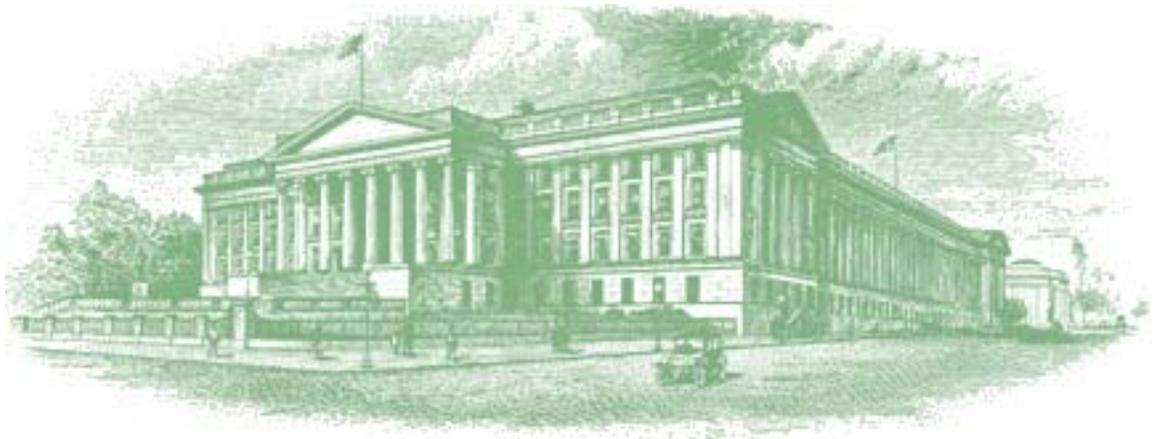




Audit Report



OIG-07-034

SAFETY AND SOUNDNESS: OTS Could Further Strengthen Its Ability to Assess Risks to Thrifts Following Emergencies

March 28, 2007

Office of
Inspector General

Department of the Treasury

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Abbreviations

CAMELS	Capital, Assets, Management, Earnings, Liquidity, Sensitivity to risk
COOP Plan	Continuity of Operations Plan
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
TFR	Thrift Financial Report
Treasury	Department of the Treasury

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*The Department of the Treasury
Office of Inspector General*

March 28, 2007

John M. Reich
Director
Office of Thrift Supervision

During the 2005 hurricane season, Hurricanes Katrina and Rita struck states along the Gulf of Mexico, causing major destruction and disruption in portions of Alabama, Louisiana, Mississippi, and Texas. Following these hurricanes, we conducted an audit to determine (1) how prepared Treasury's Office of Thrift Supervision (OTS) was to address the needs of thrifts¹ and their customers during and immediately following the two hurricanes and (2) OTS's plans and abilities to assess and manage increased risks to thrifts following the hurricanes.

Results in Brief

OTS determined that Hurricanes Katrina and Rita had posed risks to thrifts in the Gulf Coast Region. Short term risks were primarily to the thrifts' operations, while long term risks were primarily to the thrifts' financial condition. OTS evaluated these risks by obtaining assessments from thrift management and subsequently performing analyses and examinations. On average, OTS obtained information on four components of financial condition for affected thrifts that ranged between 13 and 68 days following the hurricanes. We found that OTS could improve its procedures to assess the financial condition of affected thrifts following emergencies as:

- OTS guidance did not specifically address obtaining critical financial information from affected thrifts in a consistent manner.

¹ In this report, we refer to all financial institutions regulated by OTS as thrifts.

-
- OTS guidance did not specify timeframes for analyzing the effects of the hurricanes on the affected thrifts' financial condition.

We also found areas where OTS could improve its operational risk assessment of affected thrifts following emergencies as:

- OTS lacked continuity of operations (COOP) plans for field offices in 2 of its 4 regions.
- OTS had difficulty establishing communication with certain thrifts following Hurricane Katrina.

We are recommending that OTS: (1) develop a process that will enable it to obtain critical information about thrifts' financial conditions following emergencies in a consistent manner; (2) following an emergency, determine timeframes for analyzing the affected thrifts financial condition, based on the gravity of the situation; (3) develop COOP plans for its field offices; and (4) maintain alternative contact information for thrift personnel. OTS agreed to implement the recommendations in its response to our report, which is provided as appendix 2.

Background

Hurricane Katrina made landfall on the Gulf Coast on August 29, 2005, with Hurricane Rita following on September 24, 2005. These hurricanes, two of the most intense hurricanes ever recorded in the nation's history, caused major destruction and disruption to the infrastructure in portions of Alabama, Louisiana, Mississippi, and Texas. Over 80 percent of the city of New Orleans flooded and more than 800,000 citizens, affected by the storms, were forced to live outside of their homes.

OTS is the primary regulator of all federal and many state-chartered thrift institutions, which include savings banks and savings and loan associations. Its mission is to supervise thrifts and their holding companies in order to maintain their safety and soundness and compliance with consumer laws and to encourage a competitive industry that meets the nation's financial services needs.

In keeping with its mission, OTS had to determine which thrifts were affected by Hurricanes Katrina and Rita and what types of assistance the thrifts might require as a consequence. OTS, the other federal financial institution regulators, and the Federal Financial Institution Examination Council (FFIEC)² issued information that addressed a variety of issues that arose following the hurricanes. The topics covered included assistance to affected customers, availability of additional supervisory guidance on regulatory and reporting issues, establishment of Community Reinvestment Act credits to stimulate support for disaster relief in the financial industry,³ and examination guidance for regulatory personnel for institutions affected by Hurricane Katrina.⁴

FFIEC-issued guidance specifically intended to help financial institutions recover from the hurricanes addressed such topics as granting extensions to financial institutions for filing 3rd quarter Thrift Financial Reports (TFRs);⁵ permitting financial institutions to use estimates to determine their loss reserves for the 3rd quarter TFR until a determination on the collectibility of loans was confirmed; allowing institutions, for liquidity purposes, to immediately sell securities designated as held to maturity;⁶ and exempting institutions from appraisal requirements for real estate transactions in designated counties affected by the hurricanes.⁷

OTS coordinated with thrifts' Technology Service Providers to expedite the repair of data lines, worked through the Financial and

² FFIEC is an interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and OTS.

³ OTS CEO Letter 232, "Community Reinvestment Act (CRA) Consideration for Activities Related to Hurricanes Katrina and Rita," (Dec. 20, 2005).

⁴ OTS CEO Letter 234, "Interagency Supervisory Guidance for Institutions Affected by Hurricane Katrina," (Feb. 3, 2006).

⁵ Every federally insured savings institution regulated by OTS files a quarterly TFR. These institutions are required to file a consolidated TFR that includes detailed information about the institution's operations and financial condition as of the close of business on the last day of the calendar quarter. Five thrifts availed themselves of extensions for their 3rd quarter TFR filings and filed between 14 and 45 days after the deadline.

⁶ "FFIEC Agencies Announce Additional Guidance for Financial Institutions in Response to Hurricane Katrina and Rita" (FFIEC press release, Oct. 6, 2005).

⁷ OTS CEO Letter 229, "Appraisal Exceptions in Major Disaster Areas" (Oct. 12, 2005).

Banking Information Infrastructure Committee (FBIIC) to provide a military escort for thrift personnel into restricted areas, worked with the Federal Reserve to provide armored car service for thrifts in affected areas, and posted information on its web site to help thrifts and consumers affected by Hurricanes Katrina and Rita.

OTS also participated in the FFIEC's lessons learned review for Hurricane Katrina. In particular, the review identified the importance of alternate means of communication. OTS is considering requiring thrifts to maintain emergency telephone numbers at their data provider to ensure OTS contact following an emergency.

A total of 50 OTS-supervised financial institutions were in the areas affected by Hurricanes Katrina and Rita – 26 in Louisiana, 5 in Mississippi, and 19 in Texas. Of this total, OTS identified 19 institutions that it considered affected by the storms. Of these, 18 were considered affected⁸ by Hurricane Katrina and 1 by Hurricane Rita. OTS contacted the affected thrifts to collect information on their financial condition and subsequently conducted analyses that covered the financial effects of the hurricanes on the thrifts' CAMELS ratings.⁹ Assets of the affected thrifts totaled \$4 billion and deposits \$2.9 billion respectively. As of December 31, 2005, 12 of the affected thrifts had increased their combined loss reserves in the preceding 6 month period by \$20 million, representing 3.9 percent of the combined June 30, 2005, capital levels for the 19 affected thrifts.¹⁰ These 12 thrifts had all been affected by Katrina.

⁸ OTS considered a thrift to have been affected if it experienced any disruption of business due to the hurricanes. Office closure was commonly used to determine whether an institution had experienced a disruption of business and had therefore been affected by the storms.

⁹ The Uniform Financial Institutions Rating System was adopted by the FFIEC on November 13, 1979. The rating system, called CAMELS, is used to evaluate the safety and soundness of a savings association or a bank. CAMELS is an acronym for the six component elements that are evaluated: capital, asset quality, management, earnings, liquidity and sensitivity to risk. Each of these elements is rated on a scale of 1 to 5.

¹⁰ A financial institution's loss reserve is an estimate of the amount needed to offset possible losses on loans. After the hurricanes, financial institution's estimated the storm related losses to their loan portfolios and increased loss reserves to cover the estimated losses.

Findings and Recommendations

Emergencies pose serious risks to the safety and soundness of thrifts. In the short term, the risks are primarily to the thrifts' operations while long term, the risks are primarily to the thrifts' financial condition. OTS's supervisory responsibility to determine the thrifts' safety and soundness is therefore paramount following emergencies.

Improvements Could be Made to OTS's Guidance to Assess the Financial Condition of Affected Thrifts Following Emergencies

The OTS *Examination Handbook*¹¹ states that although it may be sufficient for OTS's monitoring of non-high-risk¹² thrifts to consist of quarterly compliance and summary monitoring reports, OTS's monitoring of high-risk thrifts should be more extensive and more frequent. The *Examination Handbook* further states that all phases of the regulatory process, from off-site monitoring between examinations to the final report of examination (ROE), involve some form of interpretation of financial data through careful and questioning study.

OTS's *Examination Handbook* does not contain timeframes by which OTS should assess and report on the condition of thrifts after emergency events, such as Hurricanes Katrina and Rita. OTS identified 19 thrifts as having been adversely affected by the hurricanes. OTS was in contact with these thrifts on an ongoing basis. OTS initially used standardized daily summaries to obtain operational assessments of the affected thrifts following the hurricanes, and then transitioned to narrative weekly summaries to monitor the overall condition of the thrifts including their financial condition. While, the daily operational assessments gave an overall view of the thrifts' operational condition, depending on the week, the weekly updates focused on one or more elements of the thrifts'

¹¹ The OTS *Examination Handbook* (May 2006).

¹² High-risk thrifts may include those that have a higher overall risk profile based on such factors as asset quality, asset composition, earnings and operations, liquidity, or capital.

operational or financial condition. As a result these weekly summaries did not consistently cover all elements of thrifts' financial condition. OTS also obtained financial condition from the thrifts' 3rd quarter TFRs. On average, it took OTS 68 days after hurricane landfall to obtain post storm information on capital, 62 days to obtain post storm earnings-related information, 50 days to obtain post storm information on asset quality, and 13 days to obtain post storm information on liquidity from the 19 adversely affected thrifts. OTS informed us, that with the exception of 1 thrift, they considered capital levels and bank management to be sound. It should be noted that as of June 30, 2006, none of these 19 financial institutions had failed as a result of Hurricanes Katrina and Rita.

The information provided by the thrifts in their communications with OTS was often limited and consisted of initial estimates. For example, in a report dated October 20, 2005, 1 thrift reported that it had performed a zip code analysis to determine the potential losses caused by the hurricanes. The thrift estimated the potential for losses at approximately \$6 million, but "management was sure that the actual loss would not be that great." OTS also performed an initial review of the affected thrifts' potential exposure to credit and liquidity risks in late September 2005. This review provided limited information, covered only 12 of the 19 adversely affected thrifts, used 2003 Home Mortgage Disclosure Act data and June 2005 TFR data.¹³

OTS subsequently performed two sets of analyses on the financial condition of adversely affected thrifts. OTS's first set of analyses of the affected thrifts' financial condition appeared in a report dated January 11, 2006, or 4½ months after Hurricane Katrina. These analyses consisted of 3rd quarter 2005 TFR information together with information provided by thrift officials and did not always include an assessment of all components of the thrifts' CAMELS ratings. While FFIEC-issued guidance permitted institutions to use estimates to determine their loss reserves for the 3rd quarter TFR until a determination on the collectibility of loans was confirmed, only 1 affected thrift made a provision for losses in its 3rd quarter TFR filing, representing less than 2 percent of its

¹³ The Home Mortgage Disclosure Act (HMDA), enacted by Congress in 1975 and implemented by the Federal Reserve Board's Regulation C, requires lending institutions to report public loan data.

mid-year capital. 11 of the other thrifts made a provision for losses in their 4th quarter TFR filings. For 2 of these thrifts, these 4th quarter provisions represented more than 18 percent of their mid-year capital.

OTS deferred all regular examinations until thrifts had time to restore operations and OTS examiners had time to work through personal affairs. It took OTS an average of nearly 6 months after Katrina, to complete a comprehensive on-site set of analyses of the financial condition of affected thrifts, while off-site analysis was ongoing. The analysis conducted through on-site examinations covered 17 of the 19 affected thrifts as OTS determined that 1 thrift was so minimally affected by the hurricanes as not to warrant an examination, and another thrift was no longer regulated by OTS at that time. OTS performed 13 special limited scope examinations and 4 comprehensive federal examinations conducted between 4½ to 8 months after Katrina on these remaining 17 affected thrifts.¹⁴ Prior to Hurricane Katrina, OTS had identified 1 thrift as being in a less than satisfactory financial condition. After Hurricane Katrina, OTS assigned an examiner to remain on site at the thrift to monitor the condition of the thrift.

By not using a structured or standardized approach to gathering financial condition information following an emergency, OTS might not obtain critical information about the thrifts' financial conditions for further analysis in a consistent manner.

Recommendations

We recommend that the Director of OTS do the following:

1. Ensure that OTS develops a process that will enable the collection of critical information about thrifts' financial conditions following an emergency in a consistent manner. As

¹⁴ OTS undertakes comprehensive exams with limited scope whenever it needs to conduct an examination outside the normal cycle. A comprehensive examination with limited scope can be conducted on- or off-site and CAMELS ratings are not required. A comprehensive federal examination is conducted on-site every 12-18 months, based on size and condition of the thrift. It is sufficient to assess a thrifts composite and component CAMELS ratings.

part of this process, OTS should consider developing a structured questionnaire for obtaining critical information.

2. Ensure that, following an emergency, OTS determine and establish appropriate timeframes based on the gravity of the situation, for analyzing the effects on affected thrifts financial condition.

Management Response

OTS concurred with these two recommendations. Its supervision staff in Washington will work with the Regional offices to develop a structured approach for collecting critical information from thrifts following an emergency. OTS will also establish appropriate timeframes based on the gravity of the situation, for analyzing the effects on affected thrifts financial condition. Its staff will complete this work by July 31, 2007.

OIG Comment

Management's planned corrective action is responsive to the intent of our recommendations.

Improvements Could be Made to OTS's Operational Assessment Process of Thrifts Following Emergencies

Presidential Decision Directive 67 requires federal agencies to establish continuity of operations (COOP) plans,¹⁵ and Federal Preparedness Circular 65 provides guidance for use by federal executive branch agencies and their subcomponents in developing COOP plans to facilitate performance of essential functions during any emergency or situation that may disrupt normal operations.¹⁶ The COOP plan elements outlined in the circular apply to all levels

¹⁵ Presidential Decision Directive 67 (PDD 67), "*Enduring Constitutional Government and Continuity of Government Operations*" (Oct. 21, 1998), required Federal agencies to develop COOP plans for essential operations. The plans are to identify those requirements, such as emergency communications, establishing a chain of command, and delegation of authority, necessary to support the primary function of the agency.

¹⁶ Federal Preparedness Circular 65, "*Federal Executive Branch Continuity of Operations (COOP)*," was issued by the Federal Emergency Management Agency on June 15, 2004 (superseding the previous version, dated July 26, 1999).

of executive branch organizations, regardless of location. According to the circular: (1) the COOP plans of agencies and their subcomponents must include plans and procedures that delineate essential functions; (2) specify succession to office and emergency delegation of authority; (3) provide for the safekeeping of vital records and databases; (4) identify alternate operating facilities; (5) provide for interoperable communications; (6) and validate the capability through tests, training, and exercises. In particular, COOP plans should contain a human capital component encompassing methods of employee communication. All federal agencies, regardless of location, are to have in place a viable COOP capability to ensure continued performance of essential functions from alternate operating sites during any emergency or situation that may disrupt normal operations. The absence of field office COOP plans may have impeded OTS's ability to quickly establish communication with key OTS Field Office personnel as well as with the thrifts themselves.

Also, under the FFIEC "Supervisory Emergency Communication Protocols,"¹⁷ each member agency is to establish and maintain the capability of rapidly communicating during emergencies with the institutions over which it has primary supervisory authority. Gaps in OTS's COOP plans and the lack of alternative methods of communication increase the risk that OTS will not be able to communicate effectively with its field office staff and thrifts during emergencies.

We found the following areas where OTS could strengthen its ability to assess risk following emergency events:

- Field Office Continuity of Operations Plans.
- Communication with thrifts following emergencies.

Field Offices Lacked Continuity of Operations Plans

During our audit, we found that OTS did not have COOP plans for its field offices and field office staff. Although OTS had established COOP plans at the headquarters and regional office levels, neither the headquarters nor the regional office COOP plans were activated

¹⁷ FFIEC "Supervisory Emergency Communication Protocols" (updated Mar 31, 2005).

during Hurricanes Katrina and Rita because those locations were not affected by the storms.

OTS established a COOP plan at the headquarters level in March 2003. COOP plans were also established at the regional office level. OTS did not have a COOP plan covering its New Orleans field office personnel at the field office facility or at off-site locations and, as a result, did not have procedures addressing communications between OTS field office personnel and other OTS personnel in emergencies.

We reviewed COOP plans for 2 of OTS's 4 regions and found that they did not include COOP plans for field offices in these regions. Furthermore, OTS could not provide us COOP plans for these field offices, including the region covering areas affected by the hurricanes. OTS management initially stated that COOP plans for small field offices were not necessary because of their intermittent use. However, OTS management subsequently informed us that they had identified a need for COOP plans for all field offices.

Without a field office COOP plan containing alternate procedures for contacting field office personnel, it took OTS regional office personnel 3 to 4 days after Hurricane Katrina to contact its New Orleans field office personnel. While communication efforts were hampered by power outages and loss of telephone service, lack of timely communication among OTS personnel during emergencies could increase the risk of disruptions to the operations of affected thrifts and delay resumption of normal service.

OTS Had Difficulty Establishing Communication with Thrifts Following Hurricane Katrina

OTS's Midwest Regional Office¹⁸ started assessing Hurricane Katrina's impact on thrifts on August 30, 2005, the day after the hurricane made landfall. The contact information that OTS maintained for thrift personnel consisted mostly of thrift office

¹⁸ OTS has four regional offices: the Midwest Regional Office, in Dallas, Tex.; the Southeast Regional Office, in Atlanta, Ga.; the Northeast Regional Office, in Jersey City, N.J.; and, covering the West, the San Francisco Regional Office, in San Francisco, Ca. The Midwest Regional Office supervises institutions in Arkansas, Iowa, Kansas, Louisiana, Minnesota, Missouri, Mississippi, Nebraska, Oklahoma, Tennessee, Texas, and Wisconsin.

telephone numbers and thrift office e-mail addresses. As a result of damage to power lines and telephone lines caused by Hurricane Katrina, OTS had difficulty contacting thrifts through these channels. OTS staff who attempted the contacts estimated that it took approximately a week to make contact with all the potentially affected Katrina thrifts and that establishing contact was very difficult in the first few days after Hurricane Katrina made landfall. In many cases, OTS was able to contact thrifts only by calling their Technology Service Providers, establishing that the thrift had been in contact with the Technology Service Provider, and implementing system backup plans, and obtaining from the Technology Service Provider emergency contact information that had been provided by the thrift.

OTS developed reports providing information gained from contact with the thrifts on their operational condition. The September 1, 2005 report showed that, as of that date, OTS had been unable to contact 8 of 18 thrifts. The next report provided was dated September 6, 2005; by that date, all of the 18 thrifts had been contacted.

Thrifts could also have initiated contact with OTS. Under normal circumstances, according to OTS personnel, thrifts have their local field manager's cell phone number and e-mail address, their examiners' contact information, and OTS regional office contact information. However, OTS personnel were unsure exactly what contact information thrifts had in their contingency plans. Because of the infrastructure damage caused by Hurricane Katrina, thrifts would have found it difficult to contact OTS personnel by conventional means using non-emergency contact information. Furthermore, OTS also informed us that the initial priority for the thrifts was to ensure the safety of their staff, rather than being operational.

As a result of the communication difficulties experienced after Katrina, OTS took steps to ensure that its personnel had alternate emergency contact information for potentially affected thrifts in preparing for Hurricane Rita. While Rita had a lesser impact, OTS contacted all the thrifts affected by Rita within 3 days of landfall. OTS subsequently developed suggested actions from lessons learned following Katrina. In particular, OTS suggested including

thrifts' needs as part of its COOP plans, requiring thrifts to maintain emergency telephone numbers at their technology service providers to ensure contact by regulators, and recommending thrifts to maintain a satellite or cellular telephone with a remote area code.

Recommendations

We recommend that the Director of OTS do the following:

3. Ensure that field offices are included in its COOP planning to address potential disruptions of service during emergencies at those locations.
4. Ensure that OTS maintains current alternative contact information for thrifts and alternative channels of communication for use by OTS personnel to contact thrifts during emergencies. OTS should also encourage thrifts to contact OTS during emergencies and provide thrifts alternative OTS contact information to facilitate communications.

Management Response

OTS indicated that it has initiated efforts to comply with these two recommendations. OTS will complete this work by July 31, 2007.

OIG Comment

Management's planned corrective action is responsive to the intent of our recommendations.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss this report, you may contact me at (202) 927-0382. Major contributors to this report are listed in appendix 4.

Alain Dubois
Director, Banking Audits

Our audit objectives were to (1) determine the preparedness for and responsiveness of OTS with respect to addressing the needs of thrifts and their customers during Hurricanes Katrina and Rita and (2) determine OTS's plans and abilities to assess and manage increased risks to thrifts following the hurricanes.

To accomplish these objectives, we performed the following activities:

- Conducted interviews with OTS personnel from OTS headquarters in Washington, D.C., the Midwest Regional Office in Dallas, Tex, and the OTS New Orleans Field Office
- Reviewed OTS documentation obtained from thrifts and OTS personnel
- Reviewed Reports of Examination and Visitation Reports
- Reviewed headquarters and regional office COOP plans
- Reviewed Uniform Thrift Performance Reports for thrifts in the affected areas

We performed our fieldwork from November 2005 through August 2006. We performed our audit in accordance with generally accepted government auditing standards.

Appendix 2
Management Response



Office of Thrift Supervision
Department of the Treasury

Scott M. Polakoff
Deputy Director

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6853

VIA U.S. MAIL AND TELECOPY

March 19, 2007

Mr. Alain Dubois
Director, Banking Audits
Office of Inspector General
Department of the Treasury
740 15th Street, NW
Suite 600
Washington, DC 20220

Dear Mr. Dubois:

OTS has received and reviewed the draft audit report, *OTS Could Further Strengthen Its Ability to Assess Risks to Thrifts Following Emergencies*. Thank you for the opportunity for OTS to review and comment on the draft report. Upon due consideration of the draft report, the agency supports the recommendations outlined.

The primary mission of OTS is to ensure the safety and soundness of the thrift industry. The agency continually enhances its safety and soundness oversight program. As a result of the lessons learned from the destruction of Hurricanes Katrina and Rita, OTS initiated several improvements in its emergency response program. The combination of changes OTS has already made, along with implementation of the report recommendations, will place OTS in an excellent position to monitor and assist the thrift industry following an emergency. The following summary outlines OTS's plans for implementing corrective measures for each report recommendation.

1. "Ensure that OTS develops a process that will enable the collection of critical information about thrifts' financial conditions following an emergency in a consistent manner. As part of this process, OTS should consider developing a structured questionnaire for obtaining critical information."

OTS concurs with this recommendation. OTS supervision staff in Washington will work with the Regional offices to develop a structured approach for collecting critical information from thrifts following an emergency. OTS staff will develop this process by July 31, 2007.

Alan Dubois
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2. "Ensure that, following an emergency, OTS determine and establish appropriate timeframes based on the gravity of the situation, for analyzing the effects on affected thrifts financial condition."

In conjunction with the first recommendation, OTS will establish appropriate timeframes for analyzing the effects on affected thrifts' financial condition following an emergency. OTS will complete this work by July 31, 2007.

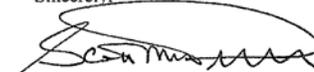
3. "Ensure that field offices are included in its COOP planning to address potential disruptions of service during emergencies at those locations."

4. "Ensure that OTS maintains current alternative contact information for thrifts and alternative channels of communication for use by OTS personnel to contact thrifts during emergencies. OTS should also encourage thrifts to contact OTS during emergencies and provide thrifts alternative OTS contact information to facilitate communications."

OTS has initiated efforts to comply with recommendations three and four. It will complete this work by July 31, 2007.

OTS appreciates OIG's efforts in developing this report and the opportunity to comment on the recommendations. The agency found its interactions with the review team useful and informative. OTS will continue working to improve its ability to assess risks and to assist our institutions as they prepare for future emergencies.

Sincerely,



Scott M. Polakoff

Appendix 2
Management Response

Alan Dubois
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