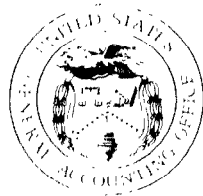


January 1992

FINANCIAL AUDIT

Office of Thrift Supervision's 1989 Financial Statements



**Comptroller General
of the United States**

B-242241

January 24, 1992

**To the President of the Senate and the
Speaker of the House of Representatives**

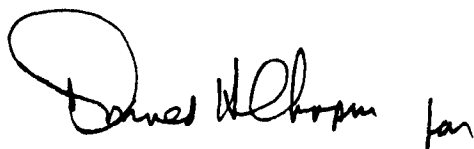
This report presents our opinion on the Office of Thrift Supervision's (OTS) financial statements for the period from October 8, 1989, through December 31, 1989. Our reports on OTS's internal control structure and on its compliance with applicable laws and regulations for that period are also included. These reports were delayed as a result of the time required by OTS and the Federal Housing Finance Board to resolve a legal issue we identified concerning winding up the affairs of the Federal Home Loan Bank Board. The agencies resolved the issue on October 30, 1991, and the 1989 financial statements were revised to reflect the settlement.

OTS was established as an office within the Department of the Treasury by Public Law 101-73, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which abolished the Federal Home Loan Bank Board as of October 8, 1989, and established OTS to regulate and examine federally insured savings and loan associations. FIRREA provided for the Chairman of the Bank Board to become the Director of OTS and to be responsible for concluding the Bank Board's affairs. The Bank Board's responsibilities for overseeing and supervising the 12 Federal Home Loan Banks were transferred to a new, independent agency, the Federal Housing Finance Board. FIRREA requires that OTS's operations be funded through assessments of savings and loan associations and, through 1989, the Federal Home Loan Banks.

Our opinion on OTS's financial statements for the period October 8, 1989, through December 31, 1989, is without qualification. However, our accompanying reports on OTS's internal control structure and compliance with laws and regulations discuss our concerns regarding two matters. Specifically, we found that (1) OTS's assessments charged to the savings and loan industry provided funding in excess of OTS's operating expenses and need for working capital and (2) OTS did not comply with FIRREA because it used Bank Board funds to conclude the Bank Board's affairs and did not distribute the appropriate amount of funds owed to the Federal Housing Finance Board. OTS and Federal Housing Finance Board officials have agreed to a payment of \$8.9 million in satisfaction of the amount OTS owes the Finance Board. This amount is reflected in OTS's financial statements as an accounts payable. In addition, the Director,

OTS, has agreed to adjust the assessments to better reflect OTS's working capital and operating needs.

We are sending copies of this report to the Secretary of the Treasury; the Director of the Office of Thrift Supervision; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs.

A handwritten signature in black ink, appearing to read "Charles A. Bowsher" followed by a small flourish.

Charles A. Bowsher
Comptroller General
of the United States

Contents

Letter	1
Opinion Letter	6
Report on Internal Control Structure	8
Report on Compliance With Laws and Regulations	12
Financial Statements	15
Statement of Financial Position	15
Statement of Operations and Retained Earnings	16
Statement of Cash Flows	17
Notes to the Financial Statements	18
Appendix	22
Appendix I: Comments From the Office of Thrift Supervision	

Abbreviations

CSRS	Civil Service Retirement System
FERS	Federal Employee Retirement System
FHFB	Federal Housing Finance Board
FHLBB	Federal Home Loan Bank Board
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FSLIC	Federal Savings and Loan Insurance Corporation
HOLA	Home Owners' Loan Act
OTS	Office of Thrift Supervision

**Comptroller General
of the United States**

B-242241

The Honorable Timothy Ryan, Director
Office of Thrift Supervision

We have audited the accompanying statement of financial position of the Office of Thrift Supervision (OTS) as of December 31, 1989, and the related statements of operations and retained earnings, and cash flows for the period October 8, 1989, through December 31, 1989. These financial statements are the responsibility of OTS management. Our responsibility is to express an opinion on these financial statements based upon our audits. In addition to this report on our audit of OTS's 1989 financial statements, we are reporting on our study and evaluation of its internal control structure and compliance with laws and regulations.

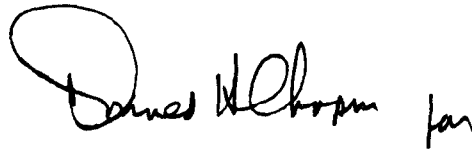
We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of OTS as of December 31, 1989, and the results of its operations and cash flows for the period October 8, 1989, through December 31, 1989, in conformity with generally accepted accounting principles.

In conducting our audit, we found that OTS's 1989 and 1990 assessments of the savings and loan industry exceeded its operating expenses and working capital needs. This matter is discussed in our report on internal control structure.

In addition, OTS did not comply with section 401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) because it used funds and other property of the dissolved Federal Home Loan Bank Board (FHLBB) to pay for expenses incurred in concluding the Board's affairs. As a result, OTS did not distribute the amount of funds required by FIRREA to the Federal Housing Finance Board (FHFB). On October 30, 1991, OTS and Federal Housing Finance board officials agreed to a payment of \$8.9 million in satisfaction of the amount OTS

owes the Finance Board, and this payment is reflected in ORS's financial statements as an accounts payable. This matter is discussed further in our report on ORS's compliance with laws and regulations.

A handwritten signature in black ink, appearing to read "Charles A. Bowsher" followed by a small flourish.

Charles A. Bowsher
Comptroller General
of the United States

October 31, 1991

Report on Internal Control Structure

We have audited the financial statements of the Office of Thrift Supervision (OTS) from its inception on October 8, 1989, to December 31, 1989, and have issued our opinion thereon. This report pertains only to our study and evaluation of OTS's internal control structure for the period ended December 31, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

In planning and performing our audit of the financial statements of OTS for the period ended December 31, 1989, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of OTS is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For purposes of this report, we have classified OTS's significant internal control structure policies and procedures into the following categories:

- assessments: the policies and procedures for billing and collecting assessments charged the savings and loan industry to fund OTS operations and working capital;
- financial reporting: OTS policies and procedures for processing accounting entries and preparing OTS's annual financial statements;
- expenditures: policies and procedures for preparing and processing payroll and nonpayroll administrative expenses; and

- treasury: OTS policies and procedures for collecting and disbursing cash, reconciling cash balances, investing cash, and managing debt.

For all of the internal control structure categories listed above, we obtained an understanding of the design of the relevant policies and procedures, determined whether they had been placed in operation, and assessed the associated control risk. We performed limited tests of control procedures for all the categories. In addition, we performed audit tests to substantiate account balances associated with each control category. Such tests can serve to identify weaknesses in the internal control structure.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. During our tests, however, we noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

As discussed in more detail in the following section, we found that as a result of its assessments of the savings and loan industry since inception, OTS had accumulated a 6-month reserve for operating expenses and working capital needs at the end of 1990. In response to our concerns about excessive assessments, OTS is working to bring its assessments closer to its actual expenses.

1989 and 1990 Assessments Exceeded OTS Operating Expenses and Working Capital Needs

OTS's assessments charged to the savings and loan industry since inception were more than it needed to fund its operating expenses and working capital needs and resulted in about a 6-month reserve at December 31, 1990. OTS does not have responsibility for resolving troubled thrifts. Therefore, OTS's assessment would only need to be sufficient to cover its expected operating expenses and maintain a small working capital reserve to cover unexpected contingencies.

Section 9 of the Home Owners' Loan Act (HOLA), as amended by section 301 of FIRREA, authorizes the OTS Director to assess fees to fund OTS's operating expenses. In addition, section 9(1) of HOLA authorizes the

Director to impose fees and assessments, "in excess of actual expenses for any given year, to permit the Director to maintain a working capital fund." Subsection (1) further provides that any amount in excess of what the Director deems necessary for working capital needs should be refunded to those institutions. HOLA does not provide criteria for what constitutes an adequate working capital fund or for determining the additional fees or assessments the Director may levy on the institutions to meet working capital needs.

To meet its operating expenses for the period October 8, 1989, through December 31, 1989, OTS assessed the Federal Home Loan Banks and savings and loan institutions. Specifically, to meet its operating expenses, OTS assessed the Federal Home Loan Banks 25 percent of its quarterly operating budget, and it assessed the savings and loan industry 75 percent of that same amount. OTS determined the split for the assessment between the Federal Home Loan Banks and the savings and loan industry using a formula from section 723 of FIRREA for determining the share the Federal Home Loan Banks would pay to OTS through December 31, 1989.

For its working capital needs, OTS assessed only savings and loan institutions. OTS assessed the savings and loan industry for working capital needs using the same assessment basis as it did to recover its operating expenses (that is 75 percent of its quarterly operating budget). In 1990, OTS continued the 1989 assessment policy in assessing savings and loans for working capital.

At December 31, 1989, OTS reported net income of \$34 million and cash and investments of \$40 million. During 1990, OTS assessed savings and loans associations an average of \$65 million per quarter even though its average quarterly expenses were approximately \$52 million. At December 31, 1990, OTS reported unaudited net income of about \$65 million and cash and investments totaling \$118 million, an amount sufficient to fund over 6 months of reported operating expenses for 1990.

OTS stated that the level of assessments for working capital charged in 1989 and 1990 was to compensate for uncertainties relating to revenue and expenditures encountered during its first year of operations. Because OTS began its operations in 1989, it is understandable that uncertainties would exist. However, OTS should have been able to more reliably estimate its expenses for 1990 and lower the assessments accordingly. In addition, the OTS accounting department is substantively the same as that of its predecessor agency—the Federal Home Loan

Bank Board (FHLBB). FHLBB had years of experience in budgeting and accounting for the costs associated with the supervision and examination functions subsequently transferred to OTS. This experience should have allowed OTS to minimize uncertainties concerning the costs of OTS's operations.

Recommendation

We recommend that the Director of OTS monitor OTS's current financial position and adjust quarterly assessments to ensure that they are commensurate with OTS's working capital and operating needs.

Agency Comments

In commenting on a draft of this report, OTS did not fully agree with our conclusions regarding the level of assessments. OTS, however, stated that its 1991 assessments have been adjusted to better reflect OTS's working capital and operating needs. Also, OTS stated that it has begun to balance OTS's industry assessments against its known operating costs. OTS's comments and our evaluation thereof are included in appendix I.

Report on Compliance With Laws and Regulations

We have audited the financial statements of the Office of Thrift Supervision (OTS) for the period October 8, 1989, to December 31, 1989, and have issued our opinion thereon. This report pertains only to our review of OTS's compliance with laws and regulations for the period ended December 31, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of OTS is responsible for compliance with laws and regulations applicable to OTS. As part of obtaining reasonable assurance as to whether the financial statements are free of material misstatement, we selected and tested transactions and records to determine OTS's compliance with certain provisions of FIRREA which, if not complied with, could have a material effect on OTS's financial statements. However, it should be noted that our objective was not to provide an opinion on the overall compliance with such provisions.

Because of the limited purpose for which our tests of compliance were made, the laws and regulations tested did not cover all legal requirements with which OTS has to comply.

The results of our tests for 1989 indicate that, with respect to the items tested, OTS did not comply with certain provisions of FIRREA. With respect to transactions not tested, nothing came to our attention that caused us to believe that OTS had not complied, in all material respects, with those provisions.

The following section discusses the nature of OTS's noncompliance. This noncompliance does not affect our opinion on OTS's December 31, 1989, financial statements, which have been adjusted to recognize the effects of this noncompliance.

Bank Board Funds Were Improperly Used

OTS did not comply with section 401 of FIRREA because it used the cash and accounts receivable of the former Federal Home Loan Bank Board to pay expenses incurred for winding up the affairs of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Bank Board.

Section 401(a) of FIRREA abolished FSLIC on August 9, 1989, and abolished the Federal Home Loan Bank Board as of October 9, 1989. Under

section 401(b), the Bank Board Chairman was responsible for winding up the affairs of those agencies during the 60-day period beginning August 9, 1989. Section 401(b)(2) made the FSLIC Resolution Fund the exclusive source of funds for paying expenses incurred in winding up the affairs of FSLIC and the Bank Board from August 9 through October 9, 1989, and explicitly prohibited the Chairman from using any Bank Board or FSLIC assets to pay any of the closing expenses. Section 401 of FIRREA stipulated that any FSLIC Resolution Fund disbursements to pay expenses attributable to Bank Board employees and property transferred to other agencies during the wind-up period were to be subsequently reimbursed by the agencies acquiring the employees and property. Section 725 provides that all Bank Board funds remaining in Bank Board accounts at the time of its dissolution on October 9, 1989, shall become the property of the FHFB.

Even though FIRREA required that expenses incurred during the 60-day wind-up period be paid from the FSLIC Resolution Fund, OTS used Bank Board cash and cash received from accounts receivable to finance costs incurred from August 9 through October 8, 1989. OTS officials, who were also officials of the Bank Board before it was abolished, stated that they believed FIRREA's provision for distribution of assets required that only Bank Board cash remaining after its affairs were concluded was to be transferred to FHFB. In addition, as discussed further in the Agency Comments section, OTS asserted that it was not practical to pay wind-up expenses from the FSLIC Resolution Fund. Accordingly, OTS improperly used the Bank Board's cash and cash collected on its accounts receivable to finance the dissolution of the Bank Board and transferred \$7.4 million to FHFB on October 12, 1989.

We discussed this matter with OTS officials. OTS and FHFB officials subsequently discussed this matter and agreed to an additional payment of \$8.9 million in satisfaction of the amount OTS owes, and this payment is reflected in OTS's financial statements as an accounts payable to FHFB.

Conclusions

Bank Board assets were improperly used to pay expenses incurred during the 60-day period for winding up the affairs of the Bank Board and OTS did not pay FHFB the entire amount owed under FIRREA. OTS has reached an agreement with FHFB to resolve this matter by paying \$8.9 million to FHFB.

Agency Comments and Our Evaluation

The Director, OTS, stated that because of the settlement agreement, he did not agree with our conclusion that OTS improperly used Bank Board funds in 1989 and stated that any discussion of this matter in the report is moot. Our responsibility is to report instances of noncompliance occurring in the period covered by our audit. The settlement reached in 1991 does not affect OTS's noncompliance with applicable FIRREA provisions in 1989.

OTS's comments focus on the practical considerations of using Bank Board funds during the 60-day wind-up period. Specifically, OTS asserted that using the FSLIC Resolution Fund to pay expenses during this period was "as a practical matter not possible" because it could not get the needed funds from the FSLIC Resolution Fund, nor did it have the systems capability to make the immediate payroll payments. Because the act passed on August 9, 1989, was effective immediately, shifting funding sources and adjusting its accounting systems could have posed legitimate administrative problems even though the FSLIC Resolution Fund had sufficient funds available to pay OTS's expenses incurred immediately after the act was passed. We did not verify OTS's statement that there were impediments to OTS's using the FSLIC Resolution Fund to pay expenses incurred immediately after passage of the act. However, OTS made no attempt during the wind-up period to obtain funds from the FSLIC Resolution Fund to pay its expenses. Instead, OTS paid its expenses with Bank Board funds. If practicality was the sole reason for using Bank Board funds during the 60-day wind-up period, then OTS should have taken prompt action to repay amounts owed FHFBS later in 1989. OTS's comments are presented in their entirety in appendix I.

Financial Statements

Statement of Financial Position

AS OF DECEMBER 31, 1989
(in thousands)

Assets

Cash and cash equivalents (Note 2)	\$40,185
Accounts Receivable	4,414
Property and Buildings, net (Note 3)	46,153
Total assets	90,752
	=====

Liabilities and Equity

Accounts payable, accrued liabilities and other (Note 4)	6,613
Due to Federal Housing Finance Board (Note 5)	8,920
Assumed Capital	41,036
Retained Earnings	34,183
Total Liabilities and Equity	\$90,752
	=====

See accompanying notes

Statement of Operations and Retained Earnings

FOR THE PERIOD
 OCTOBER 8, 1989 (INCEPTION) THROUGH DECEMBER 31, 1989
 (in thousands)

Revenue

Assessments (Note 6)	
FHLB banks	\$ 6,231
Savings and Loan Industry	42,306
FHLB banks in-kind service	48,784
Other income	<u>1,916</u>
 Total Revenue	 99,237

Expenses

Personnel compensation (Note 6)	36,762
Personnel benefits (Note 4)	7,277
Travel and transportation (Note 6)	5,867
Occupancy (Note 6)	5,671
Training (Note 6)	1,543
Professional services (Note 6)	3,245
Supplies and materials (Note 6)	2,378
Administrative operating expenses (Note 6)	<u>2,311</u>
 Total Expenses	 65,054

Net Income 34,183

Retained earnings assumed at inception 0

Retained earnings at December 31, 1989 \$34,183
 =====

See accompanying notes

Statement of Cash Flows

FOR THE PERIOD OCTOBER 8, 1989 THROUGH DECEMBER 31, 1989
(in thousands)

Cash Flows from Operating Activities:

Net Income	\$34,183
Adjustment to reconcile net income to net cash provided:	
Depreciation	420
Increase in accounts receivable	(2,055)
Decrease in other assets	282
Increase in accrued annual leave	532
Increase in accounts payable and accrued liabilities	<u>2,882</u>
Net cash from operating activities	36,244

Cash Flows from Investing Activities:

Acquisition of capital assets	(1,956)
Net cash used in investing activities	(1,956)

Cash Flows from Financing Activities:

Net cash from financing activities	<u>0</u>
Net increase in cash and cash equivalents	34,288
Cash and cash equivalents - October 8, 1989	5,897
Cash and cash equivalents - December 31, 1989	\$40,185

See accompanying notes

Notes to the Financial Statements

DECEMBER 31, 1989

1. Creation of the Office of Thrift Supervision: The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was signed and enacted on August 9, 1989. FIRREA abolished the Federal Home Loan Bank Board 60 days after enactment (October 8, 1989) and transferred all examination and supervisory activities to the Office of Thrift Supervision (OTS), a new office established within the Department of Treasury. Under FIRREA, the Office of Regulatory Activities, the Bank System Office of Education, and the twelve examination Districts became part of OTS. These entities are to be funded by the twelve Federal Home Loan Banks (FHLBanks) through March 31, 1990. The OTS's operating expenses are met primarily through the assessments of the savings and loan (S&L) industry, and through December 31, 1989, the FHLBanks.

Assumed capital in the financial statements is the net assets assumed from the Federal Home Loan Bank Board by OTS at inception, October 8, 1989, in accordance with FIRREA.

Summary of Significant Accounting Policies:

Depreciation - The cost of furniture, fixtures, and equipment over \$3,000 is capitalized and depreciated using the straight-line method based on a five-year useful life. The building is depreciated on a straight-line basis over a 50-year life.

Contingencies - OTS is involved in numerous legal actions, none of which are deemed by management to result in probable losses, and therefore no accrual has been made for these in the financial statements. Lawsuits that management deems are reasonably possible to result in loss amount to \$16.7 million.

Allowance for Loss on Receivables - All accounts receivable that were recorded at December 31, 1989, were subsequently collected and therefore no allowance for loss on receivables was recorded.

2. Cash and Cash Equivalents: OTS invests its cash in overnight Treasury Securities. They are stated at cost (in thousands):

DECEMBER 31, 1989

	<u>December 31,</u> <u>1989</u>
Cash	\$ 2,436
Cash Equivalents	<u>37,749</u>
Total Cash and Cash Equivalents	<u>\$40,185</u> =====

3. Property and Buildings (in thousands):

The land and building owned by the Federal Home Loan Bank Board was distributed to OTS. OTS also assumed all furniture, fixtures, and equipment associated with personnel transferred to OTS. These assets were carried over at their existing value as recorded in the Federal Home Loan Bank Board's accounting records.

OTS's Property and Buildings, net, is comprised of the following:

	<u>December 31,</u> <u>1989</u>
Land	\$ 7,101
Office Building	47,921
Furniture, Fixtures, and Equipment	10,962
Accumulated Depreciation:	
Office Building	(10,627)
Furniture, Fixtures, and Equipment	<u>(9,204)</u>
Property and Buildings, net	<u>\$46,153</u> =====

4. Retirement Plan and Accrued Annual Leave: Approximately 60 percent of OTS's headquarters employees are covered by the Civil Service Retirement System (CSRS), which is currently two-tiered. For employees hired prior to January 1, 1984, OTS withholds approximately 7 percent of their gross earnings. This contribution is then matched by OTS and the sum is transferred to the Civil Service Retirement Fund, from which this employee group will receive retirement benefits.

DECEMBER 31, 1989

For employees hired on or after January 1, 1984, with more than five years of service (not necessarily continuous), OTS withholds, in addition to Social Security withholdings, .94 percent of their gross earnings, but matches such withholdings with a 7 percent contribution. At the point such earnings exceed the FICA maximum wages of \$48,000 for 1989, employees covered under this tier of CSRS are required to have 7 percent of their earnings withheld while the agency expense remains a 7 percent contribution. This second employee group will receive retirement benefits from the CSRS along with the Social Security System, to which they concurrently contribute.

Beginning in January, 1987, all employees hired since January 1, 1984, either as new employees or as having less than 5 years of accumulated service (with a break in service over one year) are included in the new Federal Employee Retirement System (FERS). For such employees OTS withholds .94 percent of their gross earnings and matches those withholdings with a 12.86 percent contribution. This group of employees will receive benefits from the FERS as well as the Social Security System to which they concurrently contribute. The retirement expenses incurred for all plans during the partial year 1989 was \$683,469 and it is included in salaries and employee benefits in the Statement of Operations and Retained Earnings.

Although OTS funds a portion of pension benefits under both of the above Retirement Systems relating to its employees and makes the necessary payroll withholdings from them, OTS does not account for the assets of either retirement plan nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management for both Retirement Systems and are not allocated to the individual employers. Except for one retired employee who has health insurance through OTS's own health plan, the Office of Personnel Management accounts for all health and life insurance programs for retired federal employees.

OTS's liability to employees for accrued annual leave is \$2,035,948 at December 31, 1989, and it is included in accounts payable, accrued liabilities, and other, in the Statement of Financial Position.

DECEMBER 31, 1989

5. Liability Due to FHFB: In dissolving the Federal Home Loan Bank Board's (FHLBB) affairs, sections 401 and 725 of FIRREA identified how the funds and other property of the FHLBB were to be used and distributed. As a result of these provisions, OTS and Federal Housing Finance Board (FHFB) officials have agreed that OTS owes \$8,920,000 to FHFB.

6. Assessments:

FIRREA provided that OTS make assessments to recapture its operating costs. Assessments are based on OTS's budget and are collected from two sources: FHLBanks and savings and loans. FHLBanks are to be assessed for OTS's operating expenses only for the period October 8, 1989, through December 31, 1989. After this period, assessments will be collected solely from savings and loans.

The FHLBanks are also responsible for absorbing certain costs, principally compensation, relating to supervision activities occurring at the FHLBanks through March 31, 1990. These costs are included in OTS's financial statements as an "in-kind service". Thus, they are reflected in the Statement of Operations as income and expenses. Therefore, the effect from these transactions on net income is zero.

The costs related to the in-kind services are equal in amount to the assessments reported as FHLBanks in-kind service and are interspersed in expenses as follows:

	December 31, 1989
Personnel compensation	\$27,834
Personnel benefits	6,099
Travel and transportation	5,215
Occupancy	2,924
Training	1,308
Professional services	2,475
Supplies and material	2,031
Administrative operating expenses	<u>898</u>
Total In-Kind Services	\$48,784 =====

Comments From the Office of Thrift Supervision

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Office of Thrift Supervision
Department of the Treasury

Timothy Ryan
Director

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6280

November 1, 1991

Mr. Gregory M. Holloway
Senior Assistant Director
General Accounting Office
Accounting and Financial Management
Division
441 G Street N.W. Room 6009
Washington, D.C. 20548

Dear Mr. Holloway:

Thank you for the opportunity to review your recently completed Report on the Office of Thrift Supervision's (OTS) 1989 financial statements.

This letter responds to the two concerns you discussed in your transmittal letter to Congress and the actual audit report.

Payments Due the Federal Housing Finance Board

One issue discussed by the General Accounting Office (GAO) audit report is how assets of the Federal Home Loan Bank Board (Bank Board), which was abolished by FIRREA, are to be allocated between OTS and the Federal Housing Finance Board (FHFB). Because OTS and FHFB have agreed to settle the issue of the amount still owed to FHFB, we disagree with the conclusion that OTS has "violated" or otherwise failed to comply with FIRREA, and we believe that any discussion of the merits of the issue is moot. For purposes of the settlement, OTS and FHFB have adopted an approach based largely on the formula described on pages 18-19 of the draft report.

However, to respond briefly to the discussion on the merits of the issue on pages 16-20 of the draft report, we do not believe that FIRREA is as explicit on the matter as the draft report suggests. FIRREA contains only two provisions that address the allocation of Bank Board assets among OTS, FHFB, and other surviving agencies.

See comment 1.

See comment 2.

Now on pages 12 through 14.

Appendix I
Comments From the Office of
Thrift Supervision

Mr. Gregory M. Holloway
Page 2

Section 405 states that all "property" of the Bank Board is to be divided by agreement among the agencies in accordance with the division of the Bank Board's responsibilities, functions and activities. Section 725 provides that the funds in the Bank Board's "special deposit account" -- an account maintained at the Treasury Department -- were to go to FHFB.

See comment 3.

OTS has complied with both sections 405 and 725. Bank Board property has been allocated among OTS and other agencies. Funds in the Bank Board's special deposit account were transferred to FHFB in early October 1989. The issue identified by GAO is that the Bank Board expended funds from the special account between August 9 and October 8, 1989, in alleged contravention of section 401.

See comment 3.

Adherence to section 401 in August and September 1989 was as a practical matter not possible. Section 401 would have limited expenditures by the Bank Board to funds it could obtain from the FSLIC Resolution Fund. The Bank Board, however, had immediate payroll obligations after enactment of FIRREA that could not be postponed until after the FSLIC Resolution Fund was up and running. Accordingly, the Bank Board's only recourse to meet employee payroll was to use funds from the special account. In addition, the Bank Board's computerized funds disbursement system was programmed to disburse funds from only its special deposit account. That system could not be changed immediately since the staff was busy closing the FSLIC accounting system.

See comment 4.

The settlement between OTS and FHFB fully resolves any problems that stemmed from the Bank Board's efforts to meet its obligations despite the practical difficulties posed by section 401. Accordingly, GAO's conclusion that the Bank Board's activities were a "violation" or "improper" is unreasonable.

See comment 1.

OTS' Assessments Were Excessive

The GAO concludes that "OTS's assessments charged to the savings and loan industry provided funding in excess of OTS's operating expenses and need for working capital". This statement should be clarified. The report states that not only were OTS' 1989 and 1990 assessments charged to the savings and loan industry in excess of what it needed to fund its operations and establish its working capital needs but also that neither the GAO nor the OTS could identify any need for the OTS to accumulate a substantial working capital reserve. The OTS believes this conclusion is inaccurate.

See comment 5.

Mr. Gregory M. Holloway
Page 3

As events show, the OTS, in less than a year, began adjusting its assessments to bring them more in line with its operating costs -- an action that GAO would consider acceptable. When the OTS was created on October 8, 1989 it was required by FIRREA to establish its own funding methodology for collecting revenue from the savings and loan industry. The law also stated that each of the 12 Federal Home Loan Banks would fund the operations of their respective OTS district offices through March 31, 1991 and that OTS could make an emergency assessment to the S&L industry until such time as the new funding mechanism was in place.

The OTS Director made a decision in 1989 to assess a flat rate on the industry, generating \$42.3 million. This amount covered the estimated October through December cash needs for the OTS Washington office and began establishing a cash reserve that would ultimately equal three months of the total OTS operating budget.

The rationale for this reserve was to ensure that since OTS was billing the industry on a quarterly basis, sufficient funds would be available to cover operating costs in the event any assessment was delayed. Also, since there were 14 unique organizations, it was unclear what our total operating costs would be until a uniform compensation and benefit system was established. Compensation and benefits costs are the driving forces since they amount to almost 75 percent of OTS' budget. As GAO has been informed, a decision on a uniform compensation and benefits package was finalized in the Fall of 1990 and was implemented on December 30, 1990.

See comment 6.

The OTS budget for calendar year 1990 was set at \$295 million and the working capital reserve target was initially set at \$75 million. During the first half of 1990, OTS continued to use its emergency authority to assess the industry and \$98.8 million was collected through June 30, 1991. Even though this was far less than one-half of our operating budget, the decision was made to underbill the industry in order to allow OTS the flexibility to adjust its charges based upon the final resolution as to how its revenue would be generated. In the meantime, OTS was weighing the alternatives of charging a general assessment fee in addition to or instead of examination fees. The analysis was completed in May 1990.

See comment 7.

Despite the speed with which OTS moved to meet its critical funding needs, the third quarter assessment was delayed one month and upon its billing in August 1990, the \$92.7 million assessment represented the highest OTS charge ever extracted from the S&L industry.

Mr. Gregory M. Holloway
Page 4

See comment 7.

This assessment covered the income shortfall that had occurred in the first half of 1990, OTS' actual third quarter operating costs, and the continued funding of a cash reserve. Had OTS not billed its third quarter assessment in August, its existing cash resources would have been depleted by the end of September.

The GAO observation that "by 1990 OTS should have been able to recognize its expenditures and lowered its assessments accordingly" is correct. In fact, that is exactly what OTS has done. Since its third quarter 1990 assessment of \$92.7 million, the OTS has billed the industry as follows:

<u>Assessment Date</u>	<u>Amount Billed</u>
October 1990	\$78 million
January 1991	55 million
April 1991	54 million
July 1991	51 million
October 1991	48 million

In reality, it took the Director less than a year to begin controlling OTS' operating costs and begin to balance OTS' industry assessments against its known operating costs. Since OTS only bills the industry on a quarterly basis, making any adjustment for fluctuations in operating costs takes a least three months to implement.

See comment 8.

It also appears that GAO is basing some of its concerns on OTS' large cash balance at the end of the year. This reflects a fundamental misunderstanding as to how OTS operates. When the OTS obligates funds for an expenditure, it sets aside cash to cover these obligations. However, the time the expenditure is actually paid will vary. For example, OTS obligated \$6 million for the FIRE retirement program in 1990. However, the bill was not paid until 1991. Similarly, the OTS obligates funds to cover purchase orders and contracts and sets aside the cash to pay for these services at the time the commitment is made. Thus, at any given time, the OTS has a higher stated cash balance than what is readily available. In the interim, between obligation and payment, it is OTS policy to invest all available cash in accordance with prudent cash management practices.

In the early days of operation, it was difficult at best to accurately forecast how much of the operating costs of the districts would actually be subsidized by the Federal Home Loan Banks since the support provided varied amongst the Banks and represented about 20 percent of the total OTS budget. Further, with the FIRREA provisions for employment protection through

Appendix I
Comments From the Office of
Thrift Supervision

Mr. Gregory M. Holloway
Page 5

August 1990, it was difficult to estimate how quickly the staff size would shrink and what its impact would be on the budget. In fact, the OTS experienced a 12 percent drop (400 employees) in staff during 1990.

As it turns out, OTS' unencumbered cash exceeded the three month approved reserves by about \$15 million, a budgetary deviation of only five percent. While the 1990 cash reserves were higher than expected, this is taking advantage of hindsight. During 1990, OTS was undergoing many changes while moving towards a unified organization, and it was unrealistic to assume all income and expense accounts would be met. However, as demonstrated by the decreasing assessment collections in the fourth quarter of 1990 and throughout 1991, OTS has worked to reduce its excess funds once our real cash needs have become more apparent. To that end, we expect OTS' unencumbered cash reserves at December 31, 1991 to be significantly lower than 1990.

It is OTS' belief that the above is responsive to the major concerns raised in your audit. We look forward to further cooperation and discussions on these and other topics.

Sincerely,



Timothy Ryan
Director

The following are GAO's comments on OTS's letter dated November 1, 1991.

GAO Comments

1. OTS agreed to pay FHFBS the amount owed after we completed our audit work. However, this agreement does not diminish our responsibility to report that OTS improperly used Federal Home Loan Bank Board funds during the period in 1989 covered by audit.
2. Reference deleted from final report.
3. OTS's obligation to transfer funds to FHFBS under Section 725 is not limited to funds in the Bank Board's special deposit account. As discussed in our compliance report, Section 725 also refers to moneys and funds in "other such accounts," thereby making clear that the amount of funds in the Bank Board's special deposit account does not control the total amount of moneys and funds that should have been transferred to FHFBS at the time of the Bank Board's dissolution.
4. See Agency Comments and Our Evaluation Section in our compliance report.
5. We have deleted any reference to OTS's inability to justify the need for additional assessments to meet working capital needs. However, we still maintain that the assessments were excessive. See comments 5 and 6 for a further evaluation of OTS's explanations for assessments charged.
6. OTS's explanation attributing the level of assessments charged to an inability to reasonably estimate expenses is based on OTS's presumed lack of experience in estimating the costs of carrying out its function. However, substantively, the accounting department for OTS represents the same accounting department that had responsibility for the accounting records of its predecessor agency the Federal Home Loan Bank Board (FHLBB). FHLBB has had numerous years of experience in budgeting and accounting for the oversight of the thrift industry including resolution of failed thrifts. Consequently, it does not seem reasonable that OTS, having the benefit of its staff's years of FHLBB experience, would be unable to identify and account for the costs associated with its supervision and examination functions—the portion of FHLBB's responsibility given to OTS. In any case, with the benefits of its 1989 experience, OTS should have been able to more reliably estimate its expenses for 1990.

7. OTS asserted that its assessments for the first half of 1990 were far less than half its operating budget and that it underbilled the savings and loan industry. However, our analysis showed that OTS's operating budget (\$295 million) exceeded the unaudited totals for its operating expenses (\$210 million) by about \$85 million. Consequently, the \$98.8 million of assessments billed through June 1990 approximated half of OTS's expenses reported for 1990 and thus appeared to be appropriate.

8. OTS had reported obligations of \$16.7 million at December 31, 1990, which, when subtracted from the available funds, leaves unencumbered funds of over \$100 million. This amount represents more than 5 months of OTS's average incurred monthly operating expenses for 1990.

Ordering Information

The first copy of each GAO report is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877**

Orders may also be placed by calling (202) 275-6241.

**United States
General Accounting Office
Washington, D.C. 20548**

**Official Business
Penalty for Private Use \$300**

**First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100**
