Office of Thrift Supervision
Department of the Treasury

John M. Reich
Director

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

January 30, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Geithner:

As you are well aware, the Office of Thrift Supervision closed IndyMac Bank on July 11, 2008 and appointed the Federal Deposit Insurance Corporation receiver. As required by law, the Department of the Treasury Inspector General is conducting a material loss review and, as part of that review, the IG has raised issues related to a capital infusion from IndyMac Bancorp, the holding company, to IndyMac Bank.

I am writing to you today to provide you with a complete understanding of that transaction. Let me assure you that the OTS takes this matter very seriously, and fully appreciates its potential impact on the reputation of the Agency and the perception of the quality of OTS bank supervision. As a result, we have taken decisive action, as described later in this letter.

It is important to note that ensuring strong capital is a key to maintaining a safe and sound institution—the goal of prudential bank supervision. The OTS has a longstanding practice of looking to the holding company as a source of strength for maintaining strong capital in the thrift.

The capital infusion has raised five key questions, which I will address in order:

What date was appropriate for posting the capital infusion?

After conducting a review of this transaction, we have concluded that the $18 million capital infusion that occurred on May 9, 2008 should not have been included in IndyMac's Thrift Financial Report (TFR) for March 31, 2008. Our conclusion is predicated on the fact that the institution had not recorded a note receivable from IndyMac Bancorp before the quarter ended. The infusion should have been recorded in the second quarter of 2008 (for timeline, see Attachment 1).

What was the significance of the first quarter posting date for the capital infusion?

If the capital infusion had not been included in the amended TFR that IndyMac filed for the first quarter on May 12, 2008, but audit adjustments identified in May 2008 had been incorporated, the amended TFR would have shown a risk-based capital ratio of 9.98 percent, according to IndyMac.

However, the OTS would not have deemed the institution "adequately capitalized" for purposes of prompt corrective action (PCA). Because the capital injection occurred on May 9—three days before the filing of the amended TFR—the infusion had already ensured IndyMac remained "well capitalized." PCA would not be triggered because PCA determinations reflect an institution's condition at that moment in time—not a look back at a past condition.

Would a different posting date have had any effect on the health or permissible activities of the thrift?

The first quarter posting date of the capital infusion had no effect on the ultimate outcome of IndyMac. The effect of any institution falling below "well capitalized" is that, under PCA regulations, the institution would be prohibited from accepting brokered deposits without a waiver from the FDIC. In this case, IndyMac had been steadily shedding brokered deposits in the preceding months. In addition, the capital infusion ensured that the ongoing capital position of IndyMac would remain "well-capitalized," therefore a waiver would not have been necessary.

Is it appropriate or common to amend a TFR after the end of the quarter?

The Treasury IG has been reported to say that OTS regularly permits capital infusions to be posted to prior quarters through amended TFRs. An ongoing internal review by the OTS shows this is not the case. The review found four cases that, for various reasons, were not acceptable by current OTS standards. For the four quarters ending September 30, 2008, we identified 241 amended TFRs that had changes to total equity capital. Of that number, 82 of the amended TFRs reflected increases in equity capital. There are many accounting reasons why equity capital would be higher in an amended TFR, but only one of those cases (other than IndyMac) involved a capital infusion applied to the previous quarter. That infusion took place six days after the initial TFR filing, but before the public 8-K filing.

In three separate cases identified by OTS regional managers, a capital infusion was applied to the previous quarter, but was made prior to the filing of the TFR (see Attachment 2).

In three of the four cases of capital infusions—involving institutions in OTS's Northeast, Southeast and West regions—there was an absence of a note receivable from the holding company by period end. We have communicated to our examination staff that reporting capital infusions after the end of the reporting period is not acceptable except under very limited circumstances (see Attachment 3).

Are reports of regulatory capital intended to inform the public about the health of insured depository institutions?

Generally accepted accounting principles (GAAP) form the foundation for regulatory reporting, but GAAP standards and regulatory capital standards were designed for different purposes. Regulatory capital standards are designed to give federal banking regulators a perspective for evaluating the safety and soundness of regulated depository institutions. Accounting standards, as reported through Securities and Exchange Commission (SEC) filings, are aimed at ensuring consistent information for the public to make business and investment judgments. When an investor uses regulatory information to decide whether to make an investment in an insured depository institution, a potential arises for misinformed decisions. Although some regulatory information is publicly available, a much more extensive and complete body of information, including examination reports and supervisory correspondence, is not made public.

It is important to note that IndyMac Bancorp's March 2008 Form 10-Q report to the SEC included several cautionary statements regarding the bank's ability to continue to meet the requirements of a "well-capitalized" institution. These statements included a note (page 31) that April 2008 ratings downgrades to the bank's mortgage-backed securities would negatively impact the risk-based capital at June 30 and if the lower ratings had been in effect on March 31, total risk-based capital would have fallen below the well-capitalized requirement.

OTS Actions

As I mentioned earlier in this letter, I want to make you aware of steps we have taken to ensure our West Regional Office is fully compliant with all OTS supervisory policies and practices. Regional Director Dochow has been placed on administrative leave pending completion of reviews and investigations relating to IndyMac. We have assigned an OTS regional accountant, independent of the West Region, to conduct a forensic accounting review. We have also hired a highly qualified outside expert to conduct a thorough and independent review of the actions and decisions of our West Region management team.

I hope you find this information helpful. If you have any questions or wish to discuss this information further, please do not hesitate to call me or Barbara Shycoff, Managing Director of External Affairs at (202) 906-6288.

Sincerely,

John M. Reich
Director

Attachments

cc: The Honorable Ben S. Bernanke, Chairman
The Honorable Shelia Bair, Chairman
The Honorable John Dugan, Comptroller
The Honorable Eric Thorson, Inspector General

Attachment 1 to OTS Letter Regarding IndyMac Capital Infusion – IndyMac Capital Infusion Timeline – January 30, 2009

- **December 31, 2007** – The Thrift Financial Report (TFR) for IndyMac Bank reported that risk-based capital exceeded 10 percent, and IndyMac exceeded the regulatory "well capitalized" standard.
- **February 2008** – IndyMac's external auditors, Ernst & Young (E&Y), issued the audit for the year ending 12/31/2007. E&Y had advised IndyMac management of potential adjustments to their 4Q2007 financial statements. E&Y determined that the adjustments, if taken, were not material because they would not have resulted in a change from the "well capitalized" position.
- **March 31, 2008** – After the IndyMac board approved a capital injection of up to $75 million, IndyMac Bancorp injected $70 million into IndyMac Bank, the amount the company deemed necessary to ensure that the risk-based capital ratio remained above 10 percent.
- **May 1, 2008** – IndyMac filed its first quarter 2008 TFR, reporting its capital position as "well capitalized" with a risk-based capital ratio of 10.15 percent.
- **May 5-9, 2008** – Thrift management and E&Y discussed potential adjustments to the 1Q2008 financial statements. E&Y determined that these adjustments, together with the E&Y 4Q2007 unrecorded adjustments, would have resulted in a revised risk-based capital ratio of 9.98 percent for the first quarter of 2008 (2 basis points below "well capitalized") if they had been recorded. It is important to note that based on our review of the E&Y work papers, we have not been able to substantiate the impact of recording the audit adjustments and the resulting capital status.
- **May 9, 2008** – IndyMac management agreed with E&Y that the adjustments were appropriate.
- **May 9, 2008** – IndyMac management, E&Y and OTS West Regional Director Darrel Dochow participated in a conference call to discuss whether a reported intercompany receivable of $18 million that was collected in cash on May 9 could be included in capital for purposes of the March 31, 2008 TFR. This injection would maintain the bank's capital above 10 percent and therefore at a "well capitalized" level. Dochow agreed, E&Y did not object to the transaction, and the capital injection was made.
- **May 10, 2008** – OTS informed the FDIC Regional management of the transaction and the FDIC did not raise an objection. (The FDIC was participating in the 2008 annual examination of IndyMac.)
- **May 10, 2008** – E&Y met with the IndyMac Board's Audit Committee to explain the transaction. The Audit Committee approved the transaction.
- **May 12, 2008** – IndyMac filed an amended TFR for March 31, 2008, reflecting the $18 million contribution and continuing to report its capital position as "well capitalized" with a risk-based capital ratio of 10.26 percent. E&Y determined its

proposed, unrecorded adjustments were not material since, if taken, they would not have resulted in a change to the reported "well capitalized" status.

- **May 12, 2008** – IndyMac Bancorp issued public quarterly financial report (Form 10-Q).
- **October 23, 2008** - E&Y informed the Treasury OIG that it was comfortable with the transaction because, when consolidated, the holding company and bank would have sufficient capital. E&Y reported to Treasury OIG that "what was done was not inconsistent with GAAP." The capital contribution was funded by the holding company prior to release of the company's 1Q2008 10-Q report.

Attachment 2 to OTS Letter Regarding IndyMac Capital Infusion – Summary of Post-Period Capital Infusions – January 30, 2009

Thrift #1

In conjunction with an OTS examination, Thrift #1 required additional loan loss provisions after the period end to be reflected as of June 30, 2008. As a result, OTS directed the holding company on August 4, 2008 to infuse capital to improve the regulatory capital ratio. The institution exceeded the well-capitalized standards before and after the infusion. OTS determined that the safety and soundness concerns at the institution were significant. Although the institution met the regulatory threshold for a "well capitalized" institution, the OTS notified the institution that it was reclassifying the thrift to "adequately capitalized" for regulatory purposes. Thrift #1 obtained the capital infusion after the period end and after filing its quarterly Thrift Financial Report (TFR), but prior to publishing its Form 8-K.

Thrift #2

During an OTS examination of Thrift #2, OTS examiners discussed the need for additional reserves to cover loan losses. The Board of Directors committed, via a Board resolution and promissory note in June 2008, to maintain the thrift's "well capitalized" status. Thrift #2 obtained the capital infusion to keep the institution "well capitalized." The infusion occurred after the period end date, but prior to filing its quarterly TFR.

Thrift #3

Thrift #3 identified an OTTI (Other Than Temporary Impairment) charge in conducting its post-period review of the June 30, 2008 financial data. To compensate for the charge, the thrift obtained a capital infusion to keep the institution "well capitalized." The infusion occurred after the period end date, but before the thrift filed its TFR. The thrift did not document the transaction with a note receivable prior to the June 30 period end.

Thrift #4

In the fourth quarter of 2006, new Directors and new Management of Thrift #4 entered into strategic balance sheet restructuring to enact a new business plan and operating strategy. Because of asset sales and retiring certain brokered deposits and borrowings, the thrift took a one-time expense charge. The Board determined that it would obtain the capital infusion. The Board has a long-standing mandate that it will maintain the thrift above the well-capitalized threshold. The institution exceeded the "well capitalized" standard before and after the infusion. The thrift booked the transaction after the period end date, but before filing its quarterly TFR. It documented the infusion with a receivable in January 2007.

Attachment 3 to OTS Letter Regarding IndyMac Capital Infusion – OTS Examiner Guidance – January 30, 2009

New Directions 09-04

January 23, 2009

TO:	All Examination and Supervision Staff
FROM:	Timothy T. Ward, Deputy Director
SUBJECT:	Recognition of Capital Contributions in the Form of Cash or Notes

Purpose
The purpose of this bulletin is to remind examiners and other supervisory staff of the appropriate regulatory reporting and regulatory capital treatment by savings institutions (institutions) for equity capital contributions in the form of cash or notes. The capital contribution may be a sale of equity stock or a contribution to paid-in-capital. These transactions are referred to throughout this bulletin as capital contributions. This bulletin does not address any other contributions of capital.[1]

Summary
Capital contributions of cash or notes may be included in regulatory capital only when the contribution is properly reported as equity under generally accepted accounting principles (GAAP) and complies with regulatory reporting guidance. Capital contributions in the form of cash are appropriately recognized as regulatory capital when received. Capital contributions in the form of a note receivable, executed prior to period-end[2], increase regulatory capital for that period-end only when the note is collected prior to issuance of the financial statements (including regulatory reports) for the same period.

Background
Many institutions' capital positions have been adversely affected by recent economic conditions. As a result, institutions and their holding companies are implementing various courses of action to increase capital. Consequently, the role of capital planning has taken on greater importance. A common source of capital for a subsidiary institution is a capital contribution from its parent holding company.

A majority of institutions are in corporate structures that include parent holding companies. The OTS expects these holding companies to be a source of financial strength to their subsidiary institutions. There are many circumstances under which a holding company may make capital contributions to a subsidiary institution. The most common reasons include when an institution needs capital for asset growth and, more importantly for supervisors, when an institution's safety and soundness is affected by declining capital.

An institution's capital may drop precipitously under adverse economic conditions due to a multitude of factors which may occur rapidly and simultaneously. Certain factors that cause

[1] This bulletin does not address, for example, nonmonetary contributions of capital (such as a building), nor items reported as GAAP liabilities but which may be included in regulatory capital (such as redeemable preferred stock or subordinated debt).
[2] Period-end refers to the balance sheet date of the quarterly or annual financial reporting period in question.

a decline in capital are often not measured until after the reporting period-end date. Examples of these may include evaluations of the appropriateness of the allowance for loan and lease losses, determinations of fair value estimates, and impairment assessments. These evaluations entail substantial judgment and sometimes require time after period-end to gather necessary supporting market or other data. Additionally, examination findings, audit or review adjustments, or other subsequent events occurring after period-end can result in additional losses, or other declines in GAAP equity, that must be recorded as of period-end. This can lead to post period-end adjustments that are recorded as of period end.

A capital contribution made after period-end to offset these adjustments would be properly included in the subsequent reporting period. The result can be that the institution reports lower GAAP equity/regulatory capital, including PCA category (for example, adequately capitalized instead of well capitalized), for the period in question. With proper capital planning and monitoring, management can increase the likelihood of remaining well-capitalized.

Proper Recording of Capital Contributions

Financial institutions are required to follow GAAP for regulatory financial reports. Regulatory capital rules do not specify a treatment different from GAAP for capital contributions; therefore, capital contributions increase regulatory capital only when such contributions also appropriately increase GAAP equity and comply with regulatory reporting guidance. The treatment of a contribution of cash and a contribution of a note are discussed below.

Contribution of Cash: A contribution of cash is recorded in the financial statements when it is received. Therefore, a contribution of cash prior to period-end is reported as an increase to GAAP equity/regulatory capital in that period's financial reports. Contributions of cash after period-end are **not** reflected in GAAP equity or regulatory capital of an earlier period.

Contribution of a Note: If a holding company intends to make a capital contribution to a subsidiary institution during a reporting period but needs a short amount of time to obtain the cash, the holding company may issue, on or before the last day of the reporting period, a short-term note payable to the institution. The institution would record the settlement of the note for cash when the cash is actually received. If the note is collected in cash prior to issuance of the financial statements, the institution may report the note receivable as an asset with a corresponding increase to GAAP equity/regulatory capital. Otherwise, the unpaid note receivable is reported as a reduction of GAAP equity (a contra-equity account) which offsets the corresponding credit to capital, and thus there would be no net increase in regulatory capital. Contribution of a note may only increase GAAP equity and regulatory capital reported in the Thrift Financial Report (TFR) if it satisfies both the existence and reporting criteria below.

Existence: For a note receivable to be properly reported in the TFR, it must meet the GAAP definition of an asset as of the reporting period-end. The receivable must meet **all** of the following criteria:

1. 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, CEO, or CFO);
2. A legally binding obligation to fund a specified amount by a specified date; and
3. Executed and enforceable prior to the end of the period.

While a general intent or a capital maintenance agreement that calls for the holding company to maintain its subsidiary institution at a particular capital level is an important supervisory consideration in evaluating safety and soundness, it alone would not constitute evidence that a note receivable existed at period-end that would be includable as GAAP equity or regulatory capital.

Reporting: The GAAP literature relevant to reporting notes received as a capital contribution includes:

- EITF Issue No. 85-1 (EITF 85-1), *Classifying Notes Received for Capital Stock*, and
- SEC Staff Accounting Bulletin No. 107 (Topic 4E: *Receivables from Sale of Stock*).

EITF 85-1 and SEC Topic 4E address whether a note received (debit) as a contribution to equity (credit) should be reported as either (1) a reduction in equity (a contra-equity account), or (2) an asset. For a capital contribution to increase equity capital, the note would have to qualify to be reported as an asset. In EITF 85-1, the Task Force explains the SEC's view[3] is that "such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements." SEC Topic 4E states: "The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to publication of the financial statements and the payment date is stated in a note to the financial statements."[4]

For regulatory reporting, OTS requires all institutions to follow the SEC guidance of collection in cash prior to issuance of the financial statements. Questions have arisen about how to interpret "prior to issuance of the financial statement"[5] for regulatory reporting/capital purposes. The OTS's regulatory reporting interpretation is that the cash must be received by the institution no later than the earliest date below:

1. The TFR filing deadline (30 days following the end of the reporting period);
2. Any other public financial statement filing deadline to which the institution or holding company is subject; or
3. Actual issuance of public financial statements, including filing the TFR or a public securities filing.

<u>Caution</u>: It is inappropriate for a subsidiary institution to record an increase in regulatory capital for contributions received after period-end by reporting an asset (cash or note receivable) that did not exist as of the period-end date. A capital contribution made after period-end may not be backdated for balance sheet reporting purposes as if it was received by the institution in the prior period. This applies even if the holding company has the cash on hand (including on deposit with the subsidiary institution) and would have made a capital contribution prior to period-end had it known about a capital deficiency.

---

[3] EITF 85-1 also discusses the limited cases in which nonpublic companies reported notes receivable as an asset. Specifically, it lists examples of such treatment when the note: (1) was secured by irrevocable letters of credit or other liquid collateral or discountable at a bank and (2) included a stated maturity in a reasonably short period of time. For regulatory reporting, OTS requires all savings institutions to follow the SEC guidance of collection in cash prior to issuance of the financial statements.

[4] SEC Topic 4E also states: "It should be noted generally that all amounts receivable from officers and directors resulting from sale of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity."

[5] See EITF Topic D-86, *Issuance of Financial Statements*, for the SEC staff's interpretation of when financial statements are considered to have been issued.