



Office of Thrift Supervision

Department of the Treasury

John M. Reich, Director

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

February 25, 2009

MEMORANDUM FOR: Donald P. Benson
Audit Director
Office of Inspector General
U.S. Department of the Treasury

FROM: John M. Reich /s/
Director

Scott M. Polakoff /s/
Senior Deputy Director and Chief Operating Officer

SUBJECT: Draft Audit Report on the Material Loss Review of
IndyMac Bank, FSB

Thank you for the opportunity to comment on your draft audit report entitled “Safety and Soundness: Material Loss Review of IndyMac Bank, FSB.” The report focuses on the causes of the failure of IndyMac Bank, FSB (IndyMac) and the oversight responsibility of the Office of Thrift Supervision (OTS) for IndyMac. OTS agrees with the overall findings and recommendations and has taken aggressive action to address the identified issues. The agency is committed to improve and strengthen its processes based on the lessons learned from the failure of IndyMac.

To enhance the quality of its supervisory functions, OTS is establishing a large bank unit in Washington, DC that will be responsible for reviewing and concurring with Regional office actions for savings associations with total assets above \$10.0 billion. To ensure consistent, timely, and appropriate initiation and resolution of corrective actions, OTS is implementing newly developed standards for review and approval of enforcement actions by its existing Regional Office Enforcement Review Committees.

The following chronological list of OTS actions demonstrates the agency’s commitment to strengthen its supervisory process. Beginning with your Material Loss Review of NetBank, FSB, published on April 23, 2008 (less than 90 days before the failure of IndyMac), and through both OTS’s internal review and your Material Loss Review of IndyMac, OTS has been responsive to recommendations and lessons learned.

- 1) **May 29, 2008** – OTS issued *New Directions Bulletin 08-05, Lessons Learned – Failed Thrift Institution Review*. This internal guidance to Examination and Supervision staff highlights the recommendations of the Material Loss Review of NetBank, FSB. It also established an independent, internal failed bank review process for OTS to assess and identify lessons learned and recommended actions from each failure of a financial institution.
- 2) **July 18, 2008** – OTS reissued external guidance in *Examination Handbook Section 080, Enforcement Actions*. The revised guidance clarified expectations on enforcement actions

and incorporated the Memorandum of Understanding as a written, informal enforcement tool.

- 3) **August 11, 2008** – OTS issued *New Directions Bulletin 08-08, Examination and Supervision of Mortgage Banking Activity*. OTS developed this internal guidance following a nationwide horizontal review of the examination and supervision of mortgage banking activity by OTS. It discusses liquidity, funds management, and contingency planning related to mortgage banking. It also highlights the affect of declining economic conditions on liquidity.
- 4) **September 17, 2008** – OTS issued *Chief Executive Officer (CEO) Memo #280, Documentation and Underwriting Standards*. The CEO Memo is external guidance that discusses documentation and underwriting standards regarding single-family residential loans with high-risk characteristics. It also addresses standards for managing concentration risk in mortgage loan origination. Our experience with IndyMac demonstrated that exposure from mortgage loans originated for sale can constitute a concentration risk that management should identify, measure, monitor, control, and report to the Board of Directors. The Board approved loan policy should establish a limit for aggregate pipeline, warehouse, and credit-enhancing repurchase exposure. A savings association will receive closer supervisory review of its concentration risk when the exposure exceeds Tier 1 capital.
- 5) **September 17, 2008** – OTS reissued examination guidance in *Examination Handbook Section 212, One- to Four-Family Residential Real Estate Lending*. The revisions to this handbook section address pipeline risk in relation to capital exposure.
- 6) **September 2008** – OTS distributed the Basel Committee on Banking Supervision guidance titled, *Principles for Sound Liquidity Risk Management and Supervision*, to Regional Management and will formally issue to Examination and Supervision staff by the end of the first quarter 2009.
- 7) **January 23, 2009** – OTS issued internal guidance as *New Directions Bulletin 09-04, Recognition of Capital Contributions in the Form of Cash or Notes*. This guidance outlines appropriate documentation and timing related to capital contributions.
- 8) **First Quarter 2009** – OTS will issue external guidance as a CEO Memo titled *Recognition of Capital Contributions in the Form of Cash or Notes*. This CEO Memo will outline appropriate documentation, notification, and Thrift Financial Report presentation requirements for capital contributions.
- 9) **First Quarter 2009** – OTS will issue internal guidance as a New Directions Bulletin, titled *Reminder: Required Follow-up on Examination Findings, Matters Requiring Board Attention or Savings Association Action*. The bulletin will re-emphasize the importance of problem correction and will highlight existing requirements for using OTS examination systems to document corrective actions and supervisory follow-up.
- 10) **Second Quarter 2009** – OTS is working with the other federal banking regulatory agencies to revise and reissue the *Interagency Liquidity Guidance* to address liquidity monitoring.

The Office of Inspector General report on IndyMac contains two recommended actions. **OTS has taken action to implement both recommendations.**

Recommendation #1 - Ensure that action is taken on the lessons learned and recommendations from the OTS internal review of the IndyMac failure.

OTS Response: On February 17, 2009, OTS provided a summary to the Office of the Inspector General regarding the agency's actions to address the internal review recommendations. As outlined above, OTS is dedicated to enact the recommendations and has developed or is developing revised policy guidance to address each one. OTS has also communicated the changes to staff and the thrift industry during training, staff meetings, and outreach in 2008 and 2009. The agency will continue to monitor examination activity to ensure that staff members implement, and the industry complies, with the revised guidance.

Recommendation #2 - 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, ALLL 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 the thrift offers non-traditional loan products (regardless of whether loans are sold or retained) that have not been stress tested in difficult financial environments, and whether the thrift can adequately manage the risks with such products. OTS should re-examine and refine as appropriate its guidance in this area.

OTS Response: OTS *Examination Handbook Section 070, Ratings: Developing, Assigning, and Presenting*, addresses the criteria under which an examiner should rate a financial institution. Examiners should base ratings on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The ratings should help identify associations that pose a risk of failure and merit more than normal supervisory attention. Senior managers routinely discuss the appropriateness of ratings based on examinations, off-site monitoring, and other supervisory activities. OTS is committed to ensuring that its examination ratings accurately reflect the condition of its regulated financial institutions. The enhancements described in this letter combined with OTS guidance on assigning ratings and the lessons learned in the current financial crisis will ensure that assigned ratings are appropriate for each financial institution.

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.