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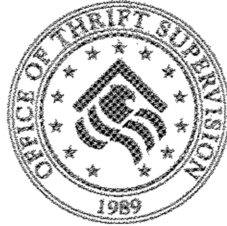

Statement of

Timothy T. Ward
Deputy Director, Examinations, Supervision and Consumer Protection
Office of Thrift Supervision

regarding

Examining the State of the Banking Industry

before the

Subcommittee on Financial Institutions
Committee on Banking, Housing, and Urban Affairs
United States Senate

October 14, 2009

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W.
Washington, DC 20552
202-906-6288

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I. Introduction

Good afternoon, Chairman Johnson, Ranking Member Crapo and members of the Subcommittee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry.

Thrift institutions continue to face significant challenges because of our nation's current economic problems. Although significant challenges lie ahead, institutions are making progress to ensure that they are positioned for a positive future.

In my testimony today, I will first discuss conditions in the housing market and broader economy. Against this backdrop, I discuss the state of the thrift industry, including industry data from our earnings release for the second quarter of 2009. The next part of my statement will focus on the challenges facing thrift lenders, including a discussion of several issues that the Subcommittee asked us to address, such as the current lending environment, the capital needs of thrifts institutions, concerns regarding commercial real estate lending and concerns specific to smaller and larger thrifts. I will

conclude my statement with a discussion of developing trends throughout the thrift industry and the economy.

II. State of the Thrift Industry

A. Conditions in the Housing Market and Broader Economy

The U.S. economy continues to suffer from the impact of a severe recession. Some have called the current recession the "Great Recession" because, through September 2009, it has been the longest recession – at 21 months – of the 11 recessions after World War II.[1] Further, the increase in the nation's unemployment rate from the beginning of the recession in December 2007 (unemployment rate of 4.9 percent) through September 2009 (9.8 percent) has been the greatest of any of the other recessions. Moreover, the nation's "underemployment" rate – a broader measure of the health of the nation's job markets that includes workers who are unemployed, working part-time due to economic reasons and not actively looking for work but would like to work – increased to 17 percent in September 2009, the highest level on record since this statistic was first calculated in January 1999.[2]

To date, the brunt of this recession has been focused on the housing sector. Home prices have dropped considerably in most markets throughout the nation. From the beginning of the recession through July 2009, home prices in major markets have declined an average of 23 percent.[3] In some markets, the declines have been more severe, for example Las Vegas (46 percent), Phoenix (44 percent), Miami (36 percent), San

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[1] Sources: National Bureau of Economic Research, Bureau of Economic Analysis, Bureau of Labor Statistics

[2] Unemployment and underemployment rates from the Bureau of Labor Statistics

[3] Measured as the 20-City Composite Index from S&P/Case-Shiller

Francisco (33 percent) and Detroit (32 percent).[4] Home sale declines have also resulted in an oversupply of unsold homes on the market. At current rates of home sales, there is a supply of approximately 8.5 months of existing homes on the market – about double the normal rate.[5]

Preliminary results of ongoing research indicate that disruption of household income through job loss, divorce, or medical emergency continue to be the primary reason for loan defaults.[6] However, research also suggests that declining home values are a growing reason for borrower defaults. Indeed, continued declines in home values are prompting some credit-worthy borrowers to voluntarily default. These actions contribute to continuing residential mortgage loan problems caused by job market weakness.

Rate resets of adjustable rate mortgages (ARMs) have not been a significant cause of recent loan defaults. Nonetheless, the OTS is closely monitoring the impact of the large number of ARM resets that will occur in 2010 and 2011. An estimated 75 percent of all option ARMs will reset during those two years.[7]

The shift in the composition of thrift troubled assets (loans more than 89 days delinquent, in nonaccrual status, and repossessed properties) from the last severe economic downturn in the early 1990s also underscores that the current recession, to date, has focused on residential mortgage markets. As of June 30, 2009, 68 percent of all thrift industry troubled assets were 1-4 family permanent loans, 22 percent in commercial real estate and 10 percent in non-mortgage consumer loans. In contrast, 1-4 permanent loans

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[4] S&P/Case-Shiller.Index for respective markets
[5] U.S. Census Bureau, National Association of Realtors
[6] Research by First American Core Logic, Moody's Economy.com
[7] Moody's Economy.com

constituted just 23 percent of thrift industry troubled assets in December 1990. During 1990, commercial real estate loans represented 68 percent of troubled assets and the remainder (9 percent) were non-mortgage consumer loans.

However, there is growing evidence that economic weakness is spreading to commercial real estate and business sectors. Delinquent commercial real estate loans have increased sharply over the past year, reflecting rising vacancy rates, increases in business bankruptcies and declining profitability of many firms. For example, the vacancy rate for apartment complexes reached a 23-year high in September 2009; vacancies at retail shopping centers reached a 17-year high; and office vacancies increased in 72 of the 79 metro areas tracked by a leading real estate research firm.[8] Further, U.S. business bankruptcies increased 64 percent for the first half of 2009 compared with the first half of 2008; that is the highest rate of increase in the past 16 years.[9]

The thrift industry will not be immune to business sector weakness. Although consumer loans, residential mortgages and related securities are the dominant thrift industry assets, nonresidential mortgages, multifamily mortgages and small business loans constitute about 15 percent of thrift total assets. This is especially true for smaller thrifts, which generally hold relatively higher percentages of their assets in nonresidential and multifamily mortgages than larger thrifts do. And although smaller thrifts generally hold relatively higher amounts of capital than do larger institutions, problems in commercial-related loans can quickly translate into capital issues since such loans are

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[8] Reis, Inc.
[9] American Bankruptcy Institute

typically much larger than consumer loans. Hence, a problem with a small number of commercial-related loans have the potential of causing capital issues.

B. Thrift Industry Data

1. Overview of the Thrift Industry

The majority of Office of Thrift Supervision (OTS)-regulated thrifts are full-service, community-based financial institutions serving consumers and small- to medium-sized businesses in cities and towns across the nation. As of June 30, 2009, there were 794 thrift institutions with combined assets of $1.1 trillion. Of these institutions, 38 percent are held in the mutual form of ownership, the historical form of thrift ownership, and 62 percent are stock-held depositories. Virtually all stock-held institutions operate within some form of a holding company structure.

Although the majority of thrift institutions specialize in retail mortgage and consumer lending activities, some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

As of June 30, 2009, the OTS also supervised 459 savings and loan holding company (SLHC) structures – including 94 mutual holding company structures – with aggregate consolidated assets of approximately $5.5 trillion. While 80 percent of thrift holding companies are "shells"[10] holding few assets outside the thrift, there are a few

[10] A shell thrift holding company structure is defined as having less than 5 percent of its consolidated assets in investments outside the thrift institution.

SLHCs that conduct operations in numerous non-financial activities, including some manufacturing, industrial and retail operations. Among the larger and more complex companies owning thrifts are investment banking firms, insurance companies and diversified financial services firms.

2. *Industry Performance in the First Half of 2009*

The continued weakness in the housing markets, together with high unemployment rates, has taken a toll on the profitability of lenders, such as thrift institutions, that focus on home mortgages and consumer lending. The OTS-regulated thrift industry posted a loss of $1.6 billion for the first half of 2009, for an annualized return on average assets of negative 0.28 percent. The industry posted a record loss of $15.8 billion in 2008 and the return on average assets was negative 1.17 percent.

There are some signs of thrift earnings stabilization. The industry achieved break-even results in the second quarter of 2009, even after the estimated after-tax expense of $325 million for the special assessment by the Federal Deposit Insurance Corporation. Nevertheless, industry earnings remain weak by historical standards and generally depend on the direction of the U.S. economy, particularly employment.

The economic conditions have tended to dampen consumer demand for mortgages to purchase homes. However, prevailing low interest rates for long-term, fixed-rate mortgages has resulted in strong demand for refinancing loans. Thrift industry mortgage originations (including single-family and multifamily lending) were $150 billion for the first half of 2009 and about 55 percent of those originations were for refinancing an

existing mortgage. Total industry mortgage originations were $341 billion in 2008; approximately 43 percent were for refinancing.

A large portion of thrifts' recent single-family mortgage origination volume was sold into the secondary market – primarily to government-sponsored enterprises. Thrifts sold 74 percent of single-family originations and purchases in the first half of 2009, up from 65 percent in 2008. Strong sales activity reflects thrift managers' interest rate risk management and their reluctance to keep on their books relatively low-rate, long-term, fixed rate loans. Low asset growth also results from strong sales activity.

Thrifts currently hold approximately 60 percent of their assets in mortgages and mortgage related instruments. As of June 30, 2009, one-to-four family mortgage loans constituted 39.9 percent of industry assets (including 4.9 percent of assets in home equity lines of credit); 3.2 percent of industry assets were in multifamily loans; and 13.0 percent of industry assets were in other mortgage-related instruments. Of total outstanding one-to-four family mortgages and mortgage-related instruments held by the industry, approximately 48.9 percent were ARMs.

Thrifts also hold commercial and business-related loans and the industry is not immune to the growing weaknesses in this sector. Nonresidential mortgage loans represented 6.5 percent of industry second quarter assets; commercial/small business loans another 5.5 percent. Loans on multifamily properties were 3.2 percent of assets. Construction loans represented 3.3 percent of thrift assets. Loans to construct single-family residences represented 37 percent of all construction loans, multifamily

constructions loans represented 22 percent of the total, and loans for the construction of nonresidential properties represent the remainder of 41 percent.

3. Capital, Provisioning and Loan Loss Reserves

Reflecting the economic climate and housing market weakness, thrift managers have significantly bolstered loan loss reserves. Since additions to loan loss reserves are direct charges against current income, increases in loan loss reserves have dampened recent industry earnings. Nevertheless, stronger levels of loss reserves make the industry better positioned to absorb potential loan losses.

The industry's loan loss provision expense for all of 2008 was a record $39.3 billion (2.92 percent of average assets). This large provision expense resulted in the industry's $15.8 billion loss for the year. Loan loss provisions eased somewhat in 2009, but remain very high by historical standards. Loan loss provision expense was $10.5 billion in the first half of 2009 (1.82 percent). The provision expense for the first and second quarters of 2009 were the fifth and sixth highest on record, respectively, behind only the 2008 provisions.

Despite these earnings difficulties, it is important to note that thrift capital levels remain strong. The industry's equity-to-assets ratio – a measure of capital according to generally accepted accounting principles (GAAP) – was 10.37 percent at June 30, 2009. Thrift regulatory capital measures also remain strong. As of the end of the second quarter, 96.2 percent of all thrifts – holding 95.9 percent of industry assets – exceeded the "well-capitalized" regulatory standards. Moreover, some analysts are increasingly

reviewing tangible common equity capital ratios along with regulatory capital measures as indicators of financial strength. Tangible common equity ratios are typically expressed as a percent of tangible assets and also as a percent of risk-weighted assets. For thrifts, these ratios were also strong, measuring 8.73 percent and 13.90 percent, respectively, at the end of the second quarter of 2009.

Taken together, loan loss reserves and capital provide a cushion against total loan losses. One measure of this cushion is the "loss coverage ratio," defined as the ratio of capital and loan reserves to total loans and leases. Reflecting strong provisioning for loan losses and strong capital, the industry loss coverage ratio was a record 18.06 percent at the end of the second quarter of 2009. This combination of strong capital and bolstered loan loss reserves should help the industry withstand continued weakness in the housing and labor markets.

4. Liquidity and Thrift Industry Access to Funding

a. Liquidity

As can be expected in this uncertain operating environment, thrifts have increased their liquidity. Cash, deposits and government securities rose to 9.1 percent of assets at the end of June 2009 from 8.5 percent at the end of 2008.

b. Capital Markets

Capital markets are currently very selective regarding investments in insured depositories. However, some thrifts have had recent success in raising capital from the capital markets, from existing shareholders, and from private placements. These capital

raising efforts added approximately $5.8 billion in new capital during the first half of 2009 for thrifts.[11]

c. Deposits

Deposits as a funding source generally rose in 2008 from 2007 levels, and that trend has continued through the first half of 2009. Deposits as a percentage of assets increased to 65.7 percent at June 30, 2009, compared to 61.2 percent at the end of 2008. All types of deposits have increased and about 60 percent of thrifts have experienced an increase in their deposit-to-asset ratio. These increases are the result of reduced consumer spending, increased savings and continued uncertainty surrounding the equities markets.

d. Federal Home Loan Bank Advances

Strong deposit inflows have offset declines in borrowings, including Federal Home Loan Bank (FHLB) advances. Nonetheless, such advances remain an important source of funds for thrifts. As a percent of assets, FHLB advances represented 12.8 percent of thrift assets at the end of the second quarter of 2009, down from 17.5 percent at the end of 2008. The decline was focused on short-term advances. Thrifts' use of longer-term advances increased as thrift managers utilized advances to increase the duration of their liabilities, thereby reducing interest rate risk. The weighted average maturity of all advances rose to 30 months during the second quarter, from 28 months at the end of 2008, and 26 months one year ago.

[11] Excludes capital infusions of $7.0 billion from the U.S. Treasury Capital Purchase Program.

C. Troubled Institutions

While the current economic challenges have resulted in an increase in problem thrifts, the level of problem thrift institutions is consistent with the level of problem financial institutions reported by the other federal bank regulatory agencies. OTS uses the interagency ratings definitions to rate thrifts on a scale of one to five and defines "problem thrift" as an institution with a composite examination rating of "4" or "5." As of September 30, 2009, there were 42 problem thrifts, representing 5.4 percent of OTS-regulated thrifts. This is a notable increase from September 30, 2008, when there were 16 problem thrifts, or 2.0 percent of OTS-regulated thrifts. The growth in problem financial institutions has stemmed from the challenging economic environment, including the housing downturn, rise in unemployment, and growing weaknesses in commercial lending.

In the first three quarters of 2009, 12 thrifts failed, compared with five failures in 2008. OTS is working closely with problem institutions to prevent additional deterioration, but it is likely there will be additional failures during this economic cycle. In addition to focusing on problem thrifts, OTS is closely monitoring "3" rated thrifts, which have significantly increased in the past year. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. There were 107 thrifts with "3" composite ratings representing 13.7 percent of all OTS-regulated thrifts at September 30, 2009. In the same quarter of 2008, there were 57 thrifts, or 7 percent of all thrifts.

III. Challenges Facing Thrifts

A. Current Lending Environment

One of the biggest challenges facing thrifts is the current lending environment. As loan performance and property values have deteriorated across the country, banks and thrifts have tightened lending standards. The rise in the national unemployment rate has also affected borrowers' repayment ability and has contributed to a decline in demand for new loans. Declining consumer confidence has resulted in businesses and households restricting spending, which has resulted in less demand for credit. Declines are apparent in lending categories for real estate mortgages, construction, consumer and commercial. Such declines vary substantially by geographic region.

To ensure that banks and thrifts are making loans to creditworthy borrowers, the OTS and the other federal banking agencies (FBAs) issued an interagency statement in November 2008 urging regulated institutions to make credit more available to such borrowers. The statement emphasized that the FBAs expect banks and thrifts to fulfill their fundamental role in the economy by providing credit to consumers, businesses and other creditworthy borrowers. "Problems in financial markets were causing the economy to become increasingly reliant on banking organizations to provide credit that purchasers of securities formerly provided or facilitated," the statement said. The statement reminded banks and thrifts to follow prudent lending practices but warned that excessive tightening in underwriting standards could make market conditions worse, leading to slower growth, potential damage to the economy, and harm to the long-term interests and profitability of banks and thrifts.

There are early indicators that real estate values are stabilizing in many geographic locations, which is a necessary first step for recovery. Despite the national trends, there are also geographic areas with improvement in credit availability and borrower demand. The low interest rate environment is positive for qualified and willing borrowers. Improved underwriting standards will also have a beneficial long-term affect once the industry recovers from this economic cycle.

The OTS examination staff continues to review lending activity for compliance with safe and sound underwriting guidelines, and the OTS is committed to encouraging lending to qualified borrowers. While there are significant challenges ahead, the thrift industry is positioning itself for a positive future.

B. Capital Needs of Thrifts

As indicated earlier, despite the turmoil that the industry has faced, capital measures for thrifts, as a whole, continue to be relatively strong and generally well in excess of regulatory minimum requirements. At the end of the second quarter of 2009, equity capital was 10.37 percent of assets, up from 8.65 percent of assets one year ago. At the end of the second quarter of 2009, more than 96 percent of the industry exceeded well-capitalized standards and only 15 thrifts were less than adequately capitalized. As mentioned earlier, the industry also continues to bolster its provisions for loan losses, which are now at or near record levels. These reserves provide an additional buffer against future loans losses.

Notwithstanding the relatively positive capital position of the industry, there are a number of stresses within the system that will continue to affect capital, both industry-wide, and particularly for some thrift institutions.

The first category of stress comes from the adverse economic conditions that continue to dampen earnings and asset quality, and thus capital. Problem assets continue to increase as a result of the ongoing housing market downturn and rising unemployment. Troubled assets (noncurrent loans and repossessed assets) rose to 3.52 percent of total assets in the second quarter of this year, up from 3.35 percent in the prior quarter, and 2.68 percent one year earlier. This compares to an average level of 0.78 percent from 2000 to 2007.

A second stress on capital is the impact of downgraded securities. Many savings associations hold investments in structured credit products, such as asset-backed and mortgage-backed securities, collateralized loan obligations and collateralized debt obligations. The underlying collateral of certain structured credit products has performed poorly. As a result of the deterioration in the performance of the underlying collateral, the level of credit support for senior and mezzanine tranches has diminished and the volume and severity of credit rating downgrades have increased. Many securities that were once rated AA or AAA have now been downgraded to below investment grade. As a result, they are much less liquid, their prices are no longer readily determinable and price volatility has increased. Consequently, an increasing number of financial institutions are recognizing other-than-temporary impairment (OTTI) charges and substantial fair value markdowns. Asset classifications are increasing as securities fall

below investment grade or are otherwise impaired. As securities are downgraded, the risk-based capital requirements have increased.

A third source of stress on capital will be the impact of recent accounting changes, namely changes to FAS 167 and FAS 168. These changes, which are being proposed for regulatory capital purposes by the federal banking agencies (with adoption as early as year-end), will bring onto the balance sheet certain assets that had been considered "off-balance sheet assets" under generally accepted accounting principles. This change in accounting will, among other things, increase the balance sheet assets of certain institutions. The capital requirements for these institutions would thus rise commensurate with the new on-balance sheet treatment.

The best response to the capital stresses faced by the entire banking industry would be for asset quality and earnings performance to improve. Although we anticipate continued stress in 2010, signs of economic recovery bode well for the longer-term earnings and capital positions of the banking system. In the shorter term, institutions may strengthen their capital position by shrinking their balance sheets through the sale of assets and by acquiring new outside capital. In the current economic environment, however, both of these alternatives pose challenges. Many assets, particularly those that institutions would most like to remove from their books, are not readily marketable. Also symptomatic of an inhospitable marketplace, access to outside capital, especially high quality capital, has been very limited for quite a while.

Although the OTS actively encourages private equity investments, there is to date, too little interest from investors in the type of high quality capital that regulators seek—in the form of common stock and non-cumulative perpetual preferred shares. Instead, we are analyzing somewhat novel proposals from thrifts and outside investors for capital in the form of hybrid capital instruments, or minority interests in consolidated subsidiaries, which might be eligible for inclusion in regulatory capital. Within the past few months, there have been positive signs of market improvement, in that a few well-managed institutions have been able to raise common stock. We hope this trend continues.

To ensure that well-capitalized but stressed institutions remain well-capitalized, and to address capital deficiencies in those that are not, we are taking the following actions:

1. Continuing to work with institutions to address asset quality problems through improved risk management, asset restructuring and loan modifications, and the sale or disposition of problem assets.

2. Assessing capital adequacy beyond the minimum regulatory capital requirements to ensure that capital is, in fact, adequate for the risks posed by the institution, both now and under further stressed market conditions.

3. Acting to help in the conservation of capital through, for example, limitations on dividend distributions, especially for troubled institutions.

4. Encouraging institutions to increase reserves—We want to ensure that the thrift industry continues to build up buffers, particularly when it has the earnings capacity

to do so, to use those buffers in times of stress. This helps ensure that the banking sector does not act in a pro-cyclical way to amplify economic and financial cycles.

5. Working aggressively with our most troubled institutions to require the development of comprehensive, near-term and long-term strategies for improving asset quality and earnings, addressing liquidity needs to withstand any anticipated or extraordinary demands against their funding bases, assessing capital adequacy and capital needs, and enhancing capital.

C. Commercial Real Estate Lending

Another challenge facing thrifts is in the area of commercial real estate (CRE) loans.[12] As noted previously, CRE loans represent about 15 percent of total thrift assets. The CRE loan category comprises multifamily, nonresidential, and construction and land loans. As a result of the current economic environment, many of these loans are now delinquent or under significant stress.

In December of 2006, OTS issued guidance on concentrations in commercial real estate. We had observed that some institutions had high and increasing concentrations of CRE loans on their balance sheets and were concerned that these concentrations might cause some savings associations to be more vulnerable to cyclical CRE markets. The current recession has indeed confirmed our concerns. In the past, concentrations in CRE

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[12] Section 5(c) of the Home Owners Loan Act limits the amount of a Federal savings association's business and commercial real estate lending. The aggregate amount of a Federal savings association's loans secured by nonresidential real property may not exceed 400 percent of the association's capital. 12 U.S.C. 1464(c)(2)(B). Further, loans for commercial, corporate business or agricultural purposes are limited to 20 percent of the total assets of a Federal savings association and amounts that exceed 10 percent of such total assets may only be used for small business loans. 12 U.S.C. 1464(c)(2)(A).

lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the banking system.

Although CRE borrowers have in this current economic environment experienced deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. The OTS and other FBAs realize that financial institutions face significant challenges when working with commercial real estate borrowers that are experiencing diminished operating cash flows, depreciated collateral values, or prolonged sales and rental absorption periods. The FBAs are working together to provide additional guidance on prudent workout programs, recognizing that such programs are often in the best interest of both the lender and the borrower. The guidance we are working on is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.

As a result of the financial stress facing institutions, OTS examiners are taking a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity. In general, institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition are not subject to criticism, even if the restructured loans have weaknesses that result in adverse credit classification. In addition, we expect that renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely

because the value of the underlying collateral has declined to an amount that is less than the loan balance.

D. Asset Quality

1. In General

As the economy continues to face challenging times, many parts of the country are experiencing further reductions in home prices and real estate values. Institutions are showing increases in inventories of unsold homes, delinquencies, non-performing assets and real estate owned. In addition, job losses continue throughout most of the nation. These factors all contribute to rising levels of problem assets.

Thrifts' ratio of troubled assets to total assets continued to increase in the first half of 2009, rising to 3.52 percent at the end of the second quarter from 2.54 percent at the end of 2008. Driving the increase in troubled assets has been increases in noncurrent loans – specifically increased noncurrent loan rates for residential mortgage loans and construction loans. This is especially true for residential mortgages, which represent 40 percent of thrift assets. Construction and land loans constitute 3.3 percent of thrift assets.

In the second quarter, noncurrent single-family mortgages rose to a record 5.51 percent of all single-family mortgages, up from 3.69 percent at the end of 2008. Noncurrent construction-and-land loans also rose to a record 12.54 percent in the second quarter, up from 8.26 percent at the end of 2008.

Other types of noncurrent loans also rose in the second quarter from the end of 2008. The noncurrent loan rates for the second quarter 2009 and the end of 2008, respectively, were: for nonresidential mortgages 2.53 percent and 1.45 percent; for commercial/small business loans 2.82 percent and 1.83 percent; for multifamily loans 1.97 percent and 1.20 percent; and for nonmortgage consumer loans 1.72 percent and 1.40 percent.

Assessing asset quality is an integral part of every OTS examination. Ensuring that thrift managers perform ongoing loan monitoring and stress testing is also key. As credit risks increase in the loan portfolio and economic conditions decline, appropriate additions are required to loan loss provisions. Also, for securities, thrift managers should conduct investment monitoring and ensure necessary charges are made for other than temporary impairments. These additional provisions and charges reduce earnings, but better position the institution for the future. In some cases, additional loan loss provisioning and charges will cause net losses and declines in capital that may lead to the need to raise additional capital.

2. Mortgage Metrics Report and Loan Modifications

The OTS continues to work with the Office of the Comptroller of the Currency (OCC) in collecting performance data on first lien residential mortgages serviced by national banks and federally regulated thrifts. This information is compiled in a joint report issued by both agencies referred to as the Mortgage Metrics Report. The report covers all types of first lien mortgages serviced by most of the industry's largest mortgage servicers, whose loans make up approximately 64 percent of all mortgages outstanding in

the United States. The report covers nearly 34 million loans totaling approximately $6 trillion in principal balances. Our most recent report, issued on September 30, 2009, provides information on the performance of these residential mortgages through the end of the second quarter of 2009. This report is also provided directly to Congress.

The mortgage data reported for the second quarter of 2009 continued to reflect negative trends influenced by weakness in economic conditions. As a result, the number of seriously delinquent mortgages and foreclosures in process continued to increase. Against the backdrop of economic weakness and rising mortgage delinquencies, home retention actions—loan modifications and payment plans—rose 21.7 percent over the first quarter, to 439,574, nearly 75 percent more than were implemented a year earlier. Driving the increase were actions taken under the "Making Home Affordable" program to assist troubled homeowners.

The report also showed that home retention actions continued to increase more quickly than new foreclosures. Subprime mortgages had almost twice as many new home retention actions as new foreclosures during the quarter. By contrast, there were more foreclosures than home retention actions in prime mortgages during the quarter, but the gap shrank to its lowest level in the last year.

Loan modifications that reduced borrowers' monthly principal and interest payments continued to increase in the second quarter, to more than 78 percent of all new modifications, up from less than 54 percent in the previous quarter. Also noteworthy, the number of modifications that reduced principal more than doubled, with 10 percent of modifications made in the second quarter reducing principal, compared with 3.1 percent

in the first quarter of 2009. This trend represented a significant shift from earlier practices in which the vast majority of loan modifications either did not change monthly payments or increased them. As noted in earlier reports, modifications that reduce the borrowers' monthly payments continue to show lower levels of re-defaults and longer term sustainability than modifications that increased payments or left them unchanged.

The OTS has had a long-standing commitment to affordable and sustainable mortgage modification efforts and has repeatedly encouraged its institutions to work constructively with troubled borrowers. For example, in April 2007, OTS and the other FBAs issued a statement that encouraged financial institutions to work with homeowners who were unable to make mortgage payments. "Prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower," the statement said. Institutions were assured that they would not face regulatory penalties if they pursued reasonable workout arrangements with borrowers.

Borrowers unable to make their mortgage payments should contact their lender or servicer as soon as possible to discuss available options, according to the statement. Examples of constructive workout arrangements included modifying loan terms and moving borrowers from variable-rate loans to fixed-rate loans. The statement also explained that bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans may also receive favorable consideration under the Community Reinvestment Act (CRA), if the loans are made in a safe and sound manner. In January 2009, the OTS and other agencies that evaluate CRA

performance expanded this guidance to more broadly provide positive CRA consideration for foreclosure prevention programs for low- or moderate-income homeowners that have the objective of providing affordable, sustainable, long-term loan modifications and restructurings.[13]

In September 2007, the OTS joined the other FBAs and the Conference of State Bank Supervisors in issuing a statement "encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership."

The statement noted that many subprime and other mortgage loans had been transferred into securitization trusts governed by pooling and servicing agreements. The agreements could allow servicers to contact borrowers at risk of default, assess whether default was reasonably foreseeable and, if so, apply loss mitigation strategies to achieve sustainable mortgage obligations. Servicers could have the flexibility to contact borrowers in advance of loan resets.

As the statement said, "appropriate loss mitigation strategies could include loan modifications, conversion of an adjustable rate mortgage into a fixed rate, deferral of payments, or extending amortization." In addition, institutions were asked to consider referring appropriate borrowers to qualified homeownership counseling services to work with all parties to avoid unnecessary foreclosures.

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[13] 74 FR 498 (January 6, 2009).

Our experiences with servicers, our data collection efforts, industry analyses, academic research, and internal analyses suggest the following:

- Loan modifications are costly for the servicer. We believe that providing additional incentives to servicers for loan modifications will likely result in more modifications.
- Providing incentives to servicers and borrowers to make successful modifications, as opposed to any modification, as measured by prompt payments over time, serves a useful purpose to properly align behavior.
- The significant difference in performance between bank-owned modified loans and those serviced for others suggests certain legal and accounting impediments exist in securitization structures that inhibit successful loan modifications.
- Analyses by market participants suggest that three major factors affect the performance of loan modifications:
    1. A decrease in the monthly payment. Larger decreases are associated with lower post-modification delinquencies.
    2. The extent to which the borrower is underwater (owes more than the home is worth) after the loan modification. Borrowers who are still underwater after a loan modification are more prone to delinquencies.
    3. The length of time the borrower has been in the home. In general, the longer the borrower has been in the home, the more likely the modified mortgage will perform.

Successful modification plans avoid unnecessary foreclosures by making changes that address affordability issues within the framework of aligning appropriate incentives. To achieve these goals, the OTS continues to collect data to report on the performance of first lien mortgages and any modification efforts undertaken by servicers. Additionally, the OTS, in conjunction with the other FBAs, worked with the Administration to develop the "Making Home Affordable" program.

The second quarter Mortgage Metric Report showed that newly initiated foreclosures decreased as servicers worked to implement the "Making Home Affordable" program. Emphasis on taking actions under the "Making Home Affordable" program contributed to a dramatic shift in the composition of home retention actions toward payment plans. There was a 73.9 percent increase in payment plans reported for the quarter, alongside a 25.2 percent drop in loan modifications. The 114,538 trial period payment plans reported in the second quarter more than offset a 47,995 decrease in loan modifications as servicers reallocated resources to the "Making Home Affordable" program.

The OTS continues to support all prudent home retention efforts through its monitoring of first lien data and its continued cooperation in the development and refinement of all aspects of the "Making Home Affordable" program. Additionally, we continue to encourage our institutions and servicers to work with borrowers to achieve affordable and sustainable home mortgage payments.

E. Specific Concerns of Smaller and Larger Institutions

Most of the 794 OTS-regulated thrifts are smaller, community-based institutions. As of June 30, 2009, 679 thrifts (86 percent of all thrifts) had assets of less than $1 billion. And of these, 596 (75 percent of all thrifts) had assets less than $500 million. As of the same date, there were 90 thrifts (11 percent) with assets of $1 billion to $10 billion. And 25 thrifts (3 percent) had assets greater than $10 billion.

Though representing a small percentage of the number of thrifts, larger thrifts held the majority of industry's $1.1 trillion in aggregate assets. As of the second quarter 2009, thrifts with assets greater than $10 billion held $721 billion in assets (66 percent of total industry assets). Thrifts with assets between $1 billion and $10 billion held combined assets of $224 billion (20 percent). Smaller institutions – those with assets less than $1 billion -- held assets of $153 billion (14 percent). And of those institutions, thrifts with assets less than $500 million held combined assets of $93 billion (8 percent).

OTS tailors its examination and supervisory approach to meet the unique challenges presented from thrifts of different asset sizes and operating complexities. As a general statement, it is expected that an institution's operating policies, procedures, controls, and risk management practices reflect the complexity of its operations. However, OTS on-site examination activities and supervisory approaches are also flexible and modified based on an institution's unique circumstances. These circumstances can change based on off-site monitoring of an institution's financial condition and performance, as well as other changes that could potentially impact the operations and condition of the thrift. These changes could be internal to the thrift – such as a change in

management; local – such as changes in the institution's local labor markets; or global – such as a significant change in accounting rules that impact capital or sudden changes in liquidity and capital markets.

1. Larger Institutions

During the past decade, both large banks and thrifts and their mortgage banking affiliates took advantage of the rapid growth of securitization markets to fund a variety of retail products to service the explosive growth in the residential housing market, growth that was fueled by steadily increasing home prices. These firms became increasingly dependent on the wholesale funding provided by securitizations. Because of extremely favorable market conditions, some of the largest institutions focused their businesses on a single mortgage-related product line, which created concentration risk.

This dependence also made these institutions unknowingly vulnerable to additional sources of risk. The sudden seizure in the asset securities markets stopped the mortgage funding pipeline in its tracks and led to enormous market uncertainty about the values of the assets supported by the loans, as well as the worth of the loans held by these institutions. A funding pipeline can often have a larger dollar volume than the net worth of the firm. As the pipeline seized up, firms had to hold on their books the loans already in the pipeline. Liquidity-strapped institutions made increasingly distressed asset sales, further pressuring security and loan prices. This market dynamic threatened the solvency or forced the insolvency of many of these firms that employed an "originate-to-sell" strategy.

The capital markets also created a plethora of structured financial securities, from credit default swaps to collateralized debt obligations, whose relationships to the performance of the underlying assets can be difficult to discern. The uncertainty concerning the risk and the valuation of these structured securities can make an assessment of the current financial condition of financial institutions a challenging task.

In an effort to ensure that loans are adequately underwritten, in September 2008 the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale had to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

In addition, both smaller and larger thrifts should take greater account of the risks faced, and created, by both their funding practices and their securities holdings. The focus of risk management has shifted from the "silo" approach of assessing the risk of individual asset and liabilities to an enterprise-level risk management expectation. Such an approach encompasses an assessment of not only concentration risk in its various forms but also of the effect on the firm of interaction of their assets and liabilities under

stressful conditions. For some institutions, this represents a significant change in orientation, but one important for their survival.

2. Smaller – Community-Based Thrifts

Although the financial crisis did not originate in smaller thrifts, they have not escaped damage from the crisis and from the serious recession that ensued. Small thrifts are by their nature geographically concentrated and many are located in communities that have experienced significant declines. Not surprisingly, these thrifts have keenly felt the impact. Even within a single geographic area, however, thrifts that offered products they understood and maintained traditional underwriting standards have tended to withstand the stresses.

Smaller thrifts meet the financial services and credit needs of their local communities with a wide range of loan and deposit products. These thrifts are often one of few sources of small business and commercial real estate lending in their immediate market area.[14] As such, smaller thrifts typically hold higher relative amounts of business-related loans in portfolio than larger thrifts. With mounting weakness in the business sector, as evidenced by such trends as increasing vacancy rates and rising business bankruptcies, we are concerned that some small thrifts in particularly hard-hit areas may need additional capital to weather the potential downturn. Even though smaller thrifts typically maintain higher capital ratios than larger institutions, commercial real estate and business-related loans are generally larger than consumer-related loans. Hence, problems in even a few commercial real estate and business loans have the potential to impact

capital levels. For these reasons, we continue to closely monitor commercial real estate and business trends, with a special focus on those local market areas in which thrifts are exposed.

Community banks and thrifts survive, in a large part, because their local presence and personal interactions give them an advantage in meeting the financial needs of families and small businesses. Their local knowledge often allows them to make better judgments about the creditworthiness of local borrowers. This ability to employ their local knowledge across a spectrum of lending products is the source of their strength and a key to their ultimate survival.

IV. Developing Trends

A. Interest Rate Risk

Currently short-term interest rates are considerably lower than long-term interest rates. In light of this factor and the continuing constriction within the credit markets, OTS is concerned that some institutions may be tempted to take on unsafe and unsound levels of interest rate risk in an attempt to bolster earnings. Historically, the thrift industry has had greater exposure to interest rate risk because of its heavy concentration of long-term, fixed-rate residential mortgages. As a result, OTS developed an off-site supervisory model in 1991 to measure and monitor interest rate risk exposure in the thrift industry and has issued advisory letters reminding institutions of our supervisory expectations regarding sound practices for managing interest rate risk. Reports from the OTS model are shared with both bank officials and OTS examiners on a quarterly basis. This supervisory approach is unique among the FBAs.

Our model suggests that the level of interest rate risk in the industry is still at manageable levels. However, we recognize that the economic environment could change quickly and, under certain scenarios, some institutions could experience severe downward pressure on both earnings and capital. To that end, OTS will continue to identify those institutions in an effort to ensure they take appropriate action to reduce their interest rate risk.

The OTS recognizes that banking institutions are in the business of taking and managing risk and the current environment offers attractive opportunities. Given this, our goal is to discourage unsafe and unsound practices without curtailing investment in residential mortgages.

B. Continuing High Levels of Unemployment

As mentioned earlier, the increase in the nation's unemployment rate from the beginning of the recession in December 2007 (unemployment rate of 4.9 percent) through September 2009 (9.8 percent) has been the greatest of any of the other ten recessions since 1945. Moreover, the nation's "underemployment" rate – a broader measure of the health of the nation's job markets that includes those unemployed, working part-time due to economic reasons, and not actively looking for work but would like to work – has increased to 17 percent in September 2009, the highest level on record since this statistic has been calculated (January 1999).

One small positive trend is that the rate of job loss appears to be slowing. According the Bureau of Labor Statistics, total nonfarm payroll employment declined by

263,000 in September 2009. From May through September, job losses averaged 307,000 per month, compared with losses averaging 645,000 per month from November 2008 to April. Since the start of the recession in December 2007, payroll employment has fallen by 7.2 million.

These job losses have and will continue to put enormous financial pressure on struggling borrowers and will likely result in further economic challenges to those holding loan-related assets, as well as those attempting to operate in this sector of the economy.

C. Liquidity

As indicated earlier, thrifts have increased their liquidity. Cash, deposits and government securities rose to 9.1 percent of assets at the end of June 2009 from 8.5 percent at the end of 2008. Despite these encouraging trends, recent events illustrate that liquidity risk management at many banks needs improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.

As a result of these concerns, the OTS along with the other FBAs and the Conference of State Bank Supervisors, drafted guidance that reiterates the principles contained in existing guidance and, where appropriate, conforms these principles to the guidance issued by the Basel Committee on Banking Supervision in September 2008. More specifically, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal well-developed contingency funding plan as primary tools for measuring and managing

liquidity risk. The guidance also puts the industry on notice that we expect all financial institutions (and affiliated holding companies) to manage liquidity risk in a manner consistent with their size, complexity and risk profile, and that failure to maintain an adequate liquidity risk management process is considered an unsafe and unsound practice.

The proposed guidance went out for comment on July 6, 2009. The 60-day comment period closed on September 4, 2009. In general, the industry feedback was supportive, but we received several suggestions for improving the document. The FBAs are currently weighing the merits of those suggestions. We expect to issue final guidance before year-end.

D. Regulatory Restructuring

Regarding concerns on the horizon for the thrift industry, the proposed consolidation of bank and thrift regulators certainly fits into that category. The Administration proposal to merge the OTS and the OCC, as well as the proposed consolidation of all federal bank regulatory functions under a single new super-regulator, would impose major costs and disruption for the thrift industry. The prospect of such consolidation has caused unease and uncertainty that has a chilling effect on new charter applications and institutions' planning for the future.

The OTS currently conducts consolidated supervision of thrifts and their holding companies. Although the OTS is not the proper regulator for systemically important conglomerates, the agency is well-suited to continue to supervise thrift holding

companies, particularly for the many local consumer and community lenders across America who should not be asked to bear the cost and inefficiency of separate holding company regulation. The overwhelming majority of thrifts are small, conservative lenders that offer home mortgages, car loans and other day-to-day financial services to consumers. Quite a few are community-based mutual institutions that have been integral parts of their communities for decades. The health of the financial services industry is improving, but by no means robust. The transition costs of thrifts converting to a different supervisor and a separate holding company regulator would be an unnecessary burden at a difficult time.

Another potential point of cost and disruption are the quarterly financial reports that banks and thrifts submit to their regulators. Thrifts report their financial status to the OTS through Thrift Financial Reports, while banks file Call Reports. Under consolidation proposals, either thrifts would need to overhaul their financial reporting systems, or the consolidated agency would need to operate and maintain two different reporting systems.

For smaller, community-based institutions, the specter of consolidation also brings unease because their operations are so different from the operations of large banks, particularly the trillion-dollar mega-banks. Under a single super-regulator, the needs of the community-oriented majority could be too often overlooked because of the need to focus attention and resources on institutions posing the greatest risk to the financial system. Consumer-and-community institutions would no longer have a regulator focused

on their traditional business model of knowing their customers and meeting the everyday financial needs of families and small businesses.

Consolidating agencies would take years, cost the industry millions of dollars and generate upheaval in the day-to-day supervision of financial institutions. All of this would be done with no efficiencies or other benefits for taxpayers, consumers or the industry.

E. Overdraft Protection

A number of measures indicate that while credit card usage is dropping, the use of debit cards is increasing. One of the reasons for increased debit card use may be that – given the current economic downturn - consumers are attempting to manage their finances more carefully by spending what they have, rather than borrowing to pay for purchases.

However, with the advent of fee-based overdraft protection, consumers who overdraw their debit accounts may face significant fees relative to the size of the overdrafts they incur. In fact, recent research indicates that because debit transactions are generally small – around $20.00 – the typical $27 overdraft fee often exceeds the value of the transaction.[15]

The OTS shares the concerns about overdraft programs that have been expressed by members of Congress. As a result, we are in the process of supplementing our existing

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[15] See FDIC Study of Bank Overdraft Programs at p 79 (Nov. 2008) (FDIC Overdraft Study), available at: http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_FinalTOC.pdf.

overdraft guidance[16] for thrift institutions and examiners to clarify our supervisory expectations with respect to these programs Our goal in doing so is to ensure that OTS supervised institutions are managing overdraft protection programs in a responsible way.

Beyond compliance with applicable rules, we plan to emphasize that failure to implement the best practices already advocated in OTS supervisory guidance can lead to violations of law. For example, existing OTS overdraft guidance warns against manipulating transaction clearing order to inflate fees.[17] Such an approach may violate the Federal Trade Commission (FTC) Act prohibition against unfair practices.

OTS also supports consumer choice in this area. Specifically, OTS supports requiring that a consumer affirmatively consent, or "opt-in," before an institution may charge a fee for paying an overdraft, particularly for electronic transactions. Consistent with the increased use of debit cards noted above, recent research suggests that debit transactions account for the largest share of overdraft transactions-41 percent.[18] However, institutions often automatically enroll their customers in overdraft protection programs. Studies have shown that this strategy may lead to increased consumer participation in overdraft protection programs due to the power of inertia and lack of attention on the part of consumers.[19] Yet, consumer testing indicates that many people

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[16] See 70 FR 8428 (February 18, 2005).
[17] See 70 FR at 8431.
[18] See FDIC Overdraft Study at p.78.
[19] Madrian, Brigitte C., and Shea, Dennis F., The Power of Suggestion: Inertia in 401(K) Participation and Savings Behavior, Working Paper 7682, National Bureau of Economic Research, Cambridge, MA, May 2000 (available at: http://www.nber.org/papers/w7682).

would consider removing overdraft protection from their electronic transactions if they had the opportunity to do so.[20] These consumers should be given that choice up front.

F. Reverse Mortgages

Reverse mortgages present another set of emerging issues. Reverse mortgages are loans that convert home equity into payments from a lender. Available to homeowners age 62 and older, reverse mortgages typically do not require any payments from borrowers as long as they continue to live in their homes. Many of these loans are made under the Home Equity Conversion Mortgage program administered by the Department of Housing and Urban Development[21], but institutions also offer reverse mortgages through their own proprietary programs.

Reverse mortgages present safety and soundness challenges because they rely primarily on the sale of the collateral property for repayment, and they have not been tested through the credit life cycle.[22] Although reverse mortgages are growing in popularity, they are complicated products for consumers. This, combined with the fact that they are offered to seniors who may be vulnerable to misleading marketing techniques, prompted the OTS to join other members of the Federal Financial Institutions Examination Council to develop reverse mortgage guidance for lenders. We expect to propose the guidance for comment soon.

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[20] See *Review and Testing of Overdraft Notices*, Macro International, December 8, 2008, available at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a6.pdf
[21] See 12 U.S.C. 1715z-20; 24 CFR 206.
[22] The OTS has already issued guidance on risk management issues presented by reverse mortgages. See OTS Examination Handbook, to One-to-Four Family Residential Real Estate Lending section, Appendix B available at: http://files.ots.treas.gov/422041.pdf .

G. Other Consumer Protection Issues

The OTS is also taking a number of other steps to ensure that institutions under our supervision conduct business in a manner that is compliant with consumer protection laws, including the FTC Act prohibition against unfair and deceptive acts and practices. For example, we recently published rules prohibiting a range of unfair credit card practices, including increasing interest rates on existing balances when consumers are paying on time and charging credit card account opening fees that are so high that they erode most of the credit issued.[23] While OTS recognized that credit card issuers may have to commit significant resources to comply with the new rules, we strongly encouraged OTS supervised institutions to do so as soon as possible.[24] OTS also organized a conference call for financial institutions and other interested parties to ask implementation questions to help them prepare for the new rules as quickly and efficiently as possible. This effort to spur compliance reached more than 700 callers.

As you know, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Credit CARD Act) expands the prohibition against practices that the OTS found to be unfair and restricts additional practices. OTS shares the concerns that prompted Congress to enact the Credit CARD Act and we have taken prompt steps to ensure that institutions under OTS jurisdiction are aware of their new responsibilities under this legislation.[25] In particular, we have highlighted the requirement that institutions review accounts in which consumers' interest rates have been increased since January 1, 2009

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[23] See Unfair or Deceptive Acts or Practices (UDAP) Rule, 74 FR 5498, 5502-5504 (January 29, 2009).
[24] See Letter to Thrift Chief Executive Officers dated December 18, 2008, available at: http://files.ots.treas.gov/25287.pdf
[25] See Letter to Thrift Chief Executive Officers dated June 25, 2009, available at: http://files.ots.treas.gov/25308.pdf

and develop a process for determining whether the rates applicable to such accounts should be reduced when the circumstances that warranted the rate increase are no longer present.[26] We are committed to enforcing this requirement. Moreover, we have encouraged OTS supervised institutions to go further than required under the implementing rules to ensure that consumers understand the effect of exercising the right to reject rate increases provided by the Credit CARD Act.[27]

The OTS also exercised its authority under the FTC Act earlier this year by taking formal enforcement actions that required two thrifts to cease engaging in unfair and deceptive acts and practices related to credit card and overdraft protection programs.[28] Through these actions, the OTS required the thrifts to reimburse consumers more than $1.5 million and pay civil money penalties of $250,000.

V. Conclusion

Thank you again, Mr. Chairman, Ranking Member Crapo and members of the Subcommittee, for the opportunity to testify on behalf of the OTS on the current condition of the thrift industry. In summary, the OTS-regulated thrift industry is continuing to face imposing challenges from the financial crises. However, the industry is poised to return to thriving status once the housing market recovers and the economy again swings upward.

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[26] See Letter to Thrift Chief Executive Officers dated July 13, 2009, available at: http://files.ots.treas.gov/25312.pdf

[27] See Letter to Thrift Chief Executive Officers dated September 29, 2009, available at: http://files.ots.treas.gov/25322.pdf

[28] See In re Bank of Greene County (July 22, 2009), available at: http://files.ots.treas.gov/enforcement/97159.pdf and In re: American Express Bank, F.S.B. (June 29, 2009) available at http://files.ots.treas.gov/enforcement/97146.pdf and http://files.ots.treas.gov/enforcement/97147.pdf .