to some percentage ownership. This proposal is based on our belief that the servicer needs an incentive to aggressively seek modifications of troubled loans. The cost of a loan modification can run as high as $500 per loan and takes considerable time to negotiate. The negative equity certificate gives the servicer some potential upside in a loan modification, should there be any proceeds available from the eventual sale of the home. By offering a percentage ownership of the certificate to the homeowner, it is our hope that this will give the owner an incentive to maintain the home and seek to get the highest price for the home in a sale. Finally, if desired, the second lien holder may be offered a share of the certificate to provide an incentive for the holder to agree to the loan modification. We too, understand that second lien holders may stand in the way of a modification and may require an incentive to consent to a modification.

The Committee's legislation addresses many issues that plague our housing market and we believe many participants will take the necessary measures to do their part to correct the problem. However, voluntary efforts to address troubled loans may delay the necessary and immediate action required to help these homeowners stay in their homes. We continue to believe that an incentive for those most intimately involved to execute the modification will expedite the process and help move the U.S. housing market back to health.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM JOANN JOHNSON

Q.1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser re-

quirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?

A.1. Senator Dole's proposed amendment to the Federal Housing Finance Regulatory Reform Act of 2008 would strengthen the standards used for federally regulated mortgages in that it would supersede the agreement the government sponsored enterprises (GSEs) entered into with the Office of Federal Housing Enterprise Oversight (OFHEO) and the New York State Attorney General. As a result, Senator Dole's amendment would avert the unintended consequences stemming from the agreement.

As currently drafted, by virtue of the agreement, lenders desiring to sell mortgages to the GSEs after December 31, 2008 must comply with appraisal standards that are not entirely consistent with existing federal regulations. If the agreement between the New York State Attorney General, OFHEO, and the GSEs goes into effect, lenders face an unfortunate choice of either incurring excessive costs to comply with the agreement or losing a significant source of liquidity by discontinuing their relationships with the GSEs.

While the goals of the agreement may be laudable, it unduly emphasizes structural issues, as opposed to internal controls, without the support of essential and important empirical data. Moreover, the provisions of the agreement, which affect all lenders selling to the GSEs, were not put into place through an appropriate rulemaking process.

In contrast, the existing federal regulatory structure for appraisals was developed over time and encompasses public comments that considered the views of all stakeholders. Existing guidance also provides appropriate deference to agency supervision of individual lenders and sound risk management practices.

Senator Dole's proposed amendment would improve standards by restoring the credibility of the existing federal regulatory structure and superseding any prior agreements OFHEO and the GSEs have entered into that contradict existing federal standards and regulations. Moreover, Senator Dole's proposed amendment would require OFHEO to consult with appropriate FFIEC regulators to ensure any future regulations affecting the GSEs are consistent with federal regulations and guidelines.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM DONALD L. KOHN

There was an article in the June 4, 2008, *Financial Times* that said banks could be forced to bring up to 5 trillion dollars of assets currently held off their books onto their balance sheets. This raises many questions, but I will start with three.

Q.1.a. First, in the current markets can the banks raise the capital they need to hold against these assets?

A.1.a. The Financial Accounting Standards Board (FASB) has not yet made public the proposed changes to accounting standards that would require consolidation of certain off-balance sheet securitization exposures; however, it is expected that the initial proposal would be subject to a period of public comment. It is difficult to estimate with any degree of certainty which structures would be consolidated and the associated impact on bank balance sheets and capital requirements. The basis for the $5 trillion estimate in the Financial Times article was not disclosed, so we are unable to verify that number. In addition, it is unknown whether the accounting change will include a grandfathering or transition provision, which would make the potential impact of consolidation more gradual.

The effect of the accounting change, whatever its final details, will depend on each individual bank's activities. The vast majority of banking organizations do not engage in material securitization activities; however, there could potentially be a material impact for those institutions, primarily the largest U.S. banking organizations, with significant securitization activities. With respect to those banks affected by the proposed accounting change, some may already have sufficient capital cushions to support the newly consolidated assets. Others may need to raise capital. During the current market turmoil, banks have been able to raise capital when needed. It is likely some banks will need to raise more capital to cover losses and position themselves to lend in the future. In that regard, a requirement to raise substantial amounts of new capital to accommodate the addition of securitized assets will put pressure on the cost of capital for all banks. I would urge FASB to allow banks a considerable period of time to prepare before any new consolidation requirement became effective.

Q.1.b. Second, since you are their regulators, do you know and have you known all along what those assets are?

A.1.b. We have a good understanding of bank asset securitization processes and firms' explicit exposures arising from securitizations based on both supervisory activities and information collected through regulatory reports. The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation collect information on the outstanding principal balance of assets sold and securitized by a bank with servicing retained or with seller-provided credit enhancements, as well as on the bank's maximum amount of retained credit exposure to the securitizations. They also collect information on unused commitments to provide liquidity to securitization structures. The agencies began collecting detailed data on securitization activities in 2001.

Q.1.c. And third, why were they allowed to move trillions of dollars of what turned out to be the riskiest assets off their books to avoid capital charges?

A.1.c. Accounting rules, set by the FASB, prescribe which assets must be consolidated on a banking organization's balance sheet. The U.S. banking agencies' risk-based capital requirements do not focus solely on consolidated assets, but also consider banks' expo-

sures to off-balance sheet securitization transactions. We have in place capital requirements on securitization exposures. Together with other supervisors, we are taking a hard look at the requirements for these exposures under Basel II to ensure they are appropriate.

Securitization provides banks with several important benefits. The securitization process offers banks alternative sources of funding and liquidity, and provides an opportunity to reallocate some of the risk of securitized assets (for a price) to investors. The funding costs associated with asset securitization maybe lower than the cost of direct borrowing. Moreover, the reduced risk and leverage created by securitization allows banks to redeploy capital efficiently to support other banking activities. Although regulatory capital considerations influence some securitization activity, they are not necessarily the driving force; asset securitization provides a critical source of funding for certain banks and, consequently, increases the availability of credit for borrowers.

The U.S. federal banking agencies have worked for many years to reduce opportunities for regulatory capital arbitrage associated with securitization activities. Importantly, in 2001, the agencies published a final rule directly addressing the regulatory capital treatment of securitization exposures. In many cases, a sponsoring bank is required to hold dollar-for-dollar capital against the risk it retains in association with a securitization. Capital is also required for other securitization exposures, such as investments in asset-backed securities and liquidity facilities provided to asset-backed commercial paper conduits. The new Basel II-based risk-based capital rules, which the agencies currently are in the process of implementing, provide an even more risk-sensitive approach to banks' securitization exposures. In addition, banks are required to conduct an internal assessment of the capital needed to support securitization activities.

Q.2. On June 4, 2008, Moody's placed two of the largest bond insurers (MBIA and Ambac) on watch for downgrade, and S&P lowered their rating the following day. Is any collateral pledged at the various facilities or in the Fed's assets from the Bear Stearns deal insured by those insurers? What impact does the downgrade, and the potential for further downgrades, have on the value of collateral the Fed has been taking at the various facilities and on the Fed's assets from the Bear Stearns deal? What will the Fed do about any pledged securities that are downgraded? Is the Fed continuing to rely on ratings from the rating agencies in assessing the risk and value of pledged collateral, and if so, why given the unreliability of those ratings? Beyond using ratings from ratings agencies, what is the Fed doing to verify the quality of the collateral it is getting?

A.2. The Federal Reserve accepts a wide range of collateral under its standing liquidity facilities for depository institutions and primary dealers. It is important to note that, for all of the Federal Reserve's existing liquidity facilities, the Federal Reserve has recourse to the borrowing institution beyond the specific collateral pledged. Although the collateral requirements for the various liquidity programs vary somewhat, credit ratings are used in some

cases as a screen to eliminate assets of poor quality. Assets that pass this screen are then assigned market values based on market pricing sources, and haircuts are then applied to these market values to determine the final collateral value of the pledged collateral. For those assets without available market prices, substantially larger haircuts are applied to the outstanding principal balance to determine the final collateral value. Market prices are updated regularly and haircuts are set to provide a significant measure of protection against market, credit and liquidity risk. In addition, the credit ratings of the assets pledged as collateral are monitored on an ongoing basis. Finally, the Federal Reserve independently reviews assets pledged as collateral to ensure that acceptability criteria are met and that all necessary legal documentation is in place.

A downgrade of the bond insurers could result in a corresponding downgrade of an asset that is pledged as collateral at the Federal Reserve. If the downgrade of Federal Reserve collateral meant that it no longer met basic eligibility criteria, the collateral would be returned to the borrower and the institution would be required to provide alternative collateral of sufficient quality. Of course, even if the collateral pledged at the Federal Reserve is not downgraded, the troubles at bond insurers could affect the market value of the Federal Reserve's collateral. In this case, changes in market valuation would be captured through our regular pricing updates, and the final value of the collateral pledged would decline. The Federal Reserve closely monitors the value of collateral pledged to ensure that it exceeds the value of credit extended at all times.

Regarding the special financing arrangement in the case of Bear Stearns, the Federal Reserve and JP Morgan Chase extended credit to finance a pool of about $30 billion in assets. As described in the Federal Reserve's public announcements, the Federal Reserve extended about $29 billion of senior financing under this arrangement, and JPMorgan extended about $1 billion of financing through a first loss position. The asset portfolio is professionally managed by an independent portfolio management firm and will be marked to market values on a quarterly basis; those values will reflect the effects, if any, of the downgrades of the guarantors. Details regarding the value of these assets and the outstanding balance on the credit extension are published weekly on the Federal Reserve's H.4.1. statistical release. The Federal Reserve determined to enter into this special financing arrangement because a disorderly failure of Bear Stearns would have posed a serious threat to overall financial stability and would most likely have had significant adverse implications for the U.S. economy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM DONALD L. KOHN

Q.1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser requirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal stand-

ards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?

A.1. The Federal Reserve is supportive of promoting sound appraisal practices in residential mortgage lending that ensure lenders use independent, quality appraisals and that protect appraisers from inappropriate influence by the loan production staff, borrowers, or other third parties. In fact, these important principles are embodied in the existing appraisal regulations and guidance of the Board and other federal financial regulatory agencies, which have been in place since the early 1990s.

Your proposed amendment would acknowledge that federally regulated institutions and their affiliates are already subject to an appraisal regulatory framework and would address potential confusion on the part of those entities as to the appraisal standards for which they will be held accountable.

Q.2. Vice Chairman Kohn, would you review this technical issue with the other Members at the Federal Reserve Board? Could the Board please get back to us in writing with a detailed letter articulating all the inconsistencies and conflicts of this agreement with current banking law, and the corresponding risks associated therein? I would ask that this letter not only articulate the inconsistencies and conflicts with current banking law, but also the potential risks to safety and soundness, as well as the expected impact on consumers as it relates to the costs and availability of mortgage credit.

A.2. The Federal Reserve has reviewed the agreement and the accompanying Home Valuation Code of Conduct and provided written comment to the Office of Federal Housing Enterprise Oversight.[1] Our letter to OFHEO should provide sufficient information to respond to your request for explanation on the inconsistencies and conflicts of the agreement with current banking laws and regulations. Further, the letter outlines our most significant concerns with the agreement and code, and explains how the agencies' existing appraisal regulatory framework promotes appraiser independence and reliable valuations of real estate collateral in mortgage lending by federally regulated institutions.

[1] See the attached letter dated June 19, 2008, from Randall S. Kroszner, Governor, Board of Governors of the Federal Reserve; John C. Dugan, Comptroller of the Currency; John M. Reich, Director, Office of Thrift Supervision; and JoAnn M. Johnson, Chairman, National Credit Union Administration, to James B. Lockhart, Director, OFHEO.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Office of Thrift Supervision
National Credit Union Administration

June 19, 2008

Mr. James B. Lockhart, III
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Lockhart:

The Federal Reserve Board ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration (collectively, the "Agencies") appreciate the opportunity to convey our concerns about the Home Valuation Protection Program and Cooperation Agreements ("Agreements") between your agency, the New York State Attorney General, and the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the "GSEs").[1] The Agreements require mortgage lenders, including federally regulated financial institutions and organizations ("federally regulated lenders"), seeking to sell single-family mortgage loans to the GSEs to adopt the Home Valuation Code of Conduct ("Code") attached to the Agreements and to comply with certain practices imposed by the Code.

We strongly support the goals of protecting appraisers from coercion or other undue influence by lenders, borrowers, brokers, or others involved in the mortgage lending and securitization process. Appraiser independence and reliable valuations of real estate collateral for loans in the primary and secondary residential mortgage markets are a necessary part of the foundation to protect lenders in making safe and sound residential mortgage credit decisions, consumers in their borrowing decisions, and investors in their decisions to purchase mortgage-backed securities.

We are very concerned, however, that the requirements imposed by the Agreements and Code would unnecessarily undermine the safe and sound extension of mortgage credit, reduce the availability of mortgage credit to many consumers, and ultimately lead to less reliability and accuracy in real estate appraisals. Moreover, issues regarding appraiser independence and protection from coercion are already adequately addressed by current and pending rules and guidance of the Agencies. In addition, we believe that insufficient information has been collected and inadequate analysis has been performed to permit confidence that the

[1] The OCC and the OTS have previously submitted separate comment letters concerning the legal and policy issues presented by the Agreements and the Code. See letter dated April 30, 2008, from Timothy T. Ward, Deputy Director, OTS, to Senior Vice President, Credit Risk Oversight, Freddie Mac; and letter dated May 27, 2008, from John C. Dugan, Comptroller of the Currency, to James B. Lockhart, Director, OFHEO.

Code will appropriately address the issue of potential coercion and other undue influence of appraisers without causing other significantly adverse, unintended consequences. We believe, therefore, that the Agreements and Code should be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed.

The Code conflicts in material ways with the rules and guidance established by the Agencies and undermines appropriate risk-management and consumer protection practices at federally regulated lenders. The Code inappropriately attempts to regulate the corporate structure and internal operations of federally regulated lenders in connection with their mortgage lending operations. In addition, the Code contravenes appropriate risk-management practices of federally regulated lenders by banning the use of appraisals prepared by in-house appraisers, appraisers employed by affiliates, or appraisers at entities that also provide loan settlement services. The Code also hinders the ability of federally regulated lenders to perform other types of quality controls necessary to ensure the accuracy and quality of appraisals used in lending decisions and, thereby, protect the safety and soundness of such institutions and organizations. For example, the Code overly restricts lenders from ordering or using a second or subsequent appraisal to ensure the reliability of the collateral valuation. Such appraisals are an important quality control tool for lenders, particularly when markets are turning and public data updates are delayed, as recently demonstrated in various declining markets.

The Agencies have significant concerns that compliance with overly restrictive requirements in the Code will materially disrupt mortgage lending processes and raise costs to consumers without enhancing protections for consumers, lenders, or the mortgage markets. Implementation of the Code will result in higher loan origination costs for federally regulated lenders and other mortgage lenders and thereby increase costs to consumers. For example, the Code's unwarranted restriction on a lender using any appraisal performed by an in-house appraiser or ordered by a broker will likely result in loan application processing delays and require the consumer frequently to pay for multiple appraisals for a loan. Higher costs and disruptions in mortgage lending processes also will result from the Code's restrictions on using appraisals from appraisal management companies that are affiliates of lenders or that provide both appraisal and settlement-related services for institutions. The unwarranted loss of the significant efficiencies these companies can provide to mortgage lenders that provide loans to consumers where the lender has few, if any, loan underwriting offices, and particularly to small financial institutions, is likely to result in loan processing delays, higher costs for consumers, and reductions in the availability of mortgage credit in many areas. We believe that the Code's draconian approach sacrifices quality, efficiency, and cost for a result that would not materially enhance protections against undue influence on appraisers.

The Agencies have issued and proposed appraisal regulations and supervisory guidance, applicable to federally regulated lenders, that promote sound appraisal practices; require lenders to originate, purchase, and sell mortgage loans based on reliable appraisals; and protect appraisers from inappropriate influence by loan production staff, borrowers, or other third

parties.[2] The Agencies require separation of the appraisal function from the loan production, investment, and collection functions to prevent the threat of coercion or other undue influence on appraisers. This measured approach recognizes that staff appraisers can provide the lender with impartial, independent and reliable appraisals. Importantly, staff appraisers can provide effective reviews of appraisals performed by unaffiliated appraisers to verify that such appraisals are accurate, supportable, and comply with the Agencies' appraisal regulations and guidance and the lender's appraisal standards. The Agencies already require that these quality control functions be performed independently and without any influence by the lender's loan production staff. The constraints on the role of staff appraisers imposed by the Code would inhibit these quality control functions and impose increased costs for verifying and ensuring the quality and accuracy of appraisals on mortgage lenders and ultimately on consumers without any demonstrable benefit.

The appraisal regulatory framework established by the rules and guidance of the Agencies is based on balanced requirements to help ensure that federally regulated lenders use reliable appraisals that were prepared independently by competent appraisers who are separated, and protected from coercion or other undue influence, from the lender's loan production, investment, and collection functions or any third party. The Agencies' appraisal regulations and supervisory guidance reflect our belief that the reliability of appraisals is not dependent on a blanket prohibition that requires that lenders use only appraisals prepared by third parties that do not provide settlement services. The key to promoting reliable appraisals is that the appraisal function be separated from the loan production function, whether those functions reside in one organization, affiliated organizations, or unaffiliated third parties. Federally regulated lenders must couple the independence of those functions with robust credit and compliance risk-management systems to ensure appraiser impartiality, appraiser independence, and the reliability of the appraisals used in underwriting residential real estate loans.

The Agencies' appraisal regulatory framework is monitored and enforced through examinations that review the operations of the federally regulated lenders' mortgage lending functions. Such entities are instructed to establish adequate internal controls to ensure appraiser independence through separation of the appraisal ordering, preparation, and quality control processes from the institution's and organization's loan production staff and lending processes, including separation of responsibilities and reporting lines between the appraiser and the lending function. Under the Agencies' appraisal regulations and supervisory guidance, an appraisal ordered or prepared by a third party also must meet these impartiality and independence

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[2] 12 CFR part 208, subpart E (Board); 12 CFR part 34, subpart C (OCC); 12 CFR part 564 (OTS); and 12 CFR part 722 (NCUA). See Interagency Appraisal and Evaluation Guidelines, SR letter 94-55 (Board), Comptroller's Handbook, Commercial Real Estate and Construction Lending (Appendix E) (1998) (OCC), and Thrift Bulletin 55a (OTS). See also Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (2005), SR Letter 05-5 (Board), OCC Bulletin 2005-6 (OCC), CEO Memorandum No. 213 (OTS), and NCUA Letter to Credit Unions 05-CU-06 (NCUA); and Interagency Statement on Independent Appraisal and Evaluation Functions (2003), SR Letter 03-18 (Board), Advisory Letter 2003-9 (OCC), CEO Memorandum No. 184 (OTS), and NCUA Letter to Credit Unions 03-CU-17 (NCUA).

requirements, and lenders are instructed to review any broker-ordered appraisals thoroughly to ensure that the appraisal complies with the Agencies' regulations and guidance and the institution's appraisal policies.

A federally regulated lender must demonstrate that its appraisal process complies with our requirements to protect appraiser impartiality and independence, and requires quality, independent opinions of collateral market value through appraisals that conform to minimum regulatory appraisal standards, including the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisals also must be prepared by appropriately credentialed and competent appraisers protected from coercion. The real estate appraisal and evaluation policies and procedures of federally regulated entities are reviewed by examiners, and the Agencies require corrective action when deficiencies are discovered.

In addition, the Board is currently considering revisions to its Regulation Z to enhance further the protection of consumers from improperly influenced real estate appraisals.[3] The Regulation Z proposal prohibits all creditors and mortgage brokers from pressuring an appraiser to misrepresent a dwelling's value and prohibits all creditors from extending credit if the creditor knows or has reason to know that an appraiser has been coerced to misstate a dwelling's value. The proposed amendment to Regulation Z would cover all mortgage lenders (both federally and non-federally regulated lenders) and would apply to all consumer credit transactions secured by the consumer's principal dwelling, whether the mortgage is guaranteed by the GSEs or not.

The GSEs recently invited interested persons to submit their concerns regarding the Agreements and the Code. The new requirements to be imposed by OFHEO and the GSEs through the Agreements and the Code, with their far-reaching and burdensome effects on federally regulated lenders and other mortgage lenders across the nation, are the type of federally-imposed requirements that should be subject to the full panoply of laws designed to protect the procedural and other rights of citizens and corporate entities from improper governmental action. The comment process employed, however, does not confer the protections or rigor required by the Administrative Procedures Act and other applicable laws. Use of requirements set by the GSEs to impose obligations on the entire mortgage lending industry and on consumers is tantamount to government agency action and strongly implies that the GSEs are acting as governmental agencies that should be subject to all the procedural and other laws applicable to agency action.

OFHEO requested comment from the Agencies on the implementation timetable for the Agreements and the Code to ensure that no disruption in the marketplace would occur. We believe that the time available for carefully considering the extensive number of comments and obtaining concurrence on changes needed to the Code to address the many serious concerns identified by the Agencies and the commenters will require substantial delay and revision to the content and process for the implementation of the Code, if the Agreements and Code are not

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[3] Regulation Z—Truth in Lending, 73 Fed. Reg. 1672, 1726 (proposed January 9, 2008) (to be codified at 12 CFR pt. 226). The proposal was released for comment on January 9, 2008. The proposal's comment period ended on April 2, 2008, and Board staff is analyzing the more than 4,000 comment letters received on the proposal to determine what modifications, if any, to make to the draft regulation.

withdrawn. Under the Agreements, the new requirements will apply to all single-family mortgage loans (except government-insured loans) that are originated on or after January 1, 2009, and delivered to a GSE. The actual effective date of the restrictions, however, will of necessity precede that date by a number of months due to the length of time for completion of the origination process, particularly with the new requirements. We expect that the significant number of concerns and adverse consequences identified by the Agencies and commenters will, in fact, result in further disruption of the residential mortgage lending market.

We strongly encourage that the Agreements and the Code be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed. The Agreements' and Code's overly burdensome restrictions and mandates on such a significant segment of the mortgage market would constrain the ability of our regulated institutions and organizations to provide mortgage credit to creditworthy consumers on a safe and sound and timely basis, without increased costs. The Agencies are committed to addressing any weaknesses and deficiencies in mortgage lending practices, including appraisal practices, at any of our regulated lenders through our regulatory and supervisory processes, as necessary. Moreover, the Agencies would be willing to work with OFHEO and the GSEs to identify and address any unresolved issues regarding appraiser coercion.

Sincerely,

Randall S. Kroszner
Governor
Board of Governors of the
Federal Reserve System

John M. Reich
Director
Office of Thrift Supervision

John C. Dugan
Comptroller
Office of the Comptroller
of the Currency

JoAnn M. Johnson
Chairman
National Credit Union Administration

cc: Federal National Mortgage Association
Federal Home Loan Mortgage Corporation

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CORKER FROM DONALD L. KOHN

Q.1.a. What is the banking system's exposure to the monoline insurers?

A.1.a. Banks have two basic types of exposures to monoline financial guarantors:

Direct exposures stemming from lending transactions as well as from purchasing credit derivatives protection from guarantors as hedges against a variety of structured credit products, which generates counterparty credit exposures.

Indirect exposures, which are exposures to assets that are "wrapped" (*i.e.*, guaranteed) by the guarantors, may reside on banks' balance sheets or in off-balance-sheet vehicles that are sponsored by banks or to which banks have extended some form of support.

Direct Exposures

Exposures from lending facilities to monoline guarantors are generally not a significant share of banks' capital or of total credit exposures at banking organizations.

More importantly, financial guarantors have reported selling over $500 billion in notional value of credit derivatives-based protection to financial institutions, with roughly $125 billion of that protection sold on so-called CDOs of ABS that contain subprime mortgage-related collateral in the asset pool. Some of that protection was purchased by large domestic bank holding companies. The current counterparty credit exposures generated by these hedges are a function of the market value of the positions being hedged, and are not the same as the notional values.

Given the deterioration in the positions hedged by banks using these credit derivatives, particularly with respect to the CDOs of ABS, banks' direct counterparty credit exposures to financial guarantors from these hedges have grown significantly over the past year. Nonetheless, for domestic bank holding companies, these exposures are equivalent to only a moderate share of the firms' capital and are a relatively small share of total credit exposures across the firms.

As has been noted in the press and in some firms' publicly reported statements of financial condition, many financial institutions, both foreign and domestic, have begun to take markdowns and/or reserves—generally in the form of a "credit valuation adjustment"—against the value of these exposures, with over $20 billion of write-downs reported through end-March 2008. If deterioration in credit markets continues, banks' exposures will grow further and, given the associated deterioration seen in the financial guarantor sector, they will likely take further write-downs and/or reserves against their counterparty credit exposures to the financial guarantors.

Indirect Exposures

A substantial majority of wrapped cash assets are municipal bonds, which are generally solid credit risks even without the guarantees provided by the monolines. There are also a variety of other types of credit assets that are guaranteed, including asset-backed

and mortgage-backed securities. Most of these wrapped assets have seen market price declines over the past year as the value of the guarantees have been discounted, and banks have seen some losses from marking to market these assets over that time period. Given the ongoing marking down of the value of these assets over time, significant future losses on these assets resulting from the deterioration of the guarantors appears unlikely, as market participants are generally now looking directly at the underlying assets and have already discounted the value of the guarantees.

Q.1.b. Likewise, what is the banking system's exposure to the mortgage insurance companies?

A.1.b. The banking system's exposure to the mortgage insurance companies comprises two categories: direct loans to mortgage insurers and exposure to mortgage insurers as providers of insurance on mortgages underwritten by the banks. As to the first category, as of May 2008, syndicated loans to mortgage insurers extended by federally regulated institutions totaled $3.9 billion. As to the second category, we estimate that banks' exposure to mortgage insurers as of March 2008 was approximately $37 billion.

Q.1.c. In light of the exposure of counterparty risk related to the monolines and mortgage insurers, how do you quantify the safety and soundness of these counterparties and what do the regulators need to do to understand and monitor the risk going forward?

A.1.c. Monoline financial guarantors and mortgage insurers are regulated by state insurance regulators.

The Federal Reserve has been very closely monitoring developments in the financial guarantor sector and has engaged in a number of discussions with supervised firms regarding their exposures to guarantors and the implications of continued deterioration in the condition of the guarantors. We will continue to closely monitor the monolines' financial condition as well as the size and performance of the various exposures that exist at supervised banking organizations.

As to mortgage insurers, we monitor the health of this segment continuously, by studying the industry, gathering publicly available data, and meeting with state insurance regulators. In addition, we are in contact with the banks that are the largest beneficiaries of mortgage insurance and are obtaining detailed information on their exposure to this industry. Supervised banks' exposures to the mortgage insurers are relatively small relative to their exposures to other industries and relative to their capital (and balance sheet size), and are generally well distributed across those banks that have exposure to mortgage insurers.

I appreciate the Federal Reserve's efforts to address unfair and deceptive practices in the credit card industry. I am pleased that the Federal Reserve has solicited public comments on the proposal from consumers, credit card issuers and other interested parties to fully understand the impact these new rules will have on the marketplace.

Q.2. In that regard, has the Fed considered the impact these rules will have on consumers who pay their bills on time? Could timely-paying consumers see an increase in the cost of credit as a result

of this rule due to the fact that the Fed would restrict, in a fairly significant way, the ability for banks to adjust prices for those consumers who demonstrate a higher risk?

A.2. In proposing restrictions on credit card issuers' ability to increase rates on existing balances, the Board carefully considered the potential costs and benefits for all consumers. The proposal seeks to balance issuers' need to price for risk with consumers' need to have greater transparency so they can better predict how their decisions and actions will affect their costs. The proposed rules would not affect card issuers' ability to price for risk when setting rates at account opening. Although "hair trigger" repricings for existing balances would be prohibited (for example, when a payment arrives one day late), issuers could re-price existing balances for a serious delinquency when the account is 30 days past due. In addition, after providing 45 days' advance notice, issuers could increase the rate on new transactions. As new business models emerge, consumers might see some costs decline while other costs might potentially increase, but the intent is to increase transparency and fairness in how credit card accounts operate, which should enhance competition and benefit consumers as a whole.