



Audit Report



OIG-09-039

SAFETY AND SOUNDNESS: Material Loss Review of Downey Savings and Loan, FA

June 15, 2009

Office of Inspector General

Department of the Treasury

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Abbreviations

ALLL	allowance for loan and lease losses
AML	anti-money laundering
ARM	adjustable rate mortgage
BSA	Bank Secrecy Act
C&D	cease and desist
CEO	chief executive officer
DFC	Downey Financial Corporation
Downey	Downey Savings and Loan Association, F.A.
ERC	enforcement review committee
FICO	Fair Isaac Cooperation
FDIC	Federal Deposit Insurance Corporation
LTV	loan-to-value
MRBA	matters requiring board attention
MSA	mortgage servicing assets
ND	New Directions
OFAC	Office of Foreign Assets Control
OTS	Office of Thrift Supervision
PCA	prompt corrective action
QRM	quantitative risk management
REO	real-estate owned
ROE	report of examination
TWA	transactions with affiliates
USAPA	United States of America Patriot Act

*The Department of the Treasury
Office of Inspector General*

June 15, 2009

Mr. John Bowman, Acting Director
Office of Thrift Supervision

This report presents the results of our review of the failure of Downey Savings and Loan Association, F.A. (Downey), of Newport Beach, California, and of the Office of Thrift Supervision's (OTS) supervision of the institution. Our review was mandated under section 38(k) of the Federal Deposit Insurance Act, as amended. OTS closed Downey and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on November 21, 2008. As of May 8, 2009, FDIC's estimated cost to the Deposit Insurance Fund from Downey's failure was \$1.4 billion.

Section 38(k) requires that we determine why Downey's problems resulted in a material loss to the insurance fund; review OTS's supervision of Downey, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing any such loss in the future. We reviewed the supervisory files and interviewed key officials involved in the regulatory enforcement matters. We conducted our fieldwork from January 2009 through April 2009 at OTS's headquarters in Washington, D.C.; OTS's regional office in Daly City, California; and the former Downey headquarters in Newport Beach, California. We also met with officials of FDIC's Division of Supervision and Consumer Protection in San Francisco, California, and interviewed FDIC's Division of Resolutions and Receiverships personnel.

Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on Downey and OTS's enforcement processes. We also provide a glossary as appendix 3. At their first use in this report, terms included in the glossary are underlined and hyperlinked to the glossary. Appendix 4 is a chronology of

significant events related to Downey and supervision of the thrift. Appendix 5 contains significant examination results and information on enforcement actions.

Results in Brief

The primary causes of Downey's failure were the thrift's high concentrations in single-family residential loans which included concentrations in option adjustable rate mortgage (ARM) loans, reduced documentation loans, subprime loans, and loans with layered risk; inadequate risk-monitoring systems; the thrift's unresponsiveness to OTS recommendations; and high turnover in the thrift's management. These conditions were exacerbated by the drop in real estate values in Downey's markets.

OTS conducted timely and regular examinations of Downey and provided oversight through its off-site monitoring. OTS also conducted an internal failed bank review as required by OTS policy. The review found that a more forceful regulatory response is warranted when thrifts have concentrations of higher-risk nontraditional mortgage products. We affirm OTS's internal findings and the need for corrective action, particularly the need for more definitive guidance on concentration risk for nontraditional mortgage loans and OTS's authority to address thrifts taking excessive risks in these loan products.

In addition, we found that OTS did not follow its existing guidance for taking enforcement action, as prescribed in the OTS Examination Handbook, when it issued an informal rather than formal enforcement action in 2006. OTS examiners told us that they exercised their regulatory discretion in taking informal rather than formal enforcement action. In addition, OTS examiners told us that the institution became more responsive to OTS's supervision and that OTS accomplished the same results as if formal enforcement action had been taken. In this regard, we agree that the informal action taken was strong; however, OTS did not follow its own written guidance to the letter.

We also concluded that OTS appropriately used its authority under PCA when it issued a cease and desist (C&D) order in September 2008 that, among other things, reclassified Downey's capital level

to adequately capitalized and imposed restrictions even though the thrift's capital level at the time met the definition of well-capitalized.

We recommend that the Director of OTS ensure that the recommendations from OTS's internal assessment of the Downey failure are implemented and the lessons learned described in that assessment are taken into account going forward. In this regard, OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable. OTS should assess the need for more guidance for examiners on determining materiality of concentrations and determining appropriate examiner response to high-risk concentrations, including when to impose absolute limits to prevent excessive concentration. Additionally, OTS should formally communicate to the industry the guidance in New Directions (ND) Bulletin 06-14, Concentrations of Risks, as to OTS's expectation that concentration measurements and limits be set as a percent of capital, not just as a percent of total assets or loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

In a written response, OTS concurred with our recommendation. OTS plans to issue further guidance regarding concentrations to both the thrift industry and OTS staff that will address asset and liability concentration issues described in this report, as well as those that have been identified internally by OTS. OTS plans to implement our recommendation from this review by the end of the third quarter of 2009. We consider the planned actions as outlined in OTS's response to be responsive to our recommendation. The response is provided as appendix 7.

Causes of Downey's Failure

Concentrations in Higher-Risk, Nontraditional Mortgage Loans

As of September 2008, single-family residential loans constituted 86 percent of Downey's total assets, down slightly from the end of 2002, when they constituted 90 percent of Downey's total assets.

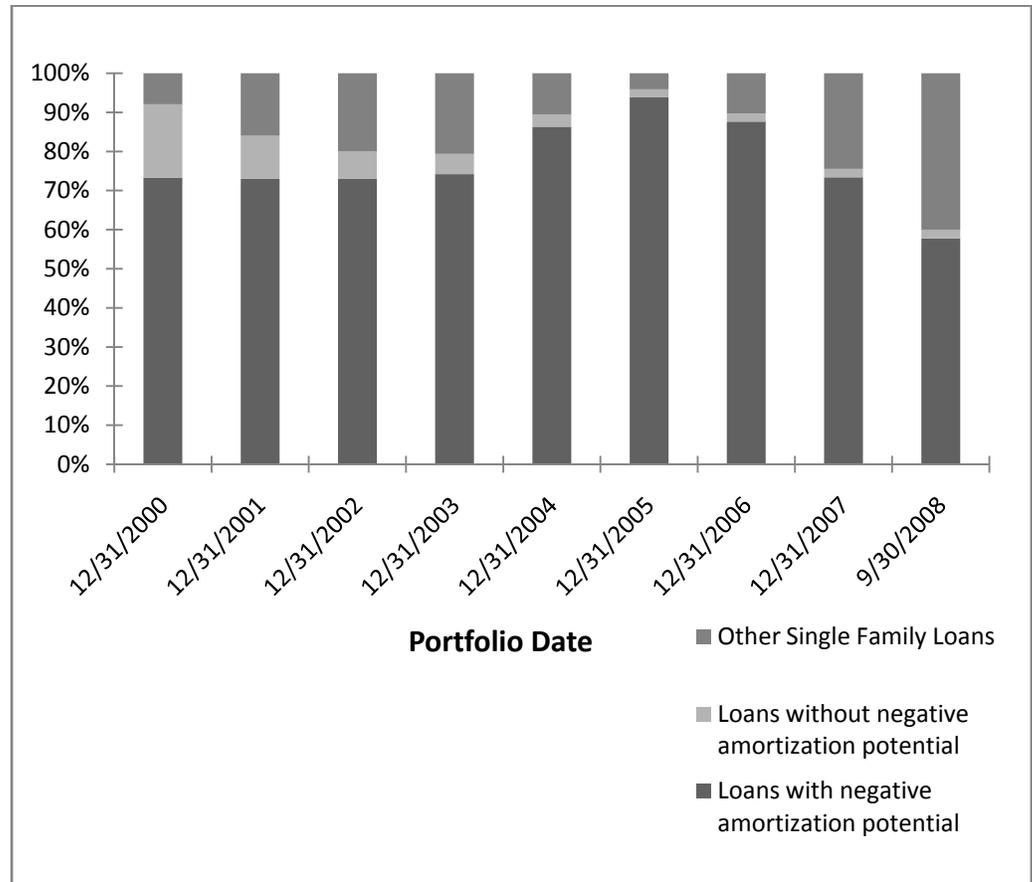
Within its single-family loan portfolio, Downey's pay option (option) ARM loans comprised 91 percent of total single-family mortgage loans as of end of 2005. Option ARM loans are a type of ARM that allows the borrower to choose between alternative monthly payment amounts during an initial period of the loan. Although single-family residential loans have historically been among the most secure assets in banks' portfolios, the downturn in the California real estate market that started in 2006 exposed the risk in Downey's high concentration in these loans. As a result, Downey suffered large losses and erosion of capital.

Concentration in Option ARM Products

Most of the loans in Downey's single-family residential loan portfolio were option ARM, a nontraditional mortgage product.¹ The underwriting for these loans can be risky because they give borrowers the option of making monthly payments that do not cover the interest charges accrued. The difference between the interest due and the amount paid is added to the principal balance of the loan, reducing the borrower's equity in the home (unless the home constantly increases in value at a rate higher than the additional principal amount, a condition unlikely sustainable in the long term). Downey started offering these loan products 10 years before its failure, and they had always been a high percentage of its total loan portfolio. As figure 1 shows, at the end of 2001, 73 percent of all Downey's loans had negative amortization potential, and by 2005, the percentage had grown to 91 percent. Most of Downey's option ARMs allowed borrowers to negatively amortize their loans up to 110 percent of the initial value of the loan. The decline in housing prices in Downey's California market area that began in 2006 resulted in even further declines in borrowers' equity in their homes.

¹ Interagency Guidance on Nontraditional Mortgage Product Risks, (October 4, 2006), states that nontraditional mortgage loans include such products as interest only mortgages where a borrower pays no loan principal for the first few years of the loan and payment option ARMs where the borrower has flexible payment options with the potential for negative amortization.

Figure 1: Downey's Residential Loan Portfolio by Type and Year



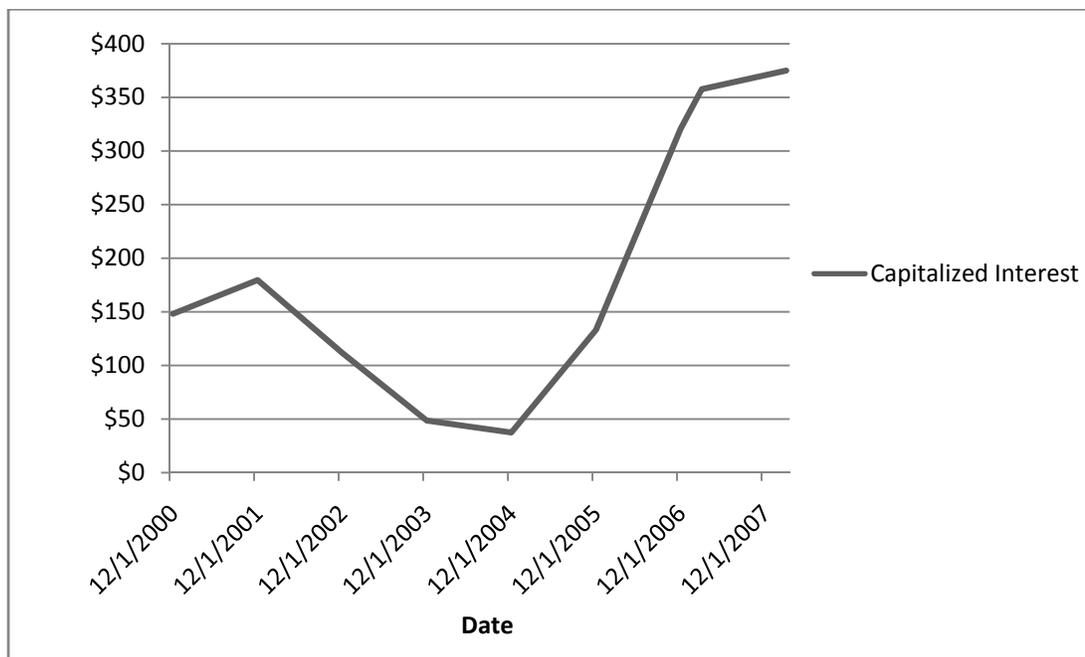
Source: Downey presentation to OTS (Sept. 30, 2008).

Furthermore, these loans, by their terms, would automatically recast into higher payment requirements after 5 years. However, Downey offered these loan products with a low introductory payment option that could potentially have accelerated the timeframe from 5 years to as few as 3 years if market interest rates were rising. For borrowers who frequently exercised the optional minimum (negative amortization) payment amount, the recast could occur sooner when the loan balance hit the 110 percent maximum value. The recast could significantly increase the borrower's monthly payment; not only would the interest rates increase, the interest amount owed would be based on a higher loan balance. As a result, Downey experienced increased delinquencies and foreclosures. Downey also had to increase its

allocations to the allowance for loan and lease losses (ALLL), all of which negatively affected Downey's income and capital.

Starting in 2005, there was an increase in Downey's capitalized interest balance. As shown in figure 2, the thrift's total amount of capitalized interest more than tripled from 2004 to 2005 and then tripled again in 2006 as borrowers elected the optional minimum payment.

Figure 2: Downey's Capitalized Interest by Year (in millions)



Source: OTS 2007 examination report, FDIC 2008 examination report

Generally accepted accounting principles require that capitalized interest be reported as earned income if there is a reasonable expectation of collection.² OTS examiners told us that in the case of Downey, the capitalized interest was reasonably expected to be collected because there was no history to suggest otherwise. Downey continued to report the capitalized interest as earned income when, in fact, in many instances the capitalized interest was never collected. As borrowers began defaulting on their loans,

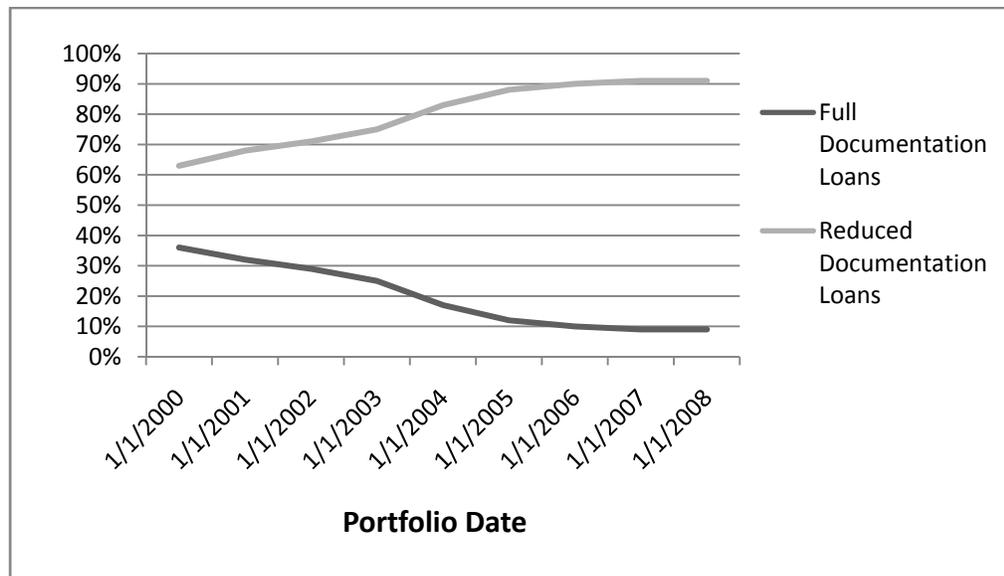
² Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

the number of foreclosures increased. As a result, Downey's losses increased, contributing to its failure.

Concentration in Reduced Documentation Loans

Over time, Downey's loan underwriting standards, in terms of income and asset documentation requirements, became more lenient. Downey required no documentation for some borrowers. For others, Downey required that assets, but not income, be documented. As figure 3 shows, the trend toward reduced documentation loans rose from an already high level of 60 percent of Downey's option ARM portfolio in 2000 to 91 percent of that portfolio in March 2008.

Figure 3: Documentation Type of Downey Option ARMs 2000-2008



Source: Downey presentation to OTS (Mar. 31, 2008).

According to OTS documentation, Downey started offering reduced documentation loan products in 1987 for borrowers who were unable to provide hard documentation of their income because they were self-employed or worked on commission. Downey decided to offer this product to borrowers outside this target group, however, and had several loan programs with reduced underwriting standards.

One of Downey's reduced-underwriting loan programs was the Downey Lite loan. For the loans made under this program, Downey did not verify the borrower's income but did verify the borrower's assets. Downey reviewed the borrower's FICO score and the appraisal of the property being held as collateral.

In October 2003, Downey expanded the use of an existing loan program called Downey Express, which was a stated income and stated asset loan – that is, Downey did not verify the borrower's income and assets. Underwriting was limited to Downey's review of the property appraisal (the program required a loan-to-value ratio (LTV) of no more than 75 percent) and the borrower's FICO score.³ According to the minutes of its October 2003 meeting, Downey's board of directors decided to expand the Downey Express program in an effort to remain competitive. Downey management informed the board that other thrifts imposed far fewer loan restrictions than Downey. Moreover, management told the board that mortgage brokers wanted the least number of loan conditions because rapid loan processing was essential in a purchase market.⁴ At the end of 2003, 90 percent of Downey's loans were originated by mortgage brokers and others in the wholesale market. At the same October 2003 meeting, the board agreed to management's request to raise the LTV ratio required for a Downey Express loan from 75 percent to 80 percent (having the effect of lowering underwriting standards further), and expanded the program to include subprime borrowers.

Concentration in Subprime Loans

As a part of its business, Downey also originated subprime loans. OTS's reports of examination (ROE) for 2002, 2004, 2005, and 2006 all reported that Downey had a concentration in subprime loans. During these years subprime loans made up as much as 16 percent of Downey's total loan portfolio. Over time, these loans represented a smaller and smaller percentage of Downey's loan portfolio, decreasing to 4 percent as of September 2008. However, both OTS and FDIC examiners expressed concerns as early as 2005 that Downey was classifying loans to borrowers with FICO

³ In its 2004 ROE, OTS noted that this program had a wide range of acceptable FICO scores for subprime borrowers.

⁴ The purchase market refers to the market for mortgages for home purchases. The other component of the primary mortgage market is the refinance market.

scores of less than 620 as prime. As of December 31, 2005, Downey had \$424 million of loans categorized as prime to borrowers with FICO scores below 620. Accordingly, the percentage of subprime loans in Downey's portfolio was potentially understated. Beginning in 2006, Downey defined all loans to borrowers with FICO scores of 620 or lower as subprime.

Layering of Risks

Downey's underwriting of option ARMs, reduced documentation, and subprime loans was considered high risk by OTS examiners. Downey engaged in an even riskier practice by offering two or more of these features in the same loan product. Through Downey, it was possible for a subprime borrower to get an option ARM loan (with negative amortization potential) with reduced documentation. At the end of 2003, 68 percent, or \$6.5 billion, of Downey's portfolio of mortgage loans held for investment had negative amortization and reduced documentation. By the end of 2005, this percentage had increased to 86 percent, or \$12.6 billion of Downey's loans held for investment. Additionally, while subprime loans were becoming a smaller portion of Downey's loan portfolio, reduced documentation and negative amortization features were being added to subprime loan products. At the end of 2003, 66 percent (\$647 million) of Downey's subprime loans had reduced documentation and negative amortization features; that percentage grew to 82 percent (\$866 million) by the end of 2005. This layering of risk greatly increased the risk associated with these Downey assets.

Resulting Collapse

By the end of 2007, Downey's option ARM portfolio began to quickly deteriorate. Downey had a large amount of option ARM loans that were on target to recast very soon and some that were on track to recast early because of negative amortization. This recasting would greatly increase many borrowers' monthly payments. Not only would interest rates on these loans rise, but - because of negative amortization - so would the principal balance on which the interest owed would be calculated. In an effort to stem the number of potential loan defaults, Downey instituted a plan for refinancing loans it deemed to have potential for default.

These refinanced loans would typically require higher monthly payments than borrowers' current minimum payments, but lower than those that would have resulted from recasting.

According to OTS examiners, Downey's external auditor initially agreed with management's view that this program was merely a loan refinancing program. After further review, however, the auditor concluded that the loan modification program was a troubled debt restructuring. Categorizing the program a troubled debt restructuring resulted in Downey deciding to designate many of the loans as nonaccrual assets, thereby removing the revenue stream from these loans from current earnings. Downey also had to increase its ALLL by \$65 million, thereby decreasing earnings.

Even with renegotiated loan terms, many Downey borrowers were unable to afford their new monthly payments. Downey reported in September 2008 that 20 percent of its borrowers were 30 days plus delinquent on their loan payments. Throughout 2008, Downey sustained substantial losses as loans continued to recast and defaults on loans increased. In the end, Downey could not recover from the massive losses it sustained on its risky nontraditional loan portfolio.

Inadequate Risk-Monitoring Systems

Throughout various examinations, OTS examiners expressed concerns about Downey's monitoring of risk in its single-family residential portfolio. OTS examiners told us that the thrift had increased its volume of nontraditional loans because of immense competition from its rivals. OTS examiners believed that Downey needed better risk-monitoring information to effectively weigh the risk associated with the nontraditional loans. Because Downey lacked quick, on demand risk-monitoring information on its single-family residential portfolio, the thrift continued to increase its use of nontraditional loans without proper knowledge of their risk potential.

Downey's assets grew from \$9.3 billion at the end of 2000 to over \$14.5 billion by the end of 2005. This growth was principally in nontraditional loan products. Downey management had little or no experience with some of these loan products during a significant

downturn in real estate values, and was slow to implement adequate risk-monitoring systems, hampering management's ability to identify the risk profiles of the loans it was selling.

OTS found in its 2004 examination that Downey had purchased risk-modeling software to measure the risk in its various single-family loan portfolios. Data to be generated by the risk-modeling software was considered to be essential for Downey to determine risk-based capital ratios and ALLL allocations. OTS examiners told us that Downey management was unfamiliar with the software, however, and did not use it appropriately. Even after the 2004 examination, risk-monitoring continued to be a problem for Downey. OTS examiners concluded that Downey's management of market risk needed to be improved, stating in the 2005 ROE that Downey's existing systems for managing market risks were not sophisticated enough to provide the thrift with a comprehensive assessment of market risk exposure. In its 2006 examination of Downey, OTS found that Downey needed to implement procedures to improve monitoring of the layered risks in its option ARM portfolio. In its 2007 ROE for Downey, OTS noted that Downey had made improvements in risk management that mitigated risks in the thrift's single-family residential portfolio and that numerous characteristics of the portfolio were being fully monitored and tracked. However, these improvements came too late as by this time Downey had a large loan portfolio with concentrations in higher-risk option ARM and reduced documentation loans. The downturn in the California real estate market that started in 2006 exposed the risk in these loans and Downey suffered large losses and erosion of capital.

Unresponsiveness to OTS Recommendations

OTS examiners described Downey management as competent but difficult, and said that many of its decisions were reactive rather than proactive. According to an OTS examiner, Downey management often challenged the opinions of the OTS examiners and began to cooperate more fully with OTS only after a 2006 board resolution, when Downey agreed to add two new directors to the board and create a task force to conduct a study of Downey's organizational and management structure. The lack of quick response by Downey management and its unwillingness to

adhere to OTS recommendations contributed to Downey's lack of an adequate risk-monitoring system and ultimately, its failure.

Another example of Downey management's failure to respond appropriately to OTS recommendations involved its mortgage servicing assets (MSAs). OTS recommended in the 2002 and 2004 ROEs that Downey hedge its MSAs to reduce risk. OTS requested several times that Downey hire someone familiar with the MSA market or to become more familiar with MSA hedging. During the same timeframe, Downey incurred net losses in its loan servicing activities. The net losses were \$40 million, \$27 million, and \$19 million for 2002, 2003, and 2004, respectively. In November 2004, Downey sold most of its MSAs to reduce future earnings volatility. The thrift's net MSA balance was reduced from \$82 million at year-end 2003 to \$18 million at year-end 2004.

High Turnover in Downey Management

Another recurring problem that OTS identified in its examinations of Downey was a lack of long-range goals and objectives, which examiners attributed in part to high turnover in senior management. Turnover was particularly high in 2004, at 37 percent. A new president and chief executive officer brought on in February 2004 resigned 7 months later. There was also turnover in the critical positions of chief credit officer and secondary marketing director. A growing concern of OTS examiners was that by 2005, Downey had experienced 50 percent growth in assets in a 5-year span, but had the same management structure as in 2000. In 2005 the situation had not improved with turnover at the senior management level reaching 43 percent. With all of these management changes, OTS examiners believed that Downey's ability to constructively plan for the future was hampered.

Decline in House Prices in Downey Markets

Ninety percent of Downey's loans were on properties located in California. A precipitous drop in California house prices between 2006 and 2008 became a significant factor in Downey's failure. OTS examiners told us that Downey's loan portfolio was geared toward borrowers who in the past, during periods of rising home values, were able to refinance their ARMs before recasting

occurred. In a declining housing market, that option became increasingly unavailable.

As of Downey's closure in November 2008, house prices in the Los Angeles metropolitan area had dropped 37 percent from their high in 2006. With the drop in housing prices, many borrowers lacked equity in their homes and were unable to refinance. This situation caused an increase in default rates and eventual foreclosures, which left the thrift with large amounts of real estate owned (REO) properties it was unable to sell. In addition, because of the decline in housing prices, Downey's loss percentage on each of its REO properties increased every month throughout 2007 and 2008. In September 2007, Downey's loss on a REO property was nearly 5 percent. By September 2008, the loss steadily increased to nearly 40 percent by September 2008. Downey reported a total net loss of \$51 million in 2007 and a total net loss of \$537 million for the 9-month period ending September 30, 2008. The increase in the number of and decline in the value of Downey's REO properties contributed significantly to Downey's ultimate failure.

OTS's Supervision of Downey

OTS conducted timely and regular examinations of Downey and provided oversight through its off-site monitoring. As required by OTS policy, OTS also conducted an internal failed bank review which found that a more forceful regulatory response is warranted when thrifts have concentrations of risky nontraditional mortgage products. We affirm OTS's internal findings and the need for corrective action. Particularly needed are more definitive guidance for examiners on concentration risk for nontraditional mortgage loans and OTS's authority to stop thrifts from taking excessive risks in these loan products.

We found that OTS did not follow its existing guidance for taking enforcement action as prescribed in the OTS Examination Handbook when it issued an informal enforcement action in 2006 rather than a formal enforcement action. OTS examiners told us that they exercised their regulatory discretion in taking informal rather than formal enforcement action. In addition, OTS examiners told us that the institution became more responsive to OTS's supervision and accomplished the same results as if formal

enforcement action had been taken. In this regard, we agree that the informal action taken was strong; however, OTS did not follow its own written guidance to the letter.

We also concluded that OTS used its authority under PCA in an appropriate manner when it issued a C&D order in September 2008 that among other things, reclassified Downey's capital level to adequately capitalized and imposed restrictions even though its capital level at the time met the definition of well-capitalized.

Table 1 summarizes the results of OTS's annual safety and soundness examinations starting with the 2002 examination cycle. Appendix 5 provides details of matters requiring board attention (MRBA) and other recommended corrective actions in the ROEs.

Table 1. Summary of OTS's Downey Examinations and Enforcement Actions

Date started	Assets (in millions)	CAMELS rating	Examination Results		
			Number of MRBAs	Number of corrective actions	Informal and Formal enforcement actions
12/2/2002	\$12,500	2/222223	3	9	None
1/12/2004	\$11,600	2/223223	6	15	None
1/3/2005	\$15,650	2/223223	8	22	None
1/3/2006	\$17,100	3/233223	9	15	Board Resolution 7/28/2006
3/5/2007	\$15,200	3/233222	3	15	C&D order for Bank Secrecy Act <u>compliance</u> issues 8/30/2007
3/10/2008	\$13,100	4/444443	10	14	C&D order for safety and soundness issues 9/5/2008
11/17/2008	NA	5/554543	Rating downgrade		Consent to the appointment of a conservator or receiver; Downey's board did not consent to appointment of receiver but did communicate that the board would be cooperative if OTS closed Downey

Source: OTS ROEs.

OTS's Internal Failed Bank Review Identified Several Key Areas Where OTS Guidance Should Be Strengthened

In accordance with OTS policy, OTS staff completed an internal review of the Downey failure.⁵ As discussed in a March 2009 report, OTS determined that the primary cause of Downey's failure was its exposure to concentrations in high-risk mortgage loans, which resulted in losses and erosion of capital as the California real estate market deteriorated.

OTS cited the following lessons learned in its report:

- Some underwriting practices evolving under competitive market conditions may produce loans of significantly greater risk. These practices must be evaluated for prudence for federally insured institutions, even if regarded as standard in the mortgage industry. The need for such evaluation is especially relevant to institutions with concentrations of loans generated under these standards.
- Due to considerably higher-risk profile of nontraditional mortgage loan products, particularly those with layered risk features, regulatory tolerance for concentrations in such loans must be significantly lower than for traditionally underwritten, prime 1 to 4 family loans.
- During extended periods of favorable economic conditions, high risk activities and concentration risks can be masked by financial success.
- Concentration risk mitigation practices are essential regardless of current economic conditions.
- The absence of explicit regulatory guidance or the support of sophisticated modeling techniques should not preclude regulators from exercising discretion in limiting or discontinuing activities presenting excessive risk.

The OTS report made the following recommendations:

⁵ OTS policy requires that an internal assessment be conducted when a thrift fails. That assessment, referred to as an internal failed bank review, is performed by staff independent of the region responsible for supervisory oversight of the failed thrift. The report is reviewed and signed by OTS's Deputy Director of Examinations, Supervision, and Consumer Protection.

Concentration Risk Mitigation

- In addition to exercising discretion towards imposing higher capital requirements, regional management should closely evaluate the need to impose concentration limits for nontraditional mortgage loans, set as a percentage of capital, appropriate to the risk level of the loan category.
- OTS should consider amendments to its Concentrations of Risk Policy providing for staff to seek absolute limits, expressed as percentages of capital, for concentrations in assets or liabilities presenting higher-risk. To prevent excessive concentration levels, such limits may need to be sought, notwithstanding the quality of management oversight or expertise.

Supervisory Approach

- In the absence of specific regulatory guidance, regional management should take aggressive proactive supervisory action to limit or cease activities presenting excessive risk.

Enforcement Review Committee (ERC) Documentation for Policy Compliance

- West Region management should remind staff of the importance of fully documenting conclusive support for recommended and approved actions under OTS Enforcement Policy. Regional staff should perform periodic reviews to validate full compliance.

OTS officials informed us that it has partially addressed the lesson learned regarding concentration risk mitigation by issuing a memorandum to thrift chief executive officers. In that memorandum, dated September 17, 2008, OTS directed that thrift board-approved loan policies should establish limits on mortgages originated by the thrift for sale to investors.⁶ The officials also stated that OTS plans to issue a directive by mid-July 2009 to fully address the issue. With respect to ERCs, OTS issued ND Bulletin

⁶ OTS, CEO Memorandum, "Documentation and Underwriting Standards," September 17, 2008. The memorandum describes how the level of pipeline, warehouse, and credit-enhancing repurchase exposure for mortgage loans originated for sale to non-government sponsored enterprise purchasers can constitute a concentration risk.

09-11, Regional Enforcement Review Committees, on May 1, 2009, requiring improved documentation supporting enforcement recommendations to the ERC. ND Bulletin 09-11 also requires OTS regions to monitor the compliance with and the effectiveness of enforcement actions, and provide recommendations to the ERC when modifications or terminations of enforcement actions are proposed.

Based on our review of the examination records and reports and our interviews with OTS staff, we affirm OTS's internal findings and the need for corrective action. Particularly needed, based on the causes of Downey's failure, are more definitive guidance on concentration risk for nontraditional mortgage loans and the expectations for OTS examiners and regional officials to address thrifts from taking excessive risks with respect to these loan products. We note that concentrations in nontraditional mortgage loans was a cause of the failure of IndyMac Bank, FSB, and other banks.⁷

A Stronger Supervisory Response to Downey's Concentrations Was Warranted

OTS examiners repeatedly expressed concern about the high risk posed by Downey's option ARMs, reduced documentation, and subprime loan products. Although OTS examiners reported their concerns about Downey's concentration in single-family residential, higher-risk, and layered-risk loans in the 2002 through 2006 ROEs, they did not direct Downey to take corrective actions to limit the thrift's concentration in these loans. However, in the 2002 ROE, OTS did impose a higher capital requirement on Downey's subprime loans. As discussed on page 8, Downey's concentration in subprime loans decreased to 4 percent as of September 2008 from 16 percent of its loan portfolio in 2002.

⁷ *OIG, Safety and Soundness: Material Loss Review of IndyMac Bank, FSB*, OIG-09-032 (Feb. 26, 2009). The primary cause of IndyMac's failure was its business strategy of originating and securitizing Alt-A loans on a large scale that resulted in a high concentration of risky assets. An Alt-A loan is a loan that typically does not involve verification or documentation of income, assets, or employment. Instead, the approval of the loan is based primarily on the applicant's FICO score.

According to OTS's October 2002 ND Bulletin 02-17, Concentrations of Risk, OTS examiners are to identify, report, evaluate, and develop an effective supervisory response concerning concentration of risk during examinations. Where supervisory concerns exist, examiners are to discuss those concerns within the body of the ROE and promptly initiate appropriate corrective or supervisory action. ND Bulletin 02-17 requires examiners to list specific concentrations of risk (defined as a higher-risk asset or liability whose aggregate total exceeds 25 percent of core capital) in an appendix to the ROE. ND Bulletin 06-14, issued in November 2006, superseded ND Bulletin 02-17 and defined a concentration as a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of core capital plus ALLL. ND Bulletin 06-14 also requires that examiners identify concentrations that exceed 100 percent of core capital plus ALLL on the concentrations page in the ROE. Additionally, both ND Bulletin 02-17 and ND Bulletin 06-14 required examiners to comment on the following factors inherent in the thrift's operations that could aggravate concentration risk:

- lack of board of director policies on concentrations and established limits on riskier type of business activities,
- lack of oversight by the board of directors,
- lack of management depth or expertise,
- poor internal controls or underwriting processes,
- rapid growth unchecked by management review and established limits on activity, and
- inadequate management information systems to identify and monitor concentrations of risk.

In the 2002 through 2006 ROEs, examiners commented on multiple factors aggravating the concentration risk at Downey. One factor discussed in every ROE was inadequate management information systems for identifying and monitoring concentration risk. In the 2002 ROE, OTS examiners recommended that Downey develop a loss modeling capability to better assess and differentiate the loss potential in the nontraditional loan products being offered. OTS reported in the 2004 ROE that Downey needed to enhance its risk-monitoring systems to address Downey's concentration in layered-risk loans. During the 2005 and 2006 exams, OTS

continued to express concerns regarding Downey's ability to analyze risk within its loan portfolio and regarding significant exposure to market risks associated with its concentration in higher-risk nontraditional mortgages.

OTS examiners also expressed concerns regarding management's depth and expertise and the lack of oversight by Downey's board. Furthermore, examiners expressed concern in the 2005 ROE about management's stability given the substantial growth that had occurred and the high turnover at Downey's executive level. In the 2006 ROE, examiners continued to report weaknesses in board oversight and how management instability continued to adversely affect management's ability to recognize and respond to emerging risk factors. OTS examiners reported that management did not satisfactorily quantify the risks relating to core and risk-based capital; therefore, OTS required that Downey management establish higher capital ratios given the higher-risk characteristics of its loan portfolio.

OTS examiners did not require Downey to limit concentrations in higher-risk loan products. We believe that in light of the OTS's repeated expressions of concern and management's unresponsiveness to those concerns, OTS should have been more forceful, at least by 2005, to limit such concentrations. In interviews, OTS examiners commented that this would have been difficult since there was no history of losses in Downey's option ARM, low documentation, and layered-risk loans from 2002 to 2006. However, both ND Bulletin 02-17 and the successor ND Bulletin 06-14 provide that examiners can direct thrifts to discontinue activities that lead to a specific high-risk concentration when proper oversight and controls are not in place. We believe that if there is one lesson to be learned from Downey's failure it is that a lack of losses in the short term should not negate the need to address risk exposure such as high concentrations.

Therefore, based on our review of the current OTS guidance on concentrations of risk and in light of the role high concentrations played in Downey's failure, we believe that OTS's guidance could be more specific as to when OTS examiners should require thrifts to take action on high concentrations. While ND Bulletin 06-14 does require examiners to make a determination about the

materiality of the risk a concentration poses and the need for corrective or supervisory action, it does not provide specific guidelines on determining materiality, beyond requiring the listing of assets and liabilities that exceed 100 percent of core capital plus ALLL in the ROE. In Downey's case, as of December 31, 2005, the thrift's option ARMs and Downey Lite loans had reached 1004 percent and 946 percent, respectively, of core capital plus ALLL.

OTS Did Not Follow Its Guidance Regarding Enforcement Actions When Downey's CAMELS Composite Rating Was Downgraded to 3

As a result of its 2006 examination of Downey, OTS downgraded the thrift's CAMELS composite and asset quality ratings from 2 to 3, and for the third consecutive examination, the management component was rated a 3. As a result, OTS had the thrift execute an informal enforcement action in the form of a board resolution.

According to section 370 of the OTS Examination Handbook in effect at the time, a formal enforcement action was presumed warranted for 3-rated thrifts under any of the following circumstances:

- weak management
- uncertainty as to whether management and the board have the ability or willingness to take appropriate corrective measures
- rapidly deteriorating conditions
- a 3 rating for two consecutive examinations following the thrift entering into an informal enforcement action, unless the thrift complies with the informal enforcement action and no new grounds exist for taking a formal action

Section 370 did permit examiners the flexibility to use informal enforcement actions against 3-rated thrifts if the thrift had strong management and examiners believed remedial measures to examination findings would be taken promptly.

We believe that the first two circumstances mentioned above were clearly met when OTS downgraded Downey's composite rating to a 3. Accordingly, based on this guidance, OTS should have issued a formal enforcement action in May 2006. The first time OTS

issued a formal enforcement action against Downey was on August 30, 2007, in the form of a C&D order. However, that C&D order related to the Bank Secrecy Act/Anti-Money Laundering compliance deficiencies. The first formal enforcement action by OTS to address Downey's unsafe and unsound lending practices was not issued until September 5, 2008, in the form of a C&D order - only about 10 weeks before OTS closed Downey on November 21, 2008.

The January 2006 examination marked the third consecutive examination in which Downey's management component was rated a 3. The resulting ROE, among other things, listed repeated concerns and noted an unresponsive/resistant Downey management. Instead of taking a formal enforcement action, OTS required Downey to execute a board resolution, an informal enforcement action requiring that (1) two new directors be added to the board with the expectation that the new directors would infuse more independence within the board, and (2) a task force be created to conduct a study of Downey's organizational and management structure and provide recommendations to enhance the structure.

When we asked why no formal enforcement action was taken earlier with regards to safety and soundness issues, OTS West Region personnel told us that OTS examiners are allowed flexibility on whether to take aggressive action and may forgo such action if they are confident in the board's and management's commitment and ability to correct problems or weaknesses. They also told us that OTS's issuance of a formal enforcement action might have hampered Downey's ability to attract qualified board candidates, since formal actions are publicly available information. OTS examiners told us that they exercised their regulatory discretion in taking informal rather than formal enforcement action.

We agree that OTS requiring Downey to add two additional directors to the board was a strong action. Downey did add two additional directors, and according to OTS officials, this did result in improved performance and responsiveness by the board to OTS's supervision.

In July 2008, OTS published Regulatory Bulletin 37-23, Administration, which replaced section 370 with section 080, Enforcement Actions. One substantive change called for by the bulletin related to guidance for enforcement actions against 3-rated thrifts. As mentioned earlier, in section 370 of the handbook, there was a presumption that OTS examiners were to issue a formal enforcement action if certain circumstances existed, such as weak management and lack of willingness by management to correct deficiencies. Under the new section 080, there is now a presumption for 3-rated thrifts that OTS examiners will issue an informal enforcement action and consider issuing a formal enforcement action in the circumstances specified.⁸ The situation at Downey by 2006 would have still warranted a formal enforcement action under this new guidance, in our opinion.

OTS Appropriately Used Prompt Corrective Action

The purpose of PCA is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. PCA provides federal banking agencies with the authority to take certain actions when an institution's capital drops to certain levels. PCA also gives regulators flexibility to discipline institutions based on criteria other than capital to help reduce deposit insurance losses caused by unsafe and unsound practices.

In the September 2008 C&D order, OTS required Downey to meet and maintain specific capital levels, and OTS deemed the thrift to be adequately capitalized even though Downey's capital level met the definition of well-capitalized. While its capital level met the definition of well-capitalized, OTS examiners stated in the 2008 ROE that capital was considered insufficient to fully support the risk profile of Downey. Because of its adequately capitalized designation, Downey was prohibited from accepting or renewing brokered deposits unless it obtained a waiver from FDIC. Downey

⁸ During our audit, we discussed with OTS officials why the change was made. The OTS officials explained that the guidance in the Regulatory Bulletin 37-23 makes it more likely a 3 rated thrift will have an enforcement action taken against it, rather than no enforcement action. The guidance retains the prior language outlining factors to consider in determining whether a formal enforcement action is warranted. We believe this explanation for the change is reasonable and note that examiners still can take stronger action when circumstances warrant.

remained designated as adequately capitalized up to its failure on November 21, 2008. We conclude that OTS appropriately used its authority under PCA to reclassify Downey's capital level to adequately capitalized and to prohibit the thrift from accepting or renewing brokered deposits.

Recommendation

Our material loss review of Downey and a concurrent material loss review of PFF Bank and Trust are the fourth and fifth such reviews we have performed of failed OTS-regulated financial institutions during the current financial crisis. Appendix 6 lists the prior completed material loss reviews and our associated recommendations. OTS management agreed with the prior recommendations and has taken or is taking corrective actions to address them.

As a result of our material loss review of Downey, we recommend that the Director of OTS ensure that the recommendations from OTS's internal assessment of the Downey failure are implemented and the lessons learned described in that assessment are taken into account going forward. In this regard, OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable. OTS should assess the need for more guidance for examiners on determining materiality of concentrations and determining appropriate examiner response to high-risk concentrations, including when to impose absolute limits to prevent excessive concentration. Additionally, OTS should formally communicate to the industry the guidance in ND Bulletin 06-14 as to OTS's expectation that concentration measurements and limits be set as a percent of capital, not just as a percent of total assets or loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

Management Response

OTS concurred with our recommendation. OTS plans to issue further guidance regarding concentrations to both the thrift

industry and OTS staff that will address asset and liability concentration issues described in this report, as well as those that have been identified internally by OTS. OTS plans to implement our recommendation from this review by the end of the third quarter of 2009. The response is provided as appendix 7.

OIG Comment

OTS's planned actions meet the intent of our recommendation.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-5776 or Jeff Dye, Audit Manager, at (202) 927-0384. Major contributors to this report are listed in appendix 8.

Susan L. Barron
Audit Director

We conducted this material loss review of Downey Savings and Loan Association, F.A., (Downey) in response to our mandate under section 38(k) of the Federal Deposit Insurance Act, as amended.⁹ This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency, that:

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution, including its implementation of the prompt corrective actions provisions of section 38; and
- makes recommendations for preventing any such loss in the future.

Section 38(k) defines a loss as material if it exceeds the greater of \$25 million or 2 percent of the institution's total assets. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss has been incurred.

We initiated a material loss review of Downey based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC). As of May 8, 2009, FDIC's estimated cost to the Deposit Insurance Fund from Downey's failure was \$1.4 billion.

To accomplish our review, we conducted fieldwork at the Office of Thrift Supervision's (OTS) headquarters in Washington, D.C., and OTS's regional office in Daly City, California. We also met with officials of FDIC's Division of Supervision and Consumer Protection in San Francisco, California, and interviewed FDIC's Division of Resolutions and Receiverships personnel. We conducted our fieldwork from January 2009 through April 2009.

To assess the adequacy of OTS's supervision of Downey, we determined (1) when OTS first identified Downey's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the

⁹ 12 U.S.C. § 1831o(k).

problems. We also assessed whether OTS (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we performed the following procedures:

- Based on reviews of the reports of examinations (ROE), we determined that Downey's composite CAMELS rating was first downgraded to 3 during the 2006 examination. Based on a limited review of ROEs prior to this examination where the problems that led to the downgraded CAMELS composite rating were first identified by OTS, we established that the scope of our audit would be from 2002, three examinations prior to the 2006 examination, through 2008. We reviewed OTS's supervisory files and records for Downey from 2002 through 2008. We analyzed ROEs, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.
- We interviewed and discussed various aspects of the supervision of Downey with OTS officials and examiners to obtain their perspective on the thrift's condition and the scope of the examinations. We also interviewed FDIC officials who were responsible for monitoring Downey for federal deposit insurance purposes.
- We interviewed FDIC Division of Resolutions and Receiverships personnel who were involved in the receivership process, which was conducted before and after Downey's closure and appointment of receiver.

- We reviewed Downey's records obtained by FDIC Division of Resolutions and Receiverships and located at the former Downey headquarters in Newport Beach, California.
- We assessed OTS's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act, at 12 U.S.C. § 1820 et seq.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Downey History

Downey Savings and Loan Association, F.A., (Downey) was formed in 1957 as a California state-chartered savings and loan association. The home office moved to Newport Beach, California, in 1990. The association converted to a federal charter in 1995. As of September 30, 2008, Downey had 170 retail branches in California and 5 branches in Arizona.

Downey Financial Corporation (DFC), which the Office of Thrift Supervision (OTS) classified as a noncomplex holding company, formed in 1994. DFC was a shell holding company that conducted limited operations.

Downey operated a wholly-owned subsidiary, DSL Service Company, a diversified real estate development company. In the several years preceding Downey's failure, DSL Service Company had sold many of its assets at a net gain, the proceeds of which were used to offset Downey's losses and erosion of capital.

Appendix 4 contains a chronology of significant events regarding Downey.

Types of Examinations Conducted by OTS

OTS conducts various types of examinations including safety and soundness, compliance, and information technology.

OTS must conduct full-scope, onsite examinations of insured thrifts once during a 12-month cycle or an 18-month cycle.

OTS conducts a full-scope examination of an insured thrift every 12-months until the thrift's management has demonstrated its ability to operate the institution in a safe and sound manner and satisfied all conditions imposed at the time of approval.

The 18-month examination interval applies to insured thrifts that have total assets of \$250 million or less that:

- received a CAMELS composite rating of 1 or 2 and a Compliance rating of 1 or 2 for their most recent examination;
- received a CAMELS Management component rating of 1 or 2 for their most recent examination;
- are well-capitalized;
- are not currently subject to a formal enforcement proceeding or order by OTS or FDIC; and
- have not undergone a change in control during the 12-month period since completion of the last full-scope examination.

During a full-scope examination, examiners conduct an onsite examination and rate all CAMELS components. OTS then assigns each thrift a composite rating based on its assessment of the overall condition and level of supervisory concern.

Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of reports of examinations (ROE) identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

Informal Enforcement Actions

When a thrift's overall condition is sound, but it is necessary to obtain written commitments from a thrift's board of directors or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in

- well- or adequately-capitalized thrifts and
- thrifts with a composite rating of 1, 2, or 3.

Informal actions notify a thrift's board and management that OTS has identified problems that warrant attention. A record of informal action is beneficial in case formal action is necessary later.

If a thrift violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil

money penalties for noncompliance. However, OTS may initiate more severe enforcement action against a noncompliant thrift. The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS notes.

Informal enforcement actions include supervisory directives, memoranda of understanding, and board resolutions.

Formal Enforcement Actions

If informal tools do not resolve a problem that has been identified, OTS is to use formal enforcement tools.

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act, as amended. They are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. OTS is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

Because formal actions are enforceable, OTS can assess civil money penalties against thrifts and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require the thrift to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and prompt corrective action directives.

OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include the following:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- whether the thrift has repeated the illegal action or unsafe or unsound practice;

- the likelihood that the conduct may occur again;
- the thrift's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the thrift's management, board of directors, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;
- whether the thrift's condition is improving or deteriorating; and
- the presence of unique circumstances.

Allowance for loan and lease losses_	A valuation reserve established and maintained by charges against the financial institution's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. These valuation allowances are established to absorb unidentified losses inherent in the institution's overall loan and lease portfolio.
Board resolution	A document designed to address one or more specific concerns identified by the Office of Thrift Supervision (OTS) and adopted by a thrift's board of directors.
CAMELS	An acronym for performance rating components for financial institutions: <u>C</u> apital adequacy, <u>A</u> sset quality, <u>M</u> anagement administration, <u>E</u> arnings, <u>L</u> iquidity, and <u>S</u> ensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst. OTS uses the CAMELS rating system to evaluate a thrift's overall condition and performance by assessing each of the six rating components and assigning numerical values. OTS then assigns each thrift a composite rating based on its assessment of the overall condition and level of supervisory concern.
Cease and desist order	A type of OTS formal enforcement action. A Cease and Desist (C&D) order normally requires the thrift to correct a violation of a law or regulation, or an unsafe or unsound practice. OTS may issue a C&D order in response to violations of federal banking, securities, or other laws by thrifts or individuals, or if it believes that an unsafe or unsound practice or violation is about to occur.
Compliance	The part of a financial institution examination that includes an assessment of how well the institution manages compliance with consumer protection and public interest laws and regulations, including the Bank Secrecy Act.

Concentration	As defined by OTS, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus allowance for loan and lease losses. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty. Some higher-risk asset or liability types (e.g., residual assets) may warrant monitoring as concentrations even if they do not exceed 25 percent of core capital plus allowance for loan lease losses.
Concentration risk	Risk in a loan portfolio that arises when a disproportionate number of an institution's loans are concentrated in one or a small number of financial sectors, geographical areas, or borrowers. If loans are more broadly distributed, weaknesses confined to one or a small number of sectors, areas, or borrowers would pose a smaller risk to the institution's financial health.
FICO score	A credit score provided to lenders by a credit reporting bureau to reflect information that the bureau keeps on file about the borrower. A score is produced using software developed by the Fair Isaac Corporation (FICO). The software takes into consideration borrower information such as (1) timeliness of payments; (2) the length of time credit has been established; (3) the amount of credit used versus the amount of credit available; (4) the length of time at present residence; and (5) negative credit information such as bankruptcies, charge-offs, and collections. The higher the credit score is, the lower the risk to the lender.
Field visit	A visit conducted to review specific areas of concern that OTS has about an institution.
Hedging	A strategy designed to reduce investment risk. A hedge can help lock in existing profits. Its purpose is to reduce the volatility of a portfolio, by reducing the risk of loss.

Loan-to-value ratio	<p>A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. In accordance with Interagency Guidelines for Real Estate Lending Policies (app. to 12 C.F.R. 560.101), institutions' internal loan-to-value limits should not exceed (1) 65 percent for raw land; (2) 75 percent for land development; and (3) 80 percent for commercial, multifamily, and other nonresidential loans. The guidelines do not specify a limit for owner-occupied one- to four-family properties and home equity loans. However, when the loan-to-value ratio on such a loan equals or exceeds 90 percent at the time of origination, the guidelines state that the thrift should require mortgage insurance or readily marketable collateral.</p>
Matters requiring board attention	<p>A practice noted during an OTS examination of a thrift that deviates from sound governance, internal control, and risk management principles. The matter, if not addressed, may adversely affect the thrift's earnings or capital, risk profile, or reputation or may result in substantive noncompliance with laws Or regulations, internal policies or processes, OTS supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the institution. Although matters requiring board attention are not formal enforcement actions, OTS requires that thrifts address them. A thrift's failure to do so may result in a formal enforcement action.</p>
Mortgage broker	<p>An intermediary that brings mortgage borrowers and mortgage lenders together but does not use its own funds to originate mortgages. A mortgage broker gathers paperwork from a borrower and passes it along to a mortgage lender for underwriting and approval. The mortgage funds are then lent in the name of the mortgage lender. A mortgage broker</p>

	<p>collects an origination fee and/or a yield spread premium from the lender as compensation for its services. A mortgage broker differs from a mortgage banker, which closes and funds a mortgage with its own funds. Mortgage brokers frequently facilitate transactions for mortgage bankers.</p>
Mortgage servicing asset	<p>The segment of a mortgage that is held by a mortgage servicer. Mortgages have two asset components: (1) a loan that can be sold as a mortgage-backed security to the wholesale market and (2) a servicing segment. Servicing a mortgage consists of collecting payments on the loan and distributing them to the loan investor. Mortgage servicers derive revenue by providing these services. The servicing segments of loans have a specific value and are therefore considered assets.</p>
Nonaccrual assets	<p>A loan in which interest accruals have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time.</p>
Payment shock	<p>A very large increase in the payment on an adjustable rate mortgage, resulting in potential inability of the borrower to afford the payment</p>
Prompt Corrective Action	<p>A framework of supervisory actions, set forth in 12 U.S.C. §1831o, for insured depository institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The prompt corrective action minimum requirements are as follows:</p>

Appendix 3
Glossary

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well capitalized ^a	10% or greater	and	6% or greater	and	5% or greater
Adequately capitalized	8% or greater	and	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

^a To be well-capitalized, a thrift also cannot be subject to a higher capital requirement imposed by OTS.

Real estate owned property Real property that a thrift holds as a consequence of defaults on loans. Such property is typically a poor or nonearning asset. A thrift's acquisition of a limited amount of real estate owned property is an unavoidable result of normal business operations.

Risk-based capital ratios These prompt corrective action ratios consist of Tier 1 risk-based capital ratio (Tier 1 capital to risk-weighted assets) and total risk-based capital ratio (ratio of total capital to risk-weighted assets). These ratios are used to determine the thrift's capital category as shown above.

Risk-weighted asset An asset rated by risk to establish the minimum amount of capital that is required within institutions. To weight assets by risk, an institution must assess the risk associated with the loans in its portfolio. Institutions whose portfolios hold more risk require more capital.

Safety and soundness The part of an examination that includes a review and evaluation of each of the component CAMELS ratings (see explanation of CAMELS, above).

Single-family residential	A residential structure designed to include one dwelling that shares no common ground with neighboring properties.
Tier 1 (core) capital	An amount consisting of common shareholder's equity (common stock, surplus, and retained earnings), noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. In accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, OTS requires that Tier 1 capital represent 4 percent of total assets, or 3 percent for thrifts with a CAMELS composite rating of 1, adjusted for investment in subsidiaries, gains and losses on available-for-sale securities, and certain hedges.
Troubled condition	<p>A condition in which a thrift meets any of the criteria below:</p> <ul style="list-style-type: none">• OTS notifies it in writing that it has been assigned a composite CAMELS rating of 4 or 5.• It is subject to a capital directive, a C&D order, a consent order, a formal written agreement, or a prompt corrective action directive relating to its safety and soundness or financial viability.• OTS informs it, in writing, of its troubled condition based on information available to OTS. Such information may include current financial statements and reports of examination.

The following chronology describes significant events in the history of Downey Savings and Loan Association, F.A. (Downey), including examinations conducted and enforcement actions taken by the Office of Thrift Supervision (OTS).

- 10/1/1957 The thrift is formed as a California-licensed savings and loan association.
- 10/21/1994 Downey Financial Corporation (DFC), Downey's holding company, is incorporated in Delaware.
- 1995 The thrift is converted into a federal savings and loan association.
- 2/9/1998 OTS issues a report of examination (ROE) expressing concern with rising negative amortization loans. In the report, OTS requires Downey to underwrite subprime loans at the fully indexed rate to decrease the risk that the borrower will default on the loan once the payments increase after the initial rate period.
- 3/26/1999 OTS issues a ROE expressing concern with rising negative amortization and subprime loans. OTS notes that increased risk warrants annual revalidation of internal capital target policies for Tier 1 leverage capital and total risk-based capital.
- 6/30/2000 OTS issues a ROE directing Downey's board to change \$1.2 billion of negative amortization loans from 50 percent risk-weight to 100 percent risk-weight because they had loan-to-value (LTV) ratios in excess of 80 percent. OTS also directed Downey not to make additional negative amortization loans because the thrift's balance of loans with LTV ratios in excess of 90 percent exceeded OTS's supervisory LTV limits.
- 9/18/2000 OTS examiners rescind both corrective actions from the June 30, 2000 ROE after concluding that Downey's appeal of those corrective actions would likely be granted. Downey, as a result, continues to make negative amortization loans.¹⁰

¹⁰ Downey appealed the decision to OTS headquarters and the decision was eventually overturned. TB-68, *Supervisory Review, Appeal and Reconsideration Process and Ombudsman Matters*, provides a process for the review and appeal of OTS supervisory decisions and examination findings, reconsideration of OTS application decisions, and utilization of the OTS Ombudsman. TB-68 was subsequently amended by TB-68a on June 10, 2004 with minor revisions.

- 12/14/2001 OTS issues a ROE requiring special quarterly reporting of negative amortization and subprime loans. OTS uses interagency guidance on subprime lending in assessing this area during the examination.¹¹
- 12/2/2002 OTS begins an examination of Downey that is completed on March 13, 2003 resulting CAMELS ratings of 2/222223. Downey meets the regulatory capital standard for a well-capitalized designation.
- 1/16/2003 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2002.
- 4/14/2003 OTS issuing a ROE with matters requiring board attention (MRBA) that mandates all subprime loans include 1.5 times the risk-weighted factor and requiring that Downey expand its loss analysis modeling and portfolio monitoring.
- 1/12/2004 OTS, joined by FDIC, begins an examination of Downey that is completed on April 1, 2004 resulting in CAMELS ratings of 2/223223. Downey meets the regulatory capital standard for a well-capitalized designation.
- 1/16/2004 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2003.
- 1/23/2004 A new president/chief executive officer (CEO) for Downey is named.
- 4/22/2004 OTS issues a ROE for Downey with the management component CAMELS rating downgraded to a 3 and includes a MRBA requiring support regarding the analysis of capital for loans with negative amortization features and reduced documentation requirements.
- 6/23/2004 A new chief credit officer for Downey is appointed.
- 8/26/2004 The President/CEO for Downey, named 8 months earlier, is terminated.
- 8/31/2004 The Chief Credit Officer for Downey, named 2 months earlier, resigns.

¹¹ The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency, and OTS jointly issued *Interagency Guidance on Subprime Lending*, on March 1, 1999. This guidance was intended to remind banks of the risks inherent in subprime lending and to outline the types of controls banks should have in place when engaging in this type of lending.

Appendix 4
Chronology of Significant Events

- 9/17/2004 A new chief financial officer for Downey is named.
- 9/30/2004 The director of portfolio management and secondary marketing for Downey resigns.
- 11/17/2004 A new director of secondary marketing is named.
- 1/3/2005 OTS, joined by FDIC, begins an examination of Downey that is completed on March 18, 2005 resulting in CAMELS ratings of 2/223223. Downey meets the regulatory capital standard for a well-capitalized designation.
- 3/1/2005 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2004.
- 4/27/2005 OTS issues a ROE requiring Downey to further support its capital assessment and develop a plan to address weaknesses in management structure and information technology and personnel resource shortages.
- 5/25/2005 A new chief credit officer for Downey is named.
- 1/3/2006 OTS, joined by FDIC, begins an examination of Downey that is completed on April 6, 2006 resulting in CAMELS ratings of 3/233223. Downey meets the regulatory capital standard for a well-capitalized designation.
- 2/28/2006 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2005.
- 3/8/2006 A new Chief Financial Officer for Downey is named.
- 5/16/2006 OTS issues the ROE for the examination of Downey that begun on January 3, 2006 and downgrades Downey's composite CAMELS rating from a 2 to a 3 as a result of increasing concerns with risks of option adjustable rate mortgages (ARM) and continuing management deficiencies, including weaknesses in board oversight and management instability.
- 6/9/2006 Downey's board met to discuss May 16, 2006 ROE findings. OTS provides the board with a board resolution that adds two independent directors and creates a special task force to evaluate Downey's management structure.

Appendix 4
Chronology of Significant Events

- 7/28/2006 OTS receives a signed copy of the board-approved resolution.
- 10/16/2006 OTS, joined by FDIC, conducts a special field visit to follow up on corrective actions from the January 3, 2006 examination.
- 11/3/2006 Two new independent directors join the board to comply with the board resolution; a chief risk officer position is created and filled as well.
- 12/14/2006 OTS receives a final copy of the board's special task force report. The report includes recommendations to enhance strategic planning, succession planning, retention planning, and expansion of the senior management team.
- 12/27/2006 OTS sends a letter to Downey summarizing the findings of the October 16, 2006 special field visit and indicating that all corrective actions in the January 3, 2006, ROE had been resolved.
- 2/28/2007 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2006.
- 3/5/2007 OTS, joined by FDIC, begins an examination of Downey that is completed on August 2, 2007 resulting in CAMELS ratings of 3/233222. Downey meets the regulatory capital standard for a well-capitalized designation.
- 8/30/2007 OTS issues a cease and desist (C&D) order against Downey. The C&D order is based on Bank Secrecy Act deficiencies identified during the examination.
- 10/1/2007 A new position of president is created for Downey and filled as required by OTS.
- 2/28/2008 DFC's external auditor issues an unqualified audit opinion on DFC's consolidated financial statements as of December 31, 2007.
- 3/10/2008 OTS, joined by FDIC, begins an examination of Downey that is completed on July 23, 2008 resulting in CAMELS ratings of 4/444443. Downey meets the regulatory capital standard for a well-capitalized designation.
- 4/29/2008 At a quarterly meeting, OTS recommends that Downey's chairman, CEO, and president hire an investment banker and actively search for capital in

advance of a possible ratings downgrade and potential enforcement action.

- 6/1/2008 DFC contributes \$50 million in capital to Downey.
- 6/25/2008 Downey's president, named 10 months earlier, is terminated.
- 7/2008 Downey hires an investment banker in an effort to market the thrift to obtain more capital.
- 7/15/2008 OTS designates Downey as in "troubled condition" as a result of examination findings.
- 7/24/2008 Downey's chairman and CEO resign from Downey to remove obstacles to a possible sale or merger of the bank.
- 7/29/2008 OTS presents the Downey board with a proposed C&D order that incorporates heightened capital ratios and a timeline to raise capital.
- 9/5/2008 OTS issues C&D orders to Downey and DFC. The C&D order to Downey requires Downey to (1) meet and maintain minimum capital levels of Tier 1 core capital of 7 percent and total risk based capital of 14 percent (regulatory minimum requirements are 6 percent and 10 percent, respectively); (2) update its capital augmentation and strategy plan; (3) adopt and submit for OTS review a classified asset reduction plan; (4) adopt and submit for OTS review a real estate owned disposition plan; (5) submit for review a management plan; (6) review, approve, and submit for OTS review a long-term business plan; (7) adequately address all corrective actions set forth in the March 10, 2008, ROE; (8) not increase its total assets during any quarter beginning with the quarter ending June 30, 2008; (9) and not resume payment option ARM or stated income lending.

The C&D order to DFC requires DFC to (1) neither accept nor request that Downey make or pay any dividends; (2) comply with prior notification requirements for changes in directors and senior executive officers; (3) not enter into, renew, extend, or revise any contractual arrangement relating to compensation or benefits for any senior executive officer or director of the holding company unless it first provides OTS 30 days prior written notice; (4) not make any golden parachute payment or prohibited indemnification payment; (5) not incur, issue, renew or rollover any debt,

increase any current lines of credit, or guarantee the debt of any entity without at least 30 days prior written notice to and receipt of non-objection from OTS; and (6) ensure that Downey complies with all of the terms of its C&D order.

- 9/22/2008 A new CEO is named in accordance with the C&D order.
- 9/29/2008 OTS, joined by FDIC, begins an examination to determine Downey's compliance with of the C&D order. No examination report is issued as the thrift is closed before completion of the examination.
- 10/20/2008 Downey submits a business plan to OTS as required by the C&D order. The business plan calls for Downey to seek a buyer for itself while managing its liquidity position, significantly reducing new lending, reducing problem assets, and reducing concentrations in option ARMs and stated income loans.
- 10/28/2008 DFC files an application with the Capital Purchase Program under the Department of the Treasury's Troubled Assets Relief Program authorized by the Emergency Economic Stabilization Act of 2008. DFC seeks \$214 million in capital. The request is filed contingent upon DFC entering into (1) a definitive agreement relative to recapitalization of the company or (2) a definitive merger agreement.
- 10/30/2008 Downey's CEO, chairman, and investment banker representatives attend a meeting requested by OTS headquarters in Washington, DC, to discuss its efforts to raise capital. The CEO states that Downey has exhausted possibilities for a private solution. OTS contacts FDIC's Division of Receiverships and Resolutions following the meeting to accelerate marketing of the institution.
- 11/17/2007 OTS rejects the business plan submitted by Downey on October 20, 2008. OTS downgrades Downey's CAMELS composite rating to a 5 and requests Downey's board sign the Consent to Appointment of Receiver.
- 11/20/2008 OTS downgrades DFC's CAMELS composite rating to a 5.
- 11/21/2008 Downey is closed by OTS, and FDIC is appointed as receiver.

This appendix lists all Office of Thrift Supervision (OTS) safety and soundness examinations of Downey beginning December 2002 until the thrift's failure in November 2008 and provides information on the significant results of those examinations. Generally, matters requiring board attention represent the most significant items requiring corrective action found by the examiners.

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
12/2/2002	2/222223	\$12,500	<p data-bbox="683 678 1089 705"><u>Matters requiring board attention</u></p> <ul data-bbox="683 716 1227 1398" style="list-style-type: none"> <li data-bbox="683 716 1227 915">• Capital – Provide the results of the subprime portfolio loss analysis and verify that management is risk-weighting subprime loans at the higher of the analysis factor or the minimum 1.5 times set forth in interagency guidance. <li data-bbox="683 926 1227 1230">• Management – Provide OTS with the internal analysis completed by management that: (1) improve the bank's loss analysis capability; (2) better project loss exposure in the various single-family residential loan products being offered; and (3) establish risk-based capital requirements based on expected loss exposure relative to prime loans. <li data-bbox="683 1241 1227 1398">• Sensitivity to Market Risk – Provide a copy of the cost/benefit analysis used to support management's ongoing decision not to hedge the mortgage servicing asset (MSA). 	None
			<p data-bbox="683 1440 980 1467"><u>Other corrective actions</u></p> <ul data-bbox="683 1478 1227 1877" style="list-style-type: none"> <li data-bbox="683 1478 1227 1877">• Capital – Thoroughly assess the loss potential inherent in the subprime portfolio, and use this analysis as a basis for allocating capital according to risk. Submit the results of your analysis that indicates the risk weight to be applied to subprime loans of varying levels of risk. Pending such assessment, risk weight single-family residential subprime loans for risk-based capital purposes at a minimum of 1.5 times the risk-weight required for prime single-family residential 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>loans.</p> <ul style="list-style-type: none"> • Capital – Deduct construction loans to DSL Service Company /Robinhood Ridge and DSL/McMillin Morgan Hill from Tier 1 Core Capital, in the same manner as advances and/or investments in a non-includable subsidiary are deducted from regulatory capital. • Asset Quality – Properly identify subprime loan to facilitate borrowers in accordance with internal guidelines, and ensure that subprime loan pricing is used in the loan to facilitate discounting methodology. • Asset Quality – Amend the internal asset review policy to clearly establish the independence of the internal asset review function. • Asset Quality – Continue refining loss analysis as well as loan monitoring and administration reports to timely identify and respond to relevant trends, including the need to make appropriate adjustments in underwriting, servicing, and other lending functions. • Management – Develop loss modeling capability to better assess and differentiate the loss potential in the various loan products being offered, including the various grades of subprime loans that negatively amortize, and loans with reduced documentation requirements. • Management – Beyond the requirements for subprime loans, risk weight negative amortization and limited documentation loans according to their loss potential as determined by the internal analysis. • Sensitivity to Market Risk – Ensure completion of a comprehensive cost/benefit analysis that justifies the bank’s strategy to leave the MSA unhedged. 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<ul style="list-style-type: none"> • Sensitivity to Market Risk – Incorporate the exposure to rising interest rates into the comprehensive loss assessment discussed elsewhere in this report. 	
1/12/2004	2/223223	\$11,600	<p data-bbox="683 583 1089 611"><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • Capital – Submit results of the analysis that indicates the risk-weight to be applied to the subprime single-family loan portfolio based on varying levels of risk. • Management – Provide information regarding the analysis of capital for loans with negative amortization features and reduced documentation requirements. • Management – Describe steps taken to develop a fair lending self-assessment program appropriate to the bank’s fair lending risk profile. • Management – Advise of the actions taken to ensure that risk limits and approval conditions are monitored and that management policies and limits will be followed. • Sensitivity – Provide information regarding the establishment of mortgage banking hedge limits. • Sensitivity – Describe the actions taken to reduce the variance allowance between the internal and external valuations of the MSA. Also, describe the hedge parameters or management triggers established relative to the MSA and earnings at risk. <p data-bbox="683 1583 980 1610"><u>Other corrective actions</u></p> <ul style="list-style-type: none"> • Capital – Identify the additional risks associated with the subprime loan portfolio, and allocate capital according to risk. • Asset Quality – Ensure that appraisals requiring a prospective future value upon completion of construction of improvements are developed with a 	None

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>discounting methodology that complies with OTS appraisal requirements.</p> <ul style="list-style-type: none"> • Management – Analyze the loan portfolio to determine if additional capital is needed for loans with negative amortization features and loans originated with limited documentation standards, including Downey Express loans. • Management – Improve fair lending self-assessments and ensure adequate resources and training are provided. • Management – Comply with board and management policies and limits, and ensure appropriate actions are taken when significant deviations occur. • Management – Eliminate inconsistencies between policies adopted by the board and the operating policies and procedures established by management. • Management – Further enhance credit administration and risk management reports and procedures. • Earnings – Develop a comprehensive strategic plan that addresses long-range operating goals and objectives. • Liquidity – Remove outdated regulatory citations from the Treasury policies and procedures. • Sensitivity to Market Risk – Model the risks derived from the mortgage banking operations so it is consistent with the risk profile produced by the Quantitative Risk Management (QRM) model. Incorporate the QRM rate shock analysis into the internal modeling process. Additionally, obtain market value estimates for the MSA under additional rate shock scenarios and reflect those estimates in the internal model results. • Sensitivity to Market Risk – Ensure that required pre-purchase analysis is performed for significant transactions and 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>that significant strategies are documented as evidence of ongoing performance/effectiveness to intended objectives. Also, ensure that risk limits and conditions of approval are monitored and not violated without appropriate authorization.</p> <ul style="list-style-type: none"> • Sensitivity to Market Risk – Establish mortgage banking hedge limits to reflect how the mortgage pipeline and warehouse loan positions are managed and how the market risks are measured via the QRM model (i.e., inside plus or minus 100 basis points rate shock and/or benchmark equivalent price sensitivity). • Sensitivity to Market Risk – Reduce the MSA valuation variance allowance between the internal and average of the independent valuations that is currently at 10 percent. • Sensitivity to Market Risk – Enhance the hedge parameters or management triggers related to the risk exposure of the MSA to include risk limits or management triggers that address earnings at risk. • Compliance – Complete the development of a fair lending self-assessment program appropriate to the bank’s fair lending risk profile. 	
1/3/2005	2/223223	\$15,650	<p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • Capital – Describe the changes made to the bank’s methodology for calculating the capital component for subprime loans. Include the results of the revised methodology. • Asset Quality – Indicate the status of management’s efforts to address credit underwriting and credit administration weaknesses and develop a system to document deviations from underwriting guidelines. • Management – Provide a summary of the 	None

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>results of a comprehensive review of staffing, systems, and controls. Include a description of the actions taken or planned to address any identified weaknesses.</p> <ul style="list-style-type: none"> • Management – Describe specific actions taken to address conflict of interest situations involving members of the board. • Management – Provide information on the corrective action plan to implement the Office of Foreign Assets Control (OFAC) customer database scans processes and detail the specific steps taken to ensure that OFAC database scans are conducted no less frequently than monthly once the new software is installed. • Earnings – Submit a copy of the revised strategic plans for both a one-year and three-year horizon. • Liquidity – Describe the actions taken to ensure that investment activity is conducted within the parameters of board approved policies and procedures. • Sensitivity to Market Risk – Describe the steps taken to develop a comprehensive market risk framework, which includes effective policies and procedures, appropriate risk measures, standards and limits. 	
			<p><u>Other corrective actions</u></p>	
			<ul style="list-style-type: none"> • Capital – Develop or adopt a more comprehensive methodology for calculating the capital component for subprime loans. • Capital – Ensure that the bank’s internal capital adequacy analysis incorporates all of the various factors of the bank’s loan portfolio risk, including credit administration weaknesses and human resource/system limitations identified 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>elsewhere in this report.</p> <ul style="list-style-type: none"> • Asset Quality – Devise a servicing contingency plan for the potential onset of adverse business conditions that establishes triggers to implement allocation of additional resources at the onset of asset quality deterioration. • Asset Quality – Provide additional support for factors utilized in allowance for loan and lease losses (ALLL) analysis that includes qualitative adjustments due to the unseasoned portfolio. • Asset Quality – Enhance the policy for cash equity investments (major loans) that requires documentation of cash equity or substitution of appraised equity. • Asset Quality – Enhance the policy for documentation of discount rates utilized on development projects. • Asset Quality – Enhance the review of guidelines noted in credit review that: <ul style="list-style-type: none"> ○ Addresses emerging trends and provides useful feedback to originators ○ Establishes acceptable risk tolerance limits ○ Ranks guideline and other exceptions by risk severity. • Asset Quality – Continue to monitor mortgage insurance concentration exposure. • Asset Quality – Provide OTS with the status of management’s efforts to address the credit underwriting and credit administration weaknesses noted in OTS’s report. • Asset Quality – Create a system to document deviations from underwriting guidelines and monitor performance of loans with guideline exceptions from the remaining portfolio. • Asset Quality – Implement procedures to ensure compliance with the guidance 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>contained within Financial Accounting Standards 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.</p> <ul style="list-style-type: none"> • Asset Quality - Detail your discussions and intentions as it relates to our suggestion for consideration of the establishment of an independent Chief Credit Officer. • Management – Conduct a bank-wide review of staffing levels, information and data systems, and controls. • Management – Develop procedures to ensure compliance with applicable conflict of interest rules and regulations. • Management – Develop an action plan to implement the OFAC customer database scans processes and detail the specific steps taken to ensure that OFAC database scans are conducted no less frequently than monthly once the new software is installed. • Earnings – Complete the comprehensive strategic plan that addresses long-range operating goals and objectives. • Liquidity – Revise board resolutions and Treasury policies as necessary for clarity and ensure that practice conforms to policy. • Liquidity – Ensure investment practices are consistent with Thrift Bulletin 13a – Management of Interest Rate Risk, Investment Securities, and Derivatives Activities. • Sensitivity to Market Risk – Address the examination findings as detailed in the following memorandums provided during the examination: <ul style="list-style-type: none"> ○ Market Risk Framework and Net Present Value Modeling dated February 24, 2005. ○ Interest Rate Risk – Net Interest 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p style="margin-left: 40px;">Income Analysis dated February 23, 2005</p> <ul style="list-style-type: none"> ○ Mortgage Pipeline and Mortgage Servicing Rights Policy dated February 23, 2005. <ul style="list-style-type: none"> • Sensitivity to Market Risk – Monitor quarterly the composition and effective duration of the bank’s liabilities compared to Cost of Funds Index. • Sensitivity to Market Risk - Ensure that Thrift Bulletin 13a is adhered to when completing significant loan sales from the held for investment portfolio. • Compliance – Refer to corrective actions in the Management section of the OTS report. 	
1/3/2006	3/233223	\$17,100	<p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • Capital – Advise OTS of the steps taken to improve capital modeling for subprime, negative amortization, and low documentation loans. • Capital – Establish more appropriate minimum capital ratios commensurate with the bank’s risk profile and business plan and confirm that the internal minimum core capital ratio is 6.75 percent. • Asset Quality – Describe the actions taken to implement each of the corrective actions required in the Asset Quality section of the OTS report. • Management – Advise OTS of the steps taken to expand the board and the depth of management to ensure that the board and management have the necessary resources, experience, and independence to address the matters contained herein. • Management – Confirm that comprehensive residential lending, ALLL, model risk, transactions with affiliates (TWA) and corporate compliance management policies and procedures 	<p>Board Resolution 7/28/2006. This informal action OTS provides for the addition of two independent directors and the creation of a special task force to evaluate Downey’s management structure.</p>

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>have been developed and implemented.</p> <ul style="list-style-type: none"> • Management – Advise OTS of the steps taken to enhance the effectiveness of the internal audit function. • Management – Describe the enhancements to TWA policies and procedures that will ensure appropriate controls for compliance with TWA Regulations. • Earnings – Submit a copy of the revised one-year and three-year strategic plan that addresses the bank’s risk profile and OTS’s supervisory concerns. • Sensitivity to Market Risk – Describe the actions taken to implement the corrective actions required in the Sensitivity Section of the OTS report. 	
			<p><u>Other corrective actions</u></p>	
			<ul style="list-style-type: none"> • Capital – Create a well-defined methodology to determine if additional capital is necessary to address the different risk components of the bank’s residential loan portfolio. <p>Capital – Develop a more comprehensive approach for determining the capital component for subprime loans. Establish written policies and procedures that address the overall Loan Performance model methodology. The policy should also provide for an independent model validation process.</p> <ul style="list-style-type: none"> • Capital – Establish board-approved minimum capital targets that are more reflective of the bank’s layered risks in the bank’s loan products. • Asset Quality – Consolidate and improve loan policies and procedures in accordance with 12 CFR Section 560.101 and Appendix A (Interagency Guidelines for Real Estate Lending Policies), and ensure that they are approved by the board. 	

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<ul style="list-style-type: none"> • Asset Quality – Implement new procedures and/or training to mitigate any reoccurrences of potential appraisal fraud or red flags resulting from loan originations. • Asset Quality – Implement procedures to improve the monitoring and presentation to the board of the layered risks comprising the Option Adjustable Rate Mortgage (ARM) portfolio. • Asset Quality – Summarize steps taken and strategies planned to minimize the potential impact of Option ARM <u>payment shock</u> risk. • Asset Quality – Revise the ALLL methodology and policy to incorporate qualitative measurements and stress testing. • Management – Adopt comprehensive residential lending, model risk, ALLL, TWA and compliance management policies and procedures. • Management – Ensure that risk management systems are implemented commensurate with the size and complexity of the bank’s operations. • Management – Expand the board through the addition of at least two independent directors and enhance the depth of management. • Management – Enhance the effectiveness of the internal audit function. Institute appropriate controls to ensure that directors consistently comply with the conflict of interest rules and regulations and ensure that Regulation W (Transactions between Member Banks and Their Affiliates) violations are corrected. • Earnings – Quantify in the business planning process the potential risk to earnings from negative amortization utilization. 	

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OTS Downey Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<ul style="list-style-type: none"> • Earnings – Develop a revised strategic plan and one-year budget. • Sensitivity to Market Risk – Ensure that the examination findings as detailed in the following memorandums are addressed: <ul style="list-style-type: none"> ○ Market Risk Practices and Interest Rate Risk Modeling – February 23, 2006 ○ Mortgage Servicing Rights – January 25, 2006 ○ Loan Sale Activity – March 2, 2006 • Compliance – Implement the necessary procedures and controls to ensure that future suspicious activities are appropriately referred to the Security Department for suspicious activity report filing considerations. 	
3/5/2007	3/233222	\$15,200	<p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • Management – Describe the methods by which the board will become better informed about compliance management. The board should require at least quarterly management presentations and reports regarding compliance issues and compliance management practices. • Asset Quality – Identify and establish a monitoring report tailored to the board’s needs that is evaluated at least quarterly and addresses the most pertinent aspects and risks of the bank’s asset quality. • Compliance – Detail the process the board will follow to ensure all corrective actions listed in the Compliance section of this report are completed. <p><u>Other corrective actions</u></p> <ul style="list-style-type: none"> • Asset Quality – Ensure implementation of broker reporting enhancements prescribed in OTS’s April 2007 memo. • Asset Quality – Improve documentation of security incident reports related to 	Cease and desist (C&D) order issued August 30, 2007 for weaknesses associated with the BSA

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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>appraisals.</p> <ul style="list-style-type: none"> • Asset Quality – Ensure agreed to recommendations to the credit review function are implemented. • Asset Quality – Reassign the \$2.8 million unallocated portion of the ALLL to the qualitative adjustment for the single-family residential portion of the ALLL and consider establishing a maximum percentage for the qualitative adjustment to the single-family residential ALLL segment. • Management – The board should receive, at a minimum, quarterly formal comprehensive compliance reports for review and discussion. • Management – Ensure corrective actions concerning compliance management as detailed in the Compliance section of the report. • Sensitivity to Market Risk – Evaluate the OTS recommendations in the memo titled “Oversight of Market Risk Management”, dated May 23, 2007. • Sensitivity to Market Risk – Document the risk assessments performed by the model validation committee in determining the frequency and robustness of the scheduled model validations for key risk models. • Compliance – Develop a more cohesive corporate-wide Bank Secrecy Act/anti-money laundering (BSA/AML) written policy/procedures for board approval. These policies and procedures need to incorporate a customer due diligence program and the customer identification program needs to incorporate the recording of date of issuance and date of expiration for documents used to identify customers, if the documents contain that information. • Compliance – Develop and implement a 	

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 OTS Downey Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>comprehensive AML/suspicious activity, monitoring program including written policies and procedures.</p> <ul style="list-style-type: none"> • Compliance – Formalize into written policies and procedures current practices for tracking and monitoring of security incident report, investigations, and suspicious activity report filings. • Compliance – Enhance the current BSA/AML United States of America Patriot Act (USAPA)/OFAC risk assessment to address the criteria contained in the memorandum to management dated May 21, 2007, on OTS’ review of BSA/AML/USAPA. • Compliance – Enhance the current BSA/AML training to include discussions and examples of placement, layering, and integration. Additionally, develop training for the board, management, accounting, central operations, loan originations, and operations personnel geared to their respective duties as they related to BSA/AML. • Compliance – Provide in-depth training on BSA/AML for the internal audit department or hire a qualified third party to perform the annual independent review of BSA/AML/USAPA compliance. • Compliance – Develop a plan to collect missing required customer identification information on new accounts opened since 2003, and implement procedures to retain required customer identification program information going forward. 	
3/10/2008	4/444443	\$13,100	<p><u>Matters requiring board attention</u></p> <ul style="list-style-type: none"> • Capital – Implement the capital plan including a signed definitive agreement from an investor or merger partner so as to accomplish a capital infusion of \$300 million or more no later than September 30, 2008. 	<p>C&D orders (formal enforcement action) issued 9/5/2008 to Downey and</p>

Appendix 5
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Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<ul style="list-style-type: none"> • Asset Quality – Develop a classified asset plan that establishes targets and procedures for ensuring the bank reduces its ratio of classified assets to tangible capital plus ALLL each succeeding quarter beginning September 30, 2008. • Asset Quality – Adopt a real estate owned (REO) disposition plan, in conjunction with the classified asset plan that will promote the effective management and disposition of REO. • Asset Quality – Implement enhancements to modification program guidelines and practices as noted in its response to OTS’s memorandum of June 13, 2008. • Management – Develop and adopt a management plan by no later than September 30, 2008 that addresses the shortcomings in the bank’s executive management structure, including proposals to fill vacancies at the chief executive officer and board level. • Management – Detail the steps it has taken to ensure that management complies with all operating restrictions imposed in the troubled condition letter. • Earnings – Develop a contingency plan to reduce operating costs and eliminate unnecessary expenses should the capital raising effort not be achieved by September 30, 2008. • Liquidity – Provide a contingent funding plan that formalizes the actions to be taken in the event of a funding crisis. • Liquidity – Enhance the monitoring and reporting for deposit accounts with balances in excess of \$100,000. • Liquidity – Provide OTS with an analysis demonstrating that the bank has a plan to deal with the rate restrictions outlined in the Federal Deposit Insurance Corporation (FDIC) brokered deposit regulation at 12 CFR 337.6. 	Downey Financial Corporation due to unsafe and unsound lending practices.

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 OTS Downey Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p><u>Other corrective actions</u></p> <ul style="list-style-type: none"> • Capital – Implement the capital plan including a signed definitive agreement from an investor or merger partner so as to accomplish a capital infusion of \$300 million or more no later than September 30, 2008. • Asset Quality – Develop a classified asset plan that establishes targets and procedures for ensuring the bank reduces its ratio of classified assets to tangible capital plus ALLL each succeeding quarter beginning September 30, 2008. • Asset Quality – Adopt a REO disposition plan that will promote the effective management and disposition of REO, in conjunction with the classified asset plan. • Asset Quality – Implement enhancements to modification program guidelines and practices as noted in its response to OTS’s memorandum of June 13, 2008. • Management – Develop and adopt a management plan by no later than September 30, 2008 that addresses the shortcomings in the bank’s executive management structure, including proposals to fill vacancies at the CEO and board level. • Management – Detail the steps it has taken to ensure that management complies with all operating restrictions imposed in the troubled condition letter. • Earnings – Develop a contingency plan to reduce operating costs and eliminate unnecessary expenses should the capital raising effort not be achieved by September 30, 2008. • Liquidity – Provide a contingent funding plan to our office that formalizes the actions to be taken in the event of a funding crisis. 	

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 OTS Downey Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<ul style="list-style-type: none"> • Liquidity – Enhance the monitoring and reporting for deposit accounts with balances in excess of \$100,000. • Liquidity – Provide OTS an analysis demonstrating that the bank has a plan to deal with the rate restrictions outlined in the FDIC brokered deposit regulation at 12 CFR 337.6. • Sensitivity to Market Risk – Ensure that liquidity projections and other forecasting assumptions are updated to reflect current prepayment behavior. • Sensitivity to Market Risk – Ensure internal net present value modeling results are prepared on a timely basis. • Compliance – Fair Lending: <ul style="list-style-type: none"> ○ conduct an analysis using year 2006 Home Mortgage Disclosure Act data of aggregate broker-sourced pricing within markets (such as MSA’s) to identify potential market level disparate treatment. The analysis must include transaction level comparative file reviews (“benchmark/overlap analysis”) to determine if individual prohibited base borrowers were adversely priced. Take appropriate corrective action where indicated both to address root causes and to compensate and such adversely priced prohibited basis borrowers. ○ Perform additional analysis of 2007 brokered-sourced applications to evaluate pricing disparities in aggregate activity within markets and take appropriate corrective action where indicated. ○ Given the high profile problems with the increasing trend of home loan delinquencies, modifications, prepayment fee waivers, 	

Appendix 5
 OTS Downey Examinations and Enforcement Actions

Date examination started	CAMELS rating	Assets (in millions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examinations	Enforcement action
			<p>foreclosures and other related problem credit activities, we recommend the fair lending program expand its review to include these servicing issues.</p> <ul style="list-style-type: none"> ○ We encourage management to expand testing to include non-Home Mortgage Disclosure Act reported products such home equity lines of credit. ● Compliance – Flood Disaster Protection Act: <ul style="list-style-type: none"> ○ When the final “Loans in Areas Having Special Flood Hazards Interagency Flood Questions and Answers” is issued, management should implement a review of the bank’s procedures for compliance with new guidance. If the review discloses that the procedures are not in compliance, then a corrective action plan to ensure compliance with the guidance should be implemented. ○ Develop written procedures for obtaining flood coverage on condominiums and loans in subordinate liens with particular attention being directed to loans where the priority lien holder is another institution. 	

Source: OIG analysis of OTS ROEs on Downey.

We have completed three mandated material loss reviews of failed thrifts since the current economic crisis began in 2007. This appendix provides our recommendations to the Office of Thrift Supervision (OTS) resulting from these reviews. OTS management concurred with the recommendations and has taken or planned corrective actions that are responsive to the recommendations. In certain instances, the recommendations address matters that require ongoing OTS management and examiner attention.

Report Title	Recommendations to OTS Director
<p><i>Safety and Soundness: Material Loss Review of NetBank, FSB, OIG-08-032 (Apr. 23, 2008)</i></p> <p>OTS closed NetBank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on September 28, 2007. At that time, FDIC estimated that NetBank’s failure would cost the Deposit Insurance Fund \$108 million.</p>	<p>Ensure that the recommendations/lessons learned from OTS’s internal assessments of the NetBank failure, as described on pages 21 and 28 of that report, are implemented.</p> <p>Re-emphasize to examiners that for 3-rated thrifts, formal enforcement action is presumed warranted when certain circumstances identified in the OTS Examination Handbook are met. Examiners are also directed to document in the examination files the reason for not taking formal enforcement action in those circumstances.</p> <p>Establish in policy a process to assess the causes of thrift failures and the supervision exercised over the institution and to take appropriate action to address any significant supervisory weaknesses or concerns identified.</p>
<p><i>Safety and Soundness: Material Loss Review of IndyMac Bank, FSB, OIG-09-032 (Feb. 26, 2009)</i></p> <p>OTS closed IndyMac on July 11, 2008, and named FDIC as conservator. As of My 8, 2009, FDIC estimated that IndyMac’s failure would cost the Deposit Insurance Fund \$10.7 billion.</p>	<p>Ensure that action is taken on the lessons learned and recommendations from the OTS internal review of the IndyMac failure.</p> <p>Caution examiners that assigning composite CAMELS ratings of 1 or 2 to thrifts with high-risk, aggressive growth business strategies need to be supported with compelling, verified mitigating factors. Such mitigating factors should consider things such as the institution’s corporate governance, risk management controls, allowance for loan and lease losses methodologies, concentration limits, funding sources, underwriting standards, and capital levels and whether the mitigating factors are likely to be sustainable in the long-term. Another important factor that should be considered is the extent to which the thrift offers nontraditional loan products (regardless of whether loans are</p>

Appendix 6
Prior OIG Material Loss Review Recommendations

sold or retained) that have not been stress tested in difficult financial environments, and whether the thrift can adequately manage the risks associated with such products. OTS should re-examine and refine as appropriate its guidance in this area.

Safety and Soundness: Material Loss Review of Ameribank, Inc., OIG-09-036 (April 7, 2009)

OTS closed Ameribank and appointed the FDIC as receiver on September 19, 2008. As of December 31, 2008, FDIC estimated that Ameribank's failure would cost the Deposit Insurance Fund \$33.4 million.

Remind examiners of the risks associated with rapid growth in high-risk concentrations.

Remind examiners to conduct more thorough loan sampling from the portfolio if they identify a rapid increase in concentration.

Remind examiners of the examination guidance for thrift third-party relationships, with particular attention to the assessment of the risk the relationship may pose to the thrift's safety and soundness.

Assess the need for guidance requiring risk assessment of construction rehabilitation account loans as an integral part of assessing a thrift's overall risk.

Ensure that the recommendations and the lessons learned from OTS's internal assessment of the Ameribank failure are implemented.

Appendix 7
Management Response



Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6372

John E. Bowman
Acting Director

June 12, 2009

MEMORANDUM FOR: Susan L. Barron
Audit Director
Office of Inspector General
U.S. Department of the Treasury

FROM: John E. Bowman /s/
Acting Director

SUBJECT: Draft Audit Report on the Material Loss Review of Downey
Savings and Loan Association, F.A.

Thank you for the opportunity to comment on your draft audit report entitled "Material Loss Review of Downey Savings and Loan Association, F.A." The report focuses on the causes of the failure of Downey Savings and Loan Association, F.A. (Downey) and oversight responsibility of the Office of Thrift Supervision for Downey.

The OIG's report on Downey contains the following recommendations:

- Ensure that the recommendations from OTS's internal assessment of the Downey failure are implemented and the lessons learned described in that assessment are taken into account going forward;
- OTS should direct examiners to closely review and monitor thrifts that refuse to establish appropriate limits for concentrations that pose significant risk and pursue corrective action when concentration limits are not reasonable;
- OTS should assess the need for more guidance for examiners on determining materiality of concentrations and determining appropriate examiner response to high risk concentrations, including when to impose absolute limits to prevent excessive concentration; and
- OTS should formally communicate to the industry the guidance in ND Bulletin 06-14 as to OTS's expectation that concentration measurements and limits be set as a percent of capital, not just as a percent of total assets or loans, and the need for a sound internal risk management system (including stress testing, regular periodic monitoring, and other risk management tools) for higher-risk concentrations.

OTS concurs with the recommendations and will implement the OIG recommendations from this Material Loss Review by the end of the third quarter of 2009. We plan to issue further guidance

Appendix 7
Management Response

Susan Barron
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regarding concentrations to both the thrift industry and OTS staff that will address asset and liability concentration issues described in the OIG's report, as well as those that have been identified internally by OTS.

Once again, thank you for the opportunity to review and respond to your draft report. We appreciate the professionalism and courtesies provided by the staff of the OIG.

Appendix 8
Major Contributors to This Report

Jeffrey Dye, Audit Manager
Michelle Littlejohn, Auditor in Charge
Alicia Bruce, Auditor
Michael Shiely, Auditor
Myung Han, Referencer

Department of the Treasury

Office of Strategic Planning and Performance Management
Office of Accounting and Internal Control

Office of Thrift Supervision

Office of Thrift Supervision
Liaison Officer

Office of Management and Budget

OIG Budget Examiner

Federal Deposit Insurance Corporation

Chairman

United States Senate

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

U.S. Government Accountability Office

Acting Comptroller General of the United States