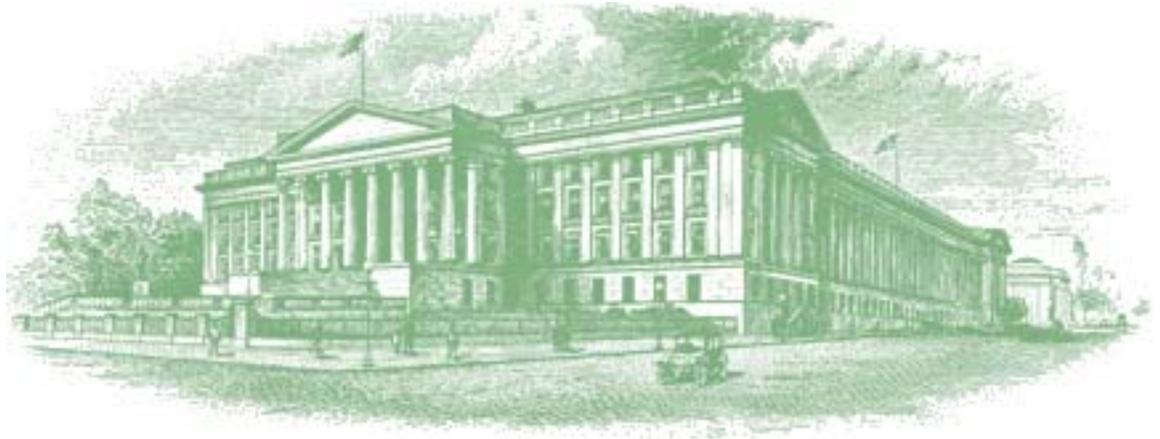




Audit Report



OIG-09-037

SAFETY AND SOUNDNESS: OTS Involvement With Backdated
Capital Contributions by Thrifts

May 21, 2009

Office of
Inspector General

Department of the Treasury

Contents

Audit Report..... 1

 Results in Brief..... 1

 Events Leading to This Review..... 3

 Summary of Capital Contributions 5

 Additional OTS Guidance on Capital Contributions Needs to Be Issued..... 6

 Recommendations 8

Appendices

Appendix 1: Objectives, Scope, and Methodology 12

Appendix 2: Detailed Discussion of Backdated Capital Contributions
at Six Thrifts..... 14

Appendix 3: Management Response 25

Appendix 4: OIG Comments to Management Response 29

Appendix 5: Report Distribution..... 30

Abbreviations

ALLL	allowance for loan and lease losses
CEO	Chief Executive Officer
CFO	Chief Financial Officer
EITF	Emerging Issues Task Force
E&Y	Ernst & Young LLP
ESCP	Examinations, Supervision, and Consumer Protection
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
GAAP	generally accepted accounting principles
OTS	Office of Thrift Supervision
OTTI	other than temporary impairment
SEC	Securities and Exchange Commission
TFR	Thrift Financial Report

This Page Intentionally Left Blank.

*The Department of the Treasury
Office of Inspector General*

May 21, 2009

John E. Bowman
Acting Director
Office of Thrift Supervision

This report presents the results of our review of the Office of Thrift Supervision's (OTS) involvement in the backdating of capital contributions by six thrifts, including the failed IndyMac Bank, F.S.B (IndyMac).¹ We initiated this review after the Federal Deposit Insurance Corporation (FDIC) Inspector General provided our office with a workpaper prepared by IndyMac's independent auditor. That workpaper indicated that a May 2008 capital contribution from the thrift's holding company was backdated to the quarter ended March 31, 2008. The workpaper also indicated that an OTS official authorized the backdating. In addition, OTS provided us with five more cases where a thrift backdated a capital contribution to a previous quarter. Accordingly, we included these thrifts as part of our review. The specific objectives of this review were to assess (1) the circumstances surrounding the backdating of capital contributions by the six thrifts, (2) the accounting treatment used for these capital contributions, and (3) the oversight exercised by OTS relating to these transactions.

We conducted our fieldwork from September 2008 through May 2009. Appendix 1 contains a detailed description of our objectives, scope, and methodology. Appendix 2 contains discussions of the backdated capital contributions at the six thrifts.

Results in Brief

We reviewed the circumstances surrounding the backdating of capital contributions to prior periods at six thrifts and concluded

¹ Capital contributions are also referred to as capital infusions.

that the backdating of these transactions was inappropriate for all six thrifts. For one thrift, the OTS Senior Deputy Director directed the regional office to instruct the holding company to contribute capital and backdate the transaction. For another thrift, IndyMac, an OTS regional director authorized the backdating of the transaction. For a third thrift, OTS objected to backdating the transaction, informed the thrift management not to backdate the transaction, but the thrift proceeded to backdate it anyway. However, in this case, and in the case of two other thrifts where OTS became aware of the backdating after the fact, OTS allowed the backdating to remain. For one of these two other thrifts, OTS did not become aware of the backdating until after the period for amending the thrift's financial reporting had closed. For the sixth thrift that backdated a transaction, when OTS became aware of the backdating it directed the thrift to reverse the transaction.

We consider these matters very serious and find it alarming that such high level OTS officials were not only aware of the backdating at two thrifts, but either directed or authorized the thrifts to backdate the capital contribution. Approving or directing the thrifts to backdate these contributions is inappropriate as the accounting treatment is not in accordance with generally accepted accounting principles (GAAP) and allows for misleading financial reporting by the thrifts.

In January 2009, OTS issued guidance to its examiners and supervisory staff on the proper recognition of capital contributions. The guidance was also issued to thrift chief executive officers (CEO). The guidance permits thrifts to recognize as regulatory capital, capital contributions in the form of a note receivable from the holding company, only if the note is executed prior to period end and the note is collected (i.e., the cash is infused) prior to issuance of the financial statements for the same period. However, we noted that there is no specific OTS guidance prescribing the steps to be taken by OTS examiners to proactively identify backdated capital contributions or what to do when a thrift is found to have inappropriately backdated a capital contribution.

We recommend that OTS (1) determine whether there have been any additional backdated capital contributions and, if so, take appropriate corrective action to remedy each situation as

necessary; (2) issue additional guidance outlining steps OTS examiners should take to identify and address the backdating of capital contributions immediately after examiners become aware of such transactions; and (3) ensure that examiners and supervisory staff understand OTS guidance on capital contributions and the implications of backdating capital contribution transactions.

In its management response to this report, OTS asserts that it has focused extensive resources on the issue of post-period capital contributions and has provided detailed guidance to its staff and the institutions it supervises regarding proper recognition and reporting of capital contributions. The response also outlines a number of actions OTS has taken or plans to take in response to the recommendations contained within this report. The management response is provided as appendix 3. Our evaluation of several specific comments in OTS's management response is presented in appendix 4.

Events Leading to This Review

On July 11, 2008, OTS closed IndyMac and appointed the FDIC receiver. Shortly thereafter, as required by law, we began a material loss review of IndyMac to determine the causes of IndyMac's failure and assess OTS's supervision over the thrift. Our report on the material loss review was issued on February 26, 2009.² As is common with the failure of publicly-held insured financial institutions, other Federal agencies including the Securities and Exchange Commission (SEC) and FDIC also conduct reviews. In the case of IndyMac, SEC reviewed workpapers prepared by IndyMac's independent auditor, Ernst & Young, LLC (E&Y). One workpaper reported a telephone conversation between IndyMac's CEO, an E&Y partner, and OTS's Western Region Director regarding an infusion of capital into IndyMac from its holding company, backdated to the first quarter of 2008. Because of its potential relevance to our material loss review, FDIC's Inspector General in turn provided the E&Y workpaper to our office.

² *OIG, Safety and Soundness: Material Loss Review of IndyMac Bank, FSB*, Feb. 26, 2009, Report No. [OIG-09-032](#).

At the request of former Treasury Secretary Paulson, we initiated a review into the circumstances described in the E&Y workpaper. In a memorandum dated December 18, 2008, we provided Secretary Paulson a status of our review. In that memorandum, we confirmed through inquiry and review of additional supporting documentation that the circumstances occurred essentially as represented in the E&Y workpaper. We further informed the Secretary that the impact of recording the capital contribution in the quarter ending March 31, 2008, was that IndyMac was able to maintain its well capitalized status, and avoid the requirement in law to obtain a waiver from FDIC to accept brokered deposits. We also advised the Secretary that during our inquiry, we discovered that OTS had allowed other thrifts to record capital contributions in an earlier period than received and while there was some support in authoritative accounting literature for permitting this practice, that support was limited. Furthermore, we informed the Secretary that we were continuing our review and would be issuing a separate audit report with our findings.

In response to our December 18, 2008 memorandum discussed above, OTS issued a letter to Secretary Geithner on January 30, 2009. In that letter, the OTS Director concluded that the May 9, 2008 capital contribution should not have been included in IndyMac's March 31, 2008 Thrift Financial Report (TFR)³ because IndyMac had not recorded a note receivable from the holding company before the quarter ended. The letter stated that there were four other thrifts that had backdated capital contributions.⁴ Furthermore, the letter discussed actions taken by OTS. These actions included the issuance of guidance to OTS staff and thrifts as well as the fact that the OTS Western Region Director had been placed on administrative leave pending completion of an internal review.⁵

³ The TFR is a quarterly financial report that thrifts are required to file with OTS. The report includes detailed information about the institution's operations and financial condition. OTS requires the TFR to be prepared in accordance with GAAP.

⁴ Since then, we were informed by the OTS Chief Accountant of another thrift that backdated a capital contribution.

⁵ Since then, the official has retired from Federal service.

Summary of Capital Contributions

The following chart summarizes the OTS regions, time periods, and actions taken by OTS for the six thrifts where capital contributions were backdated (IndyMac plus the five thrifts identified by OTS). Appendix 2 contains a more detailed discussion of the circumstances surrounding each of the six thrifts' backdated capital contributions.

Chart 1: Thrifts Backdating Capital Contributions

Thrift	OTS Region	Capital Contribution Received	Reported In Quarter Ending	OTS Action
IndyMac	Western	May 9, 2008	March 31, 2008	Authorized backdating prior to recording
1	Southeast	August 5, 2008	June 30, 2008	Directed backdating prior to recording
2	Southeast	July 29, 2008	June 30, 2008	Objected prior to the fact and notified management; did not require corrective action after management proceeded to backdate
3	Western	July 23, 2008	June 30, 2008	Discovered after the fact; required no corrective action ⁶
4	Northeast	January 11, 2007	December 31, 2006	Discovered after the fact; required no corrective action
5	Southeast	October 17, 2007 November 20, 2007	September 30, 2007	Discovered after the fact; required thrift to restate financial reports

Sources: OTS officials and examination documentation, and for IndyMac relevant thrift records and E&Y.

Note: The thrift identifying numbers (1 – 5) correspond to the numbers included in Appendix 2. In addition, we did not include specific thrift information such as the name of the institution and the amount of the backdated capital contribution as the five thrifts are still active institutions.

We reviewed the circumstances surrounding the backdating of capital contributions at the six thrifts and concluded that the backdating of these transactions was inappropriate under GAAP for all six thrifts.

⁶ *OTS Thrift Financial Report Instruction Manual*, March 2003, states that in no case can OTS process amendments to TFRs beyond 135 days after the end of the quarter. OTS did not become aware the transaction was backdated until December 2008; and therefore, would not be able to require the thrift to restate.

As discussed in the section above, Events Leading to This Review, in the case of IndyMac, OTS's Western Region Director authorized the backdating of the transaction.

In the case of Thrift 1, the OTS Senior Deputy Director directed the regional office to instruct the thrift to infuse capital and backdate the transaction. In response to a request, we provided the details of this transaction and the involvement by this OTS official to Treasury Secretary Geithner in a memorandum dated March 17, 2009. On March 26, 2009, the OTS official was placed on administrative leave pending a review by the Department of OTS's August 2008 actions related to post-period capital contributions.

For Thrift 2, OTS objected to backdating the transaction, informed the thrift management not to backdate the transaction, but the thrift proceeded to backdate it anyway. In this case, and in the cases of Thrift 3 and Thrift 4 where OTS became aware of the backdating after the fact, OTS allowed the backdating to remain for all three thrifts. For Thrift 3, it should be noted that OTS did not become aware of the backdating until after the period for amending the thrift's financial reporting had closed. For Thrift 5, OTS became aware of the backdated transaction and directed it be reversed. In this case, the transaction was reversed and the financial reports were restated.

Allowing thrifts, and in one case directing a thrift, to backdate contributions is inappropriate because the accounting treatment is not in accordance with GAAP and allows for misleading financial reporting. In addition, with the exception of the thrift that OTS directed to reverse the transaction and the thrift complied, OTS did not take appropriate action to address the other instances of backdating once the examiners became aware of such transactions.

Additional OTS Guidance on Capital Contributions Needs to Be Issued

On January 23, 2009, OTS issued New Directions Bulletin 09-04, *Recognition of Capital Contributions in the Form of Cash or Notes*, (New Directions Bulletin 09-04). The guidance permits thrifts to

recognize as regulatory capital, capital contributions in the form of a note receivable from the holding company, if the note is executed prior to period end and the note is collected (i.e., the cash is infused) prior to issuance of the financial statements for the same period. New Directions Bulletin 09-04 states that capital contributions of cash or notes may be included in regulatory capital only when the contribution is properly reported as equity under GAAP and complies with regulatory reporting guidance.⁷

The underlying authoritative support for recognizing capital contributions in the form of a note receivable as described in the OTS guidance is Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF)⁸ Abstract 85-1, *Classifying Notes Received for Capital Stock* (Abstract 85-1). Issued in 1985, Abstract 85-1 addresses when an enterprise receives a note, rather than cash, as a contribution to its equity (either as a sale of capital stock or a contribution to paid-in capital), and whether an enterprise should report the note receivable as a reduction of shareholders' equity or as an asset. EITF reached a consensus that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time.

In addition, New Directions Bulletin 09-04 states that for a note receivable to be properly reported in the TFR, the receivable must meet all of the following criteria: evidenced by written documentation that the note was contributed prior to period-end by those with authority to make such capital contributions on behalf of the holding company (e.g., board of directors, the CEO, or the chief financial officer); a legally binding obligation to fund a

⁷ OTS guidance requires thrifts to follow GAAP for all regulatory reports. The regulatory reporting requirements at 12 CFR Section 562.2(b)(i) require thrifts to incorporate GAAP whenever GAAP is the referenced accounting instruction.

⁸ EITF was formed in 1984 in response to the recommendations of a FASB task force on timely financial reporting guidance. EITF members are drawn primarily from public accounting firms but also include representatives of large companies and preparers and users of financial statements. Composition of EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by FASB as an indication that no FASB action is needed. Consensus positions of the EITF are ratified by FASB and are considered part of GAAP.

specified amount by a specified date; and executed and enforceable prior to the end of the period. On February 26, 2009, OTS issued a memorandum to thrift CEOs with the text of the guidance in New Directions Bulletin 09-04.

New Directions Bulletin 09-04 is a good step by OTS in that it clearly prohibits the improper practice noted with the six thrifts discussed in this report (i.e., backdating capital contributions to a prior period when no note receivable existed at the end of the period). We note, however, that there is no specific OTS guidance prescribing the steps to be taken by OTS examiners to identify backdated capital contributions. Based on the interviews we conducted and the documents we reviewed, it is apparent that transactions of this nature are not routinely checked for by OTS personnel. Furthermore, once officials and staff become aware of the suspect transaction, there is also no specific guidance on the steps to be taken by the examiner if it is determined that the thrift inappropriately backdated capital contributions.

Therefore, we believe OTS should issue additional guidance outlining steps an OTS examiner should take to identify and address the backdating of capital contributions if and when an examiner becomes aware of such transactions. In addition, appropriate action should be taken to ensure OTS officials communicate the proper application of GAAP in these circumstances, and verify that all appropriate personnel understand the implications of backdating capital contribution transactions.

Recommendations

We recommend that the Director of OTS do the following:

1. determine whether there have been any additional backdated capital contributions, and, if so, take appropriate corrective action to remedy each situation as necessary.

Management Response

OTS conducted an extensive search for post-period end capital contributions. Furthermore, through its off-site monitoring, in an

effort to detect potentially suspect capital contributions, OTS plans to institute a TFR edit check process to identify and report amended TFRs that reflect increases to equity capital. OTS also developed a report that highlights increases to equity capital from stock issued or capital contributions where no stock is actually issued. TFR edit checks for these line items will be implemented in June and will require the filing institutions to provide explanations of the reported amounts.

OIG Comment

OTS's response and actions to date meet the intent of this recommendation. Furthermore, the TFR edit check process as described, when implemented, should assist OTS to identify such cases in the future.

2. issue additional guidance outlining steps OTS examiners should take to identify and address the backdating of capital contributions immediately after examiners become aware of such transactions.

Management Response

OTS asserts that it has longstanding policies and procedures regarding the identification and follow-up action processes relating to the misreporting of capital contributions. These policies and procedures are reflected in the OTS Examination Handbook and Thrift Financial Report Instructions. OTS will also remind its examiners and supervisory staff of the actions required to address TFR reporting errors.

OIG Comment

We were aware of the policies and procedures reflected in the OTS Examination Handbook and TFR instructions. These policies and procedures did not include specific instructions relating to the circumstances described in this report, and in turn, were not effective in preventing the backdated capital contributions discussed in this report. However, in light of the additional guidance provided by New Directions Bulletin 09-04, its commitment to remind staff of the requirements to address

TFR reporting errors, and the planned TFR edit checks described in the response to recommendation 1, we accept that OTS does not intend to prescribe additional specific guidance at this time. That said, we emphasize the need for continuous monitoring and periodic training of examiners and supervisory staff to ensure the guidance outlining the steps OTS examiners should take to identify and address the backdating of capital contributions is effectively disseminated and institutionalized so that these circumstances do not occur in the future. OTS should also periodically assess the need for additional guidance.

3. ensure that examiners and supervisory staff understand OTS guidance on capital contributions and the implications of backdating capital contribution transactions.

Management Response

OTS has taken action to ensure staff fully understand the guidance in New Directions Bulletin 09-04. On April 2, 2009, the OTS Chief Accountant and senior accounting staff conducted a "live" supervision policy presentation (telephone conference call) available to all staff which included a review of the capital contribution guidance. The full presentation, including the questions and answers, was posted to the OTS Intranet. In addition, more than 40 OTS staff members attended the Interagency Accounting Conference on April 14-16, 2009. Recognition of capital contributions in the form of cash or notes was discussed during the OTS-only session and time was allotted for questions and answers. Additionally, on March 25, 2009, OTS conducted a presentation and discussion about the recognition of capital contributions in the form of cash or a note receivable at an OTS all-attorney meeting in Washington.

OIG Comment

OTS's actions meet the intent of our recommendation. As stated above, we continue to emphasize the need for periodic training of examiners and supervisory staff in this area.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. Major contributors to this report are Lisa DeAngelis, Senior Auditor, and Donna Joseph, Referencer. If you wish to discuss the report, you may contact me at (202) 927-5776.

Susan L. Barron
Audit Director

We received information from the Federal Deposit Insurance Corporation (FDIC) Inspector General indicating that a May 2008 capital contribution into IndyMac Bank, F.S.B. (IndyMac) was recorded in the prior quarter. During our initial review of this matter, we requested the Office of Thrift Supervision (OTS) provide us with information regarding any other similar backdated transactions that had occurred. For the fiscal year ending September 30, 2008, OTS advised our office that it had identified 241 amended Thrift Financial Reports (TFR) that had changes to total equity capital. Of that number, OTS determined that 82 of the amended TFRs reflected increases in equity capital. Upon further review, OTS found five cases where a capital contribution was backdated to the previous quarter. Our review focused on IndyMac and these additional five cases.

The specific objectives of this audit were to review (1) the circumstances surrounding the backdating of capital contributions by the six thrifts, (2) the appropriate accounting treatment for these capital contributions, and (3) the oversight performed by the OTS officials relating to these transactions.

To meet our objectives, we

- reviewed documentation obtained from OTS as to the circumstances surrounding the backdated capital contributions, including OTS's analyses of the transactions, examination workpapers, thrift documents, and internal e-mail messages;
- interviewed OTS headquarters officials, field officials, and staff (this included those officials and staff responsible for the supervision of the six thrifts discussed in this report);
- interviewed OTS officials responsible for establishing the OTS accounting policy to be followed by thrifts for recording/recognizing capital contributions;
- for IndyMac, interviewed its independent auditor and reviewed workpapers prepared by the independent auditor;
- defined and analyzed the accounting authorities and available supporting guidance relating to the accounting treatment of capital contributions; and
- discussed accounting guidance with officials from OTS, the Financial Accounting Standards Board, FDIC, the Securities and

Exchange Commission, and the Office of the Comptroller of the Currency.

We conducted our fieldwork from September 2008 through May 2009 at OTS's headquarters in Washington, D.C. and Western Region; and E&Y in Los Angeles, California.

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.

IndyMac Bank, F.S.B.

Summary IndyMac Bank F.S.B. (IndyMac) improperly backdated a May 2008 capital contribution of \$18 million from its holding company to its financial reports for the period ending March 31, 2008. The Office of Thrift Supervision's (OTS) Western Region Director approved the backdating of this transaction. This backdated transaction was done to maintain IndyMac as a well-capitalized institution when, in fact, it was not well-capitalized at that date.

Discussion The circumstances leading to the backdated capital contribution began with the thrift's independent auditor's review of its interim financial statements for the quarter ended March 31, 2008.⁹ During the course of that review, the independent auditor, Ernst & Young LLP (E&Y) proposed a number of adjustments.¹⁰ When combined with previously proposed, but unrecorded adjustments identified by E&Y during the course of its audit of IndyMac's calendar year 2007 financial statements, the effect would have put IndyMac's capital ratio as of March 31, 2008 below the 10 percent "well-capitalized" threshold.¹¹

The E&Y engagement partner for IndyMac participated in a conference call with the OTS Western Region Director and IndyMac's Chief Executive Officer (CEO) on May 9, 2008. During the call, the CEO asked if OTS would allow IndyMac to record a

⁹ A review of interim financial information by an independent auditor differs significantly from an audit. The objective of a review is to provide the auditor a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles (GAAP). A review does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP. A review consists principally of performing analytical procedures and making inquiries of persons responsible for financial accounting matters, and does not contemplate tests of account records or controls, obtaining corroborating evidence, or performing certain other procedures ordinarily performed in an audit.

¹⁰ It is not unusual for an auditor to propose adjustments. It is also not unusual for management to waive the recordation of those adjustments. In practice, the auditor keeps track of the total effect of any unrecorded adjustments and if that total effect becomes material to users, the auditor will insist that the adjustments be recorded. Failure to do so by management will result in a modification of the auditor's opinion.

¹¹ When an institution falls below "well-capitalized," certain restrictions automatically take effect like restrictions on brokered deposits.

May 2008 capital contribution¹² from IndyMac's holding company to IndyMac as of March 31, 2008. According to E&Y officials, the OTS official acknowledged the issue of the E&Y's proposed adjustments and agreed to IndyMac's proposal to backdate the capital contribution. As a result, IndyMac's total risk-based capital ratio was restored back over the 10 percent "well-capitalized" threshold for the March 31 report.

The capital contribution in question occurred on May 9, 2008, nearly 6 weeks after the end of the quarter and the day of the conference call between the IndyMac CEO, the OTS Western Region Director, and E&Y. The actual amount infused on that date was \$50 million but only \$18 million of that amount (the amount necessary for IndyMac to be "well-capitalized") was backdated to the prior quarter. According to IndyMac documentation, the capital contribution of \$50 million was intended by the holding company's board of directors to be for the second quarter (quarter ending June 30, 2008).¹³

The impact of OTS's approval to record the capital contribution in the quarter ending March 31, 2008, was that IndyMac was able to maintain its "well-capitalized" status, and avoid the requirement in law to obtain a waiver from FDIC to accept brokered deposits.¹⁴ It also solved another problem in that the independent auditor had advised IndyMac management that without IndyMac's acceptance of several proposed adjustments relating to the thrift's capitalization, the independent auditor would not have signed-off on the interim review. IndyMac needed the signed interim review in order to file a complete quarterly report (10Q), as required, with the Securities and Exchange Commission on May 15, 2008.

¹² The E&Y workpaper that was prepared around this time to document the conference call stated that the capital contribution was made in April 2008. This was apparently an error in the workpaper as there was no mention of an April 2008 contribution in the documents we reviewed and our interviews with E&Y and OTS officials.

¹³ There was some evidence that IndyMac sought OTS's approval to backdate the entire \$50 million contribution. However, the OTS West Region Director authorized only the \$18 million to be backdated.

¹⁴ There are five established capital classifications for insured financial institutions: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The use of brokered deposits is limited to well-capitalized insured depository institutions. Adequately capitalized institutions are required to obtain a waiver from the Federal Deposit Insurance Corporation (FDIC) in order to accept brokered deposits.

Although the OTS Western Region Director approved the backdating of the capital contribution, he did so without obtaining documentation supporting the circumstances surrounding the transaction. When we initially inquired about the backdated capital contribution, in September 2008, the OTS Deputy Director responsible for Examinations, Supervision, and Consumer Protection (ESCP), stated he was told that IndyMac had recorded a note receivable for the \$18 million as of March 31, 2008. The Deputy Director requested that OTS staff research the transaction. He later advised us, in an October memorandum, that such a note receivable did not exist.

We then sought to determine whether the holding company had the cash available as of March 31, 2008, to make an \$18 million capital contribution at period-end. In this regard, we reviewed the bank statements of the holding company.¹⁵ Based on our review of those records, the holding company did have about \$18.3 million in cash at March 31, 2008.

In a letter dated January 30, 2009, to the Treasury Secretary, the OTS Director concluded that the \$18 million capital contribution that occurred on May 9, 2008, should not have been included in IndyMac's Thrift Financial Report (TFR) for the period ending March 31, 2008. OTS based its conclusion on the fact that the institution had not recorded a note receivable from the holding company before the quarter ended.

E&Y officials we interviewed stated that they were not aware of Financial Accounting Standards Board Emerging Issues Task Force Abstract 85-1, *Classifying Notes Received for Capital Stock* (Abstract 85-1) and therefore, the abstract was not considered in their decision to sign-off on the IndyMac financial statements for the quarter ending March 31, 2008. The officials also stated that they had not previously encountered a situation where a capital contribution was backdated. The officials stated that they accepted the accounting treatment for the contribution based only on the OTS approval.

¹⁵ We obtained the holding company accounting records and bank statements from FDIC. At the time of our fieldwork, FDIC was operating the former IndyMac Bank under the name of IndyMac Federal Bank as conservator.

On June 20, 2008, a little over a month after IndyMac backdated the capital contribution and amended its TFR, OTS completed a comprehensive examination of IndyMac and assigned a composite CAMELS rating of 5¹⁶ to the institution. On July 11, 2008, OTS placed IndyMac into receivership, formed a newly chartered thrift (IndyMac Federal Bank, FSB), and named the FDIC as conservator. The estimated loss to the Deposit Insurance Fund from the failure of IndyMac is \$10.7 billion.

Thrift 1

Summary According to documentation provided by OTS, this thrift recorded an August 2008 contribution by its holding company as thrift capital for the quarter ending June 30, 2008. In this case, OTS directed the backdating of the capital contribution.

Discussion On August 4, 2008, OTS headquarters officials, including the Senior Deputy Director and the Deputy Director for ESCP, participated in a conference call with OTS Southeast Region officials to discuss the thrift's CAMELS ratings for a recently concluded examination of the thrift and the appropriate supervisory and enforcement response. Among the items discussed was the willingness of management to infuse capital from the holding company into the thrift to offset a loss for the quarter ending June 30, 2008. With that in mind, the amount of funds available at the holding company for infusion was discussed and the OTS Senior Deputy Director told the OTS regional officials to request the holding company to infuse as close to a certain amount of funds as possible. The timing of the recognition of the contribution was also discussed. The OTS Senior Deputy Director advised that for regulatory purposes the infusion should be recognized as of June 30, 2008, and the TFR amended accordingly.

In an interview, an OTS Southeast Region official told us that during the call, the OTS Southeast Region Director informed the Headquarters officials that the thrift did not have a note or other required documentation to support recognition of the contribution in the June quarter under GAAP. According to the OTS regional

¹⁶ CAMELS is an acronym for the following performance rating components: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the best rating and 5 being the worst rating.

official, the Senior Deputy Director indicated that he was willing to accept that in this case. After the conference call, OTS Southeast Region officials called the thrift's CEO and directed that the capital contribution be made immediately and an amended TFR be filed. The contribution was made in August 2008 and the TFR was amended accordingly to reflect the contribution as of June 30, 2008.

Even without the capital contribution, based on June 30, 2008, financial information, the thrift met the regulatory threshold as well-capitalized as it had a total risk-based capital ratio of greater than 10 percent. However, OTS had imposed a 15 percent risk-based capital level on the thrift by a Memorandum of Understanding issued in July 2008.¹⁷

According to the latest OTS Problem Bank Report provided our office, as of February 11, 2009, the thrift's composite CAMELS rating is now 5 and it is classified as critically undercapitalized.

Thrift 2

Summary According to OTS documentation, the thrift created and backdated a note receivable after the fact to improperly record a July 2008 capital contribution as capital for the quarter ended June 30, 2008. OTS was aware of the backdated capital contribution, concluded that the transaction was inappropriate, and notified management of OTS's position. However, OTS did not require the thrift to restate the TFR for June 30, 2008 after management proceeded to backdate the transaction.

Discussion On July 22, 2008, OTS examiners met with management of the thrift to discuss the thrift's capital status. Based on analysis performed by the thrift's management and with input from OTS examiners, the thrift's allowance for loan and lease losses (ALLL) needed to be increased. OTS examiners suggested that the increase to the ALLL be made as of June 30, 2008, and reported in the corresponding TFR. This increase to the ALLL would result in the thrift's capital level falling below well-capitalized.

¹⁷ OTS enters into Memorandums of Understanding with thrifts as informal enforcement actions to correct unsafe and unsound practices or compliance issues. Memorandums of Understanding are not enforceable in court or made public by OTS.

In a letter to OTS dated July 30, 2008, the chairmen of the boards of the thrift and holding company stated that the problem could be solved by creating a note payable from the holding company to the thrift. The chairmen further stated the holding company's board resolved to make a capital contribution of a size and structure necessary to maintain the thrift's well-capitalized status following a management analysis of required additions to the thrift's ALLL based on June 30, 2008, financial reports. In addition, the letter stated the contribution would occur after June 30, 2008, but before the filing of the TFR for that quarter; and that the note would be recognized as capital in the June 30, 2008, TFR and would maintain the thrift's well-capitalized status as of that date.

In a July 22, 2008 meeting with OTS examiners, the thrift's Chief Financial Officer (CFO) referred to Abstract 85-1 as the basis for action, which according to their external accountants, would allow the thrift to retroactively record the capital contribution as a note receivable from the holding company and include it as equity capital thereby keeping the thrift minimally above the well-capitalized level. The CFO stated that prior to June 30, 2008, the holding company board agreed to provide the necessary capital to the thrift for it to remain well capitalized at June 30, 2008; however, they were uncertain what the appropriate amount of capital would be at that time. The CFO also stated that the potential ramifications of filing the June 30 TFR as adequately capitalized, combined with the significant losses and elevated volume of classified assets, could create a liquidity crisis and materially impact the thrift's future viability. The CFO told the examiners that it was imperative that the thrift's well-capitalized status be maintained in order to have access to the broker deposit market for liquidity purposes.

On the same day, the examiners consulted with OTS's Southeast Region accountant about the transaction. The OTS accountant told the examiners that OTS is of the opinion that Abstract 85-1, and basic accounting principles, precluded recognition of a capital contribution where the cash is received after the balance sheet date unless the bank receives a legally enforceable note receivable dated prior to the balance sheet date.

A promissory note was created and the capital contribution received in July 2008 was recorded in the TFR as of June 30, 2008. However, OTS confirmed to us that it did not require the thrift to restate the TFR.

According to the latest OTS Problem Bank Report, as of January 6, 2009, the thrift's composite CAMELS rating is now 4 and it is classified as adequately capitalized.

Thrift 3

Summary According to OTS documentation, this thrift created and backdated a note receivable after the fact to improperly record a July 2008 capital contribution as capital for the quarter ended June 30, 2008. This action was taken to maintain the thrift in a well-capitalized status after its independent auditor identified a necessary audit adjustment. However, the action was unnecessary as OTS examiners later found accounting errors that caused the thrift's capital level to be understated. Had those errors been detected and corrected, the thrift would have been well-capitalized for the quarter without the backdated capital infusion. OTS did not require the thrift to restate the TFR for June 30, 2008.

Discussion The thrift's independent auditors noted during their review of the financial statements for the quarter ending June 30, 2008, that the thrift needed to record an additional amount for other than temporary impairment (OTTI) charges.¹⁸ As a result of the review, the thrift's change in policy required an additional amount in OTTI to be recorded on the thrift's records as of June 30, 2008.

¹⁸ Financial Accounting Standard 115, "Accounting for Certain Investments in Debt and Equity Securities," requires that for individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an OTTI shall be considered to have occurred. If the decline in fair value is judged to be other-than-temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write down shall be included in earnings (that is, accounted for as a realized loss).

To offset the amount charged off as OTTI and, in turn, the unexpected loss, the thrift obtained a capital contribution from its holding company to maintain its well-capitalized status. The contribution occurred in July 2008. The thrift also created and backdated a note receivable and recorded the infused amount as capital as of June 30, 2008.

OTS examiners discovered during the subsequent examination that the thrift was reporting single family real estate properties qualifying for 50 percent risk-weighting treatment at a 100 percent risk-weighting in error. The loans were reclassified to the correct 50 percent risk-weighting category beginning with the September 2008 TFR. This correction, had it been applied to the June 2008 quarter, would have the effect of raising the risk-based capital ratio and regardless of the capital contribution, the thrift would have remained well capitalized. However, this fact was not known at the time the backdating was done.

In an interview, the OTS Western Region Assistant Director stated that he first became aware of the backdated capital contribution in December 2008 when OTS headquarters asked for cases in which capital contributions from the holding company to the thrift had been backdated. He knew that in the case of the thrift, the capital ratio was just above the required ratio and reviewed the thrift for potential backdating. He stated that the entire backdating of the capital contribution took place in July 2008. OTS was not aware that this had been done at the time. He further stated that the holding company infused just enough capital to keep the bank over the capital standards for well-capitalized. OTS did not become aware the transaction was backdated until December 2008; and therefore, would not be able to require the thrift to restate as the closing period for amending the June 2008 TFR had lapsed.

The thrift received a composite CAMELS rating of 3 on its last examination, and is well-capitalized. The thrift is being tracked as an elevated risk requiring additional supervisory attention.

Thrift 4

Summary According to OTS documentation, this thrift created and backdated a note receivable after the fact to improperly record a

January 2007 capital contribution for the quarter ended December 31, 2006. Without the additional capital contribution, the thrift was still well-capitalized (at 10.01 percent) for the quarter. OTS documentation indicated that OTS examiners questioned the transaction but in the end determined that the accounting treatment was acceptable.

Discussion Thrift management concluded in December 2006 that the holding company would need to make a capital contribution to the thrift to continue to maintain its well-capitalized status. In December 2006, the holding company made a capital contribution based on management's estimate as to the amount needed.

However, in connection with the year-end closing process in early January 2007, the thrift determined that its risk-based capital ratio was 10.01 percent, which met well-capitalized status. The holding company infused additional capital which increased the thrift's risk based capital ratio to 10.07 percent. The thrift recorded the additional capital contribution made in January 2007 as if it had occurred on December 31, 2006, after the period end date, but before filing its quarterly TFR. The thrift documented the infusion with a note receivable created in January 2007, also backdated to December 2006.

In a report, the thrift's internal auditors stated that an audit of the TFR for December 31, 2006, found that there was no clear, direct GAAP or regulatory accounting guidance to support the recognition of the capital contribution as a receivable at December 31, 2006. The report also recognized management's key reasons for backdating the capital contribution to December 31, 2006. However, the internal auditors stated that they agreed with management's conclusions and did not object to the accounting treatment applied to the infusion. In addition, the thrift's independent auditors reviewed the accounting treatment by management and accepted it.

OTS examiners raised concerns about the backdated capital infusion during an April 2007 examination of the thrift. An OTS examiner noted disagreement in the examination workpapers with the thrift's decision to record the January 2007 capital contribution in the quarter ending December 31, 2006. The examiner stated in the workpapers that contrary to the opinion of senior management,

the examiners determined that the capital contribution should not have been included as capital in 2006 because the evidence indicates that the need for the contribution was not recognized until January 2007. The examiner also stated that he was unsure whether the thrift was well-capitalized at December 31, 2006, because its risk-based capital level was only 10.01 percent prior to recording the January 2007 contribution, and there were various errors noted which could not be determined during the course of the examination.

In addition, in a series of emails between the OTS Northeast Region accountant and examiners discussing the issue, the accountant and examiner indicated to the examiner in charge that they believed there was no support for the backdating of the transaction and that it should have been reversed. They further stated that they believe there needs to be a legally, binding transaction in order to record the receivable. The examiner in charge responded that the opinion from headquarters was that unless there was a board resolution or receivable, it was not capital. However, in the examiner workpapers, these opinions were overridden by an OTS Northeast Region field manager after considering additional information, including analysis of Abstract 85-1 and discussions with holding company's counsel and independent accountants. OTS in the end took the position that there was no problem with the accounting of the capital contribution by the thrift.

In an interview, the OTS Northeast Region Assistant Director told us that he first became aware of the capital contribution during an examination in May 2007. After reviewing the situation, the OTS official stated that OTS determined at the time that the accounting treatment was permissible and that the thrift would have met the well-capitalized threshold without the contribution.

The thrift received a composite CAMELS rating of 3 on its last examination, and is well-capitalized. The thrift is being tracked as an elevated risk requiring additional supervisory attention.

Thrift No. 5

Summary According to OTS documentation, this thrift recorded a note receivable after the fact to improperly report capital

contributions received in October and November 2007 for the quarter ended September 30, 2007. OTS required the thrift to reverse the transaction.

Discussion The capital contributions were made because loan losses related to the September fiscal year-end caused the thrift to drop from the status of well-capitalized to adequately capitalized. After determining the amount of the loan losses subsequent to fiscal year-end, the holding company infused capital into the thrift.

The thrift recognized the capital contributions as of September 30, 2007, by recording a note receivable and increasing its capital. However, the thrift did not receive a note receivable from its holding company. According to OTS's Chief Accountant, thrift officials stated that they had communicated to OTS the holding company's intent to provide capital when needed in order to maintain certain core capital levels. While there was no communication of intent to maintain well-capitalized status, the thrift officials asserted that the statement of intent regarding core capital was equivalent to a note receivable and supported recognition of an asset as of September 30, 2007. The thrift officials' views were that intent is recognizable as an asset under Abstract 85-1 as long as the holding company had the intent and ability to make the capital contribution and did so prior to issuance of the financial statements. OTS's Chief Accountant disagreed with the thrift's analysis of Abstract 85-1 and OTS directed the thrift to restate the TFR. As a result, the thrift's September 30, 2007 audit opinion on the financial statements was reissued by the audit firm.

The thrift is not included on the latest OTS problem bank report.

Note: OIG Comments appear in Appendix 4.



Office of Thrift Supervision
Department of the Treasury

John E. Bowman, Acting Director

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

May 18, 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 OTS Involvement with Post-Period End
Capital Contributions

Thank you for the opportunity to comment on your draft audit report entitled "OTS Involvement with Backdated Capital Contributions by Thrifts." The report focuses on post-period capital contributions made by a small number of savings and loan holding companies to their subsidiary thrift institutions and the responsibility of the Office of Thrift Supervision (OTS) for ensuring such contributions are reported correctly. The agency is committed to continuing to improve and strengthen its processes based on the lessons learned from its internal review and the Office of Inspector General's (OIG) findings.

OTS has focused extensive resources on the issue of post-period capital contributions and has provided detailed guidance and communication to its staff and the institutions it supervises regarding proper recognition and reporting of capital contributions on the Thrift Financial Report (TFR). The draft audit report states that for two thrifts OTS officials "either directed or authorized the thrifts to backdate the capital contribution." In each case, as OTS has previously stated, the thrift should not have recorded the capital contribution in the prior quarter TFR without a valid note receivable from its holding company.

In addition, there are four other key points that should be emphasized about these two cases:

1. The capital contributions in question were made to the thrifts in cash prior to filing of quarterly Securities Exchange Commission (SEC) public filings.
2. The contributions increased capital at the thrift level but had no impact on the equity reported by the holding companies in their consolidated public financial statements.

OIG Comment 1,
Appendix 4

OIG Comment 2,
Appendix 4

May 18, 2009
Page 2

3. The contributions were consistent with OTS's primary safety and soundness mission and longstanding practice of requiring holding companies to serve as sources of financial support for their FDIC-insured subsidiary thrifts to help prevent or reduce potential losses to the deposit insurance fund.
4. The Thrift Financial Report is specifically designed for the intended purpose of providing regulators with the financial data necessary to gauge the safety and soundness of the institution. Publicly traded companies must comply with reporting requirements of the SEC to keep investors and the public informed about their activities.

OTS has taken action to address each of the recommendations in the OIG's draft report as discussed below.

Recommendation #1 – Identify Any Other Post-Period Capital Contributions

OTS conducted an extensive search for post-period end capital contributions as described in Appendix 1 of the draft OIG audit report. This search resulted in identification of the six cases referenced in the report. In one of the cases, OTS identified the incorrect reporting and had directed the institution to file an amended TFR and to re-state its annual audited financial statements to reverse the capital contribution. In three of the other five cases, the capital contributions were not needed to maintain the well-capitalized status of the thrifts.

Going forward, to further help identify capital contributions through off-site monitoring, OTS has instituted a TFR edit check process to identify and report amended TFRs that reflect increases to equity capital. OTS has also developed a report that highlights increases to equity capital from stock issued (TFR line SI640) or capital contributions where no stock is issued (TFR line SI655). TFR edit checks for these line items will be implemented in June and will require the filing institutions to provide explanations of the reported amounts. The reports and explanations will be provided to staff through the OTS Intranet.

Recommendation #2 – Issue Additional Guidance

OTS issued New Directions Bulletin 09-04 to all examination and supervision staff on January 23, 2009. The purpose of the bulletin was to remind examiners and other supervisory staff of the appropriate regulatory reporting and regulatory capital treatment by savings institutions of equity capital contributions in the form of cash or notes receivable. This guidance was also issued to OTS supervised institutions as CEO Memorandum #293 on February 26, 2009 and is available on the OTS public website.

Appendix 3
Management Response

May 18, 2009
Page 3

The Bulletin did not specifically include references to longstanding OTS policies and procedures regarding the identification and follow-up action processes relating to misreporting of capital contributions (see attached technical note). These policies and procedures are reflected in the OTS Examination Handbook and Thrift Financial Report instructions. The Examination Handbook work programs are designed for use by examiners in performing on-site examinations of thrift institutions. The principles for correction of identified TFR errors apply whether an error is identified through an examination or outside of the examination process. OTS will remind its examiners and supervisory staff of the actions required to address TFR reporting errors.

Recommendation #3 - Ensure Staff Understands OTS Guidance

OTS has taken action to ensure staff fully understands the January 23, 2009, New Directions Bulletin guidance. On April 2, 2009, the OTS Chief Accountant and senior accounting staff conducted a "live" supervision policy presentation (telephone conference call) available to all staff which included a review of the capital contribution guidance and "opened" the phone lines for questions from staff on the topic. The full presentation, including the questions and answers, was posted to the OTS Intranet in April 2009. In addition, more than 40 OTS staff members attended the Interagency Accounting Conference on April 14-16, 2009. Recognition of capital contributions in the form of cash or notes was discussed during the OTS-only session and time was allotted for questions and answers. On March 25, 2009, OTS conducted a presentation and discussion about the recognition of capital contributions in the form of cash or a note receivable at an OTS all-attorney meeting in Washington.

In conclusion, thank you again for the opportunity to review and respond to your draft report. We appreciated the professionalism and courtesies provided by the staff of the Office of Inspector General.

Attachment

cc: The Honorable Timothy F. Geithner
Secretary of the United States Department of the Treasury

May 18, 2009
Page 4 - Attachment

Technical Note:

OTS Examination Handbook and Thrift Financial Report (TFR) Instructions

The objective of OTS's Examination Handbook Program 410 (Earnings) is to determine the accuracy of the quarterly TFRs filed with OTS and to ascertain if the savings association must file any amended reports. This Handbook section states that the examiner should review the content of the most recent TFR for accuracy. If the examiner discovers errors or omissions during the TFR review, the examiner should determine whether any association policies, procedures, or deficient or inadequate practices caused them. The examiner should explain and document any significant adjustments in the report of examination. A significant adjustment results in any one of the following:

- Failure of a capital requirement.
- Change in an association's Prompt Corrective Action category.
- Change in a component rating.
- A change that is significant for regulatory reporting purposes.

The Handbook goes on to state that generally the examiner should not require that an association amend a prior period TFR unless the adjustment is significant. If the adjustment is not significant, the examiner should direct the association to include the adjustment on its next scheduled TFR filing.

Examination Handbook Program 120 (Capital Adequacy) instructs the examiner to verify the reliability and accuracy of the institution's capital calculations. If necessary, the examiner should revise the capital calculations and recheck the resulting Prompt Corrective Action capital category. The program contains a list of areas that may be material to the reliability of the capital calculations, including the question, "Are post-period-end adjustments correct?"

Page 103 of the General Instructions to the TFR sets forth criteria for submission of an amended TFR. The objective is to file amendments within 45 calendar days of the quarter end, but no later than 135 calendar days after the end of the quarter.

OIG Comment 1 OTS stated that the capital contributions in question were made to the thrifts in cash prior to the filings of quarterly Securities and Exchange Commission public filings. Although true, the fact remains that in both cases there was not a valid note receivable recorded before the end of the quarter. Therefore, no contribution towards capital should have been recorded in the prior quarter regardless of whether the cash was received prior to the public filings. In addition, for IndyMac, the backdated capital contribution was intended by its holding company's board of directors to be for the second quarter, not as of March 31, 2008.

OIG Comment 2 OTS stated that the contributions increased capital at the thrift level but had no impact on the equity reported by the holding companies in their consolidated public financial statements. This statement is true for all contributions whether they are backdated or recorded in the proper period as these transactions would be eliminated when preparing holding companies' consolidated financial statements. However, our concern with these transactions are not on the consolidated financial statements, but on the thrift's financial reports prior to consolidation. In that regard, the thrifts' financial reports would be inaccurate and misleading to the regulatory agency and other users who rely on these reports to make decisions relating to the safety and soundness of the financial institution.

Department of the Treasury

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

Office of the Thrift Supervision

Acting Director
Liaison Officer

Office of Management and Budget

OIG Budget Examiner