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Statement of

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Office of Thrift Supervision

concerning

Exploring the Balance between Increased Credit Availability and Prudent Lending Standards

before the

Committee on Financial Services
United States House of Representatives

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I. Introduction

Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. Thank you for the opportunity to testify on behalf of the Office of Thrift Supervision (OTS) on finding the right balance between ensuring the safety and soundness of U.S. financial institutions and ensuring that adequate credit is available to creditworthy American consumers and businesses.

Available credit and prudent lending are both critical to our nation and its economic well-being. Neither one can be sacrificed at the expense of the other, so striking the proper balance is key.

Access to credit is essential to spur economic recovery. Banks and thrifts should never have to turn away a good customer. Yet, as you well know, the trust that is vital to our financial system has been shaken by fear and questions about whether money that is loaned will be repaid. If trust is the lubricant for a well-running financial system, a lack of trust is a gum that prevents the system from operating smoothly.

In a smoothly running system, financial institutions offer an array of loan products, so creditworthy borrowers are able to obtain loans at reasonable rates.

As we assess whether current economic conditions are causing mixed messages to be sent to banks and thrifts, it is important to note that the OTS and the other banking regulators are also receiving mixed signals. When financial institutions fail, regulators are subject to criticism for not having cracked down hard enough and early enough. Yet, regulators are also urged not to tighten the screws too tightly— lest financial institutions become too cautious, hoard their resources and become unreasonably hesitant to lend.

In exploring ways for making the system run smoothly again, I'd like to begin by citing reports that define the scope of the problem, then discuss important facets of the problem before discussing possible solutions. On the subject of solutions, one obvious point is that the ultimate solution is for this nation to find its way past its current economic downturn. Until that happens, credit will remain tight and our financial institutions will continue to face daunting challenges with loan delinquencies, charge-offs and other credit quality issues that threaten their viability.

II. Recent Data on Credit Demand and Availability

The OTS uses a variety of measures to gauge credit availability and lending activity. Our examiners and regional staff members routinely talk to thrift institution managers about what they are experiencing in their market areas with regard to credit demand and credit availability. These issues are discussed by supervision staff members within each OTS region, between regions and in regular meetings between our four Regional Directors and senior agency leaders at our headquarters in Washington.

We also assess the availability of credit by reviewing the detailed financial reports — called Thrift Financial Reports or TFRs — that thrift institutions file quarterly with the OTS. TFRs contain data on originations, purchases and sales for major loan types. From this data, we can detect changes in lending volumes and compare those changes to peer groups. We also compare the lending volumes to outside indicators of credit availability and demand.

For OTS-regulated thrifts, total loan originations and purchases declined about 11 percent from 2007 to 2008. However, several categories of loans — such as consumer and commercial business loans, and nonresidential and multifamily mortgages — increased during the period.

Other recent studies confirm that credit is tight, but not getting increasingly tighter, and that demand for residential mortgages has decreased.

According to a mortgage loan application survey last month (February 20, 2009) by the Mortgage Bankers' Association of America, mortgage purchase applications have declined 30 percent from one year ago. Given the rise in unemployment and general economic conditions, that finding is not surprising.

The Federal Reserve Board (Fed) has issued two releases recently on the availability of credit. In January, the Fed's quarterly opinion survey of senior loan officers on bank lending practices showed that credit continued to remain tight during the final three months of 2008.

However, the survey said credit was not getting any tighter: a smaller percentage of institutions toughened their lending standards for consumers and commercial customers during the fourth quarter of 2008 than during the previous quarter. About 45 percent of the survey respondents reported weaker demand for consumer loans of all types, similar to the percentage in the previous quarter.

A second report from the Fed, a statistical release on consumer credit dated February 6, 2009, said consumer credit decreased at an annual rate of 3 percent in the fourth quarter of 2008.

III. Facets of the Problem

a. The Swinging Pendulum

It is clear today that during the recent housing boom, credit was extended to too many borrowers who lacked the ability to repay their loans. For home mortgages, some consumers received loans based on their ability to pay introductory teaser rates, an unfounded expectation that home prices would continue to skyrocket, inflated income figures, or other underwriting practices that were not as prudent as they should have been. Many of these mortgages might have worked out fine if housing prices had continued moving upward, but as we know, home prices in many parts of the country have dramatically fallen and the consequences of weak underwriting have caused significant distress for many financial institutions, homeowners and businesses.

Given this recent history, some tightening in credit is expected and needed. Borrowers must have adequate capacity to repay the loans they receive. An absence of sound underwriting can have a severe, negative impact on financial institutions, consumers and the economy.

At the same time, we must ensure that the pendulum does not swing too far in the other direction and restrict credit availability to an unhealthy level.

b. Economic Contraction, Capital and Loan Loss Reserves

The fallout from current economic deterioration has had an impact on credit availability in a variety of ways. For example, the number of nonbank businesses offering credit has declined as many of these highly leveraged, under-regulated companies that engaged in consumer and business lending — often with loose underwriting standards — have gone out of business.

The economic contraction has also prompted some financial institutions to exit entire lines of business. In one prominent example, a large bank announced earlier this month that it will no longer write new consumer loans in the U.S. and will shut down its U.S. lending unit over the next five years due to the collapse of the subprime mortgage market. In October, another bank discontinued accepting mortgages originated by outside mortgage brokers.

To meet the challenges facing them, U.S. financial institutions are building capital and setting aside additional reserves as buffers against the effects of future losses. Decreases in asset quality, and increases in delinquencies and charge-offs for mortgages, credit cards and other types of lending, require institutions to supplement loan loss reserves and augment capital to preserve safety-and-soundness. Although these needs may place a strain on institutions' ability to lend, strengthening capital and reserves provides a critical foundation for maintaining institutions' stability and continued health.

Also, the freeze-up of the market for non-government-sponsored-enterprise mortgages has forced financial institutions to hold more loans on their books. To carry these loans, the institutions need to maintain higher capital levels.

Although the Treasury Department's Troubled Asset Relief Program, or TARP, is making capital available to institutions, access to capital from other sources remains constrained.

Regarding capital standards, I would like to dispel some inaccuracies receiving recent attention. The first is the notion that federal bank and thrift examiners are raising capital requirements for the financial institutions they regulate. This incorrect assertion has been circulated perhaps because the financial services industry generally is facing significant challenges and, at the OTS, this stress has resulted in a marked increase in formal enforcement orders related to safety-and-soundness. Under such actions, which include cease-and-desist orders, institutions are often required to maintain capital levels above the well-capitalized standard. Although these types of cases are increasing, they remain relatively few in number and the requirements are necessary to provide a counter-balance to the elevated risks confronting these institutions.

A second inaccuracy in public circulation is the assertion that federal banking regulators are raising capital standards for financial institutions that receive TARP funds. That is not the case. Funds under TARP are provided to viable banks and thrifts. By definition, these institutions are considered healthy before receiving TARP support. In some cases, the OTS is requiring institutions to raise private capital before receiving TARP support. The additional private capital is necessary for these institutions to be considered healthy before receiving that support.

c. Consumer Confidence and Complaints

Because the economic crisis has driven consumer confidence lower, many consumers are reluctant to borrow for homes, cars, or any other major purchases. In large part, they are hesitant to spend money on anything beyond daily necessities.

Rising job losses are making some would-be borrowers unable to qualify for loans. Steep declines in the stock market have reduced many consumers' ability to make down payments for home loans and drained consumers' financial strength. Sliding home prices are cutting into home equity. In reaction to their declining financial "net worth," many consumers are trying to shore up their finances by spending less and saving more.

One key question is whether the recession will prompt consumers to make lifestyle changes that will continue to have an impact for many years after recovery. Financial shocks can produce psychological changes that endure. The economic downturn may shape consumer spending habits for the long term.

For consumers who continue to seek credit, tight conditions prevail. OTS consumer complaint data show that consumers seeking extensions of credit from OTS-regulated thrifts are in some cases experiencing problems and those reported problems have grown significantly in recent years.

According to OTS data from 2006 to 2008, consumer complaints to the agency about declines in available credit increased by more than 50 percent from 2006 to 2007 (from 43 complaints to 66 complaints), and by more than 350 percent from 2007 to 2008 (to 301 complaints). By far the largest number of such complaints centered on credit cards (267 complaints over the three-year period), followed by home equity lines of credit (101 complaints) and fixed-rate mortgages (25 complaints).

The OTS responds to all consumer complaints and strives to resolve each one in an equitable manner. The agency also uses consumer complaint data in important ways during the supervisory process. Before every comprehensive examination of an OTS-regulated thrift, the exam team reviews complaint data for the institution to find out where to look further during the exam. The OTS also analyzes complaint data to spot trends for problems at individual institutions, as well as trends within the thrift industry. Patterns in consumer complaints can lead to OTS guidance to the industry, enforcement actions and agency regulations, such as the recent interagency rule on unfair credit card practices.

d. Appraisals and Loan Modifications

One question that the Committee asked is whether the federal banking regulators are requiring appraisals for loan modifications and, if so, whether such a requirement is hampering the ability of distressed borrowers to obtain modifications.

In fact, loan modifications by savings associations to avoid foreclosure are not considered “new transactions” under OTS's appraisal regulation and related guidance. Therefore, thrifts are not required to obtain appraisals for such modifications. An institution may elect to use other methods to estimate the value of the security property.

When working constructively with a borrower who is in default or whose default is reasonably foreseeable, a federal savings association is expected to perform a realistic assessment of the value of the security property. The institution will weigh the cost and time to modify a mortgage against the need to facilitate a sound and streamlined modification process. Consistent with sound policies and procedures, savings associations must be able to demonstrate that the collateral valuation methods used in loan modifications are appropriate and reliable.

e. Reductions in Home Equity Lines of Credit

A home equity line of credit is a form of revolving credit in which the borrower’s home serves as collateral. As home prices have declined in communities across the country and financial institutions are feeling pressure to shrink their balance sheets, institutions have been curtailing, suspending, or terminating customers' home equity lines of credit, and consumer complaints to the OTS about these actions have been increasing.

The OTS received no consumer complaints about home equity lines in 2006 and only two such complaints in 2007, according to the agency's consumer complaint database. In 2008, the number of such complaints spiked to 99.

Last August, the OTS issued guidance to its regulated institutions emphasizing that such actions must comply with federal laws and rules designed to protect customers, including regulations implementing the Truth in Lending Act, Equal Credit Opportunity Act, Fair Housing Act and the OTS nondiscrimination rule.

The OTS also issued a "CEO letter" to OTS-regulated thrifts on ensuring consumer protection when institutions cut back on home equity lines of credit, or HELOCs.

"To actively manage the credit risk within their HELOC portfolios, savings associations often structure HELOC plans so that the available credit limit may be reduced, suspended, or terminated," said the letter by Timothy T. Ward, OTS Deputy Director for Examinations, Supervision and Consumer Protection. "In carrying out these actions to manage credit risk, associations must follow the federal laws and rules designed to protect HELOC customers."

Specifically, such a credit line can be cut back based on a valuation of the borrower's particular home, not more general home prices in the zip code or surrounding community. The reduction can be based on a home value determined by an automated valuation model, but the model must be properly calibrated for accuracy and the data fed into it must be valid; for example, the comparable properties selected for comparison purposes must be truly comparable. When the home value goes back up, the home equity line must be restored.

Consumer complaints to the OTS center on issues such as whether the home value determined by the valuation model is accurate and whether comparable properties chosen for the valuation are really comparable.

OTS examiners are following up on this guidance by checking whether OTS-regulated thrifts that cut back on these lines of credit are following the rules. When examiners find problems, the OTS is noting the issues in exam reports, discussing remedies with thrift managers and boards of directors and, in some cases when managers and boards do not rectify problems adequately, taking enforcement actions.

For example, the OTS issued a Notice of Charges against a thrift earlier this month saying that the institution violated the Truth in Lending Act by sending notices to nearly 95 percent of its home equity line customers freezing their credit lines without the required documentation to support its action.

IV. Actions That Can Help

As mentioned earlier, the problem of tight credit can be solved fully only when the economy rebounds. However, there are steps that are being taken now and steps that can be taken in the future to ease the credit crunch.

One action that the government could take would be to prioritize government assistance, such as under TARP, to institutions that show a willingness to be active lenders. The OTS is already collecting information from thrifts applying under TARP on how they plan to use the funds. The OTS makes recommendations to the Treasury Department on whether to approve TARP applications but the final decision is up to Treasury.

Another way to improve the situation is to continue to explore ways of meeting liquidity needs of all banks and thrifts in these times when credit availability is key to their lending operations.

The federal government has already taken significant steps to bolster liquidity through programs including the Capital Purchase Program under TARP, the Commercial Paper Funding Facility, the Temporary Liquidity Guarantee Program and the Term Asset-Backed Securities Loan Facility.

Recent events illustrate that many insured depository institutions need to improve their liquidity risk management. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, insufficient cash flow projections and a lack of viable contingency funding plans.

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

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

The OTS and the other federal banking regulators urged regulated institutions to make credit more available to consumers in November 2008 by issuing an interagency statement on meeting the needs of creditworthy borrowers.

The statement emphasized that the Agencies 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.

It may be too soon to determine the effectiveness of the interagency statement. However, data from the thrift industry's Thrift Financial Reports show encouraging trends: a 29 percent decrease in foreclosures in the fourth quarter of 2008 from the third quarter and a 14 percent increase in troubled debt restructurings.

Extending credit in times of financial and economic stress might require a more "hands-on approach" to lending by banks and thrifts. The use of models — such as credit scoring models — has become common for loan originations. However, we have learned over the past two years that models, and the assumptions used in those models, are not infallible. Banks should have processes in place to review loans that are "kicked-out" by loan origination model tools. This would help ensure the accuracy of models and help ensure that creditworthy borrowers have access to funds. Banks should also have processes in place to field consumer complaints about being denied credit. The existence of such processes would serve as a quality check on institutions' loan origination and review functions.

V. Conclusion

Thank you again, Mr. Chairman, for the opportunity to testify today. I look forward to working with you on these important issues in the future and I am happy to respond to your questions.