

1998 Financial Report



***Office of Thrift
Supervision***

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Message from the Director

Both the thrift industry and the OTS remain in solid financial condition. During 1998 the industry earned a record \$7.6 billion and had an aggregate return on average assets of 97 basis points, 15 percent above the 84 basis points achieved during 1997. Although not a record, 1998 ROA was the strongest since 1962 when ROA was 98 basis points. During 1998, troubled assets fell to 0.77 percent of assets; this was the lowest level of troubled assets since 1990 when this measure was first used in the thrift industry.

Several challenges had to be addressed during 1998 in order that we could continue achieving our mission of ensuring the safety and soundness of the thrift industry. First, the OTS continued preparing both itself and the industry for the Year 2000 computer rollover. We began actively addressing the conversion of OTS' internal systems in 1995. To date all 15 of OTS' mission-critical systems have been tested and certified for Year 2000 compliance; the OTS VAX computing environment has also been successfully operated under a full range of Year 2000 conditions.

To assist the industry in preparing for the millennial rollover, the OTS has been working with the other Federal Financial Institutions Examination Council agencies to develop industry guidance on everything from contingency planning and customer awareness to testing. In addition, the OTS has had an aggressive outreach program working with industry trade groups, sponsoring conferences, and preparing and distributing a monthly Year 2000 newsletter.

Of course, the centerpiece of OTS' Year 2000 effort is examining the institutions we regulate as well as their service providers. The initial round of thrift examinations was conducted in 1997; during 1998 institutions identified in the first round of examinations as lagging in their Year 2000 awareness and assessment were queued up for second round examinations. The third round

of examinations, focusing on testing and contingency planning, was completed in March 1999. The OTS will continue monitoring preparations by the thrift industry and those firms that provide data services and software until all critical Year 2000 issues are satisfactorily resolved.

Another major goal during 1998 was helping to ensure that financial services are being provided to all Americans. The Community Reinvestment Act (CRA) encourages regulated financial institutions to help meet the credit needs of their entire communities, including low- and moderate-income areas. To ensure that thrifts are meeting credit needs, the OTS conducts CRA performance evaluations as a part of its regular compliance examinations. In addition, through its Community Affairs Program, the OTS strives to educate financial institutions about community development issues and opportunities and about government programs that help address credit and financial services needs in underserved markets. The OTS also promotes partnerships at the local level among financial institutions, community organizations and others to address specific community development needs. Partnerships enable financial institutions to do more in their communities than they could do on their own. Over the past several years, unprecedented numbers of strategic alliances involving financial institutions have been established.

In order to help meet the recent challenges of the developing thrift industry, two of OTS' key functional areas were recently restructured, supervision and compliance. The new structure streamlines the application review process and improves the Washington office's support of the regional offices. As a result of the restructuring, the OTS will be better able to address emerging issues and challenges posed by a dynamic thrift industry; it will also be better able to assist the

regional staffs on a variety of complex financial and policy issues as they carry out their supervisory responsibilities.

Lastly, as a result of market forces, momentum is again building to reform the bank and thrift charters. The OTS believes that the real challenge is to enact legislation that will enable our financial system to function safely, efficiently, and profitably in the twenty-first century. Regardless of what happens in the coming weeks and months on the legislative front, the market will continue to modernize. Legislation should facilitate this trend, promoting flexibility for existing and future financial institutions, while maintaining a framework to ensure the system's continued safe and sound operation, the provision of fair services to all, and the health and stability of the national and global economies.

A handwritten signature in cursive script, appearing to read "Ellen Seidman". The signature is written in dark ink and is positioned above the printed name and title.

Ellen Seidman
Director

Profile of the Office of Thrift Supervision

The OTS was established as a bureau of the Department of the Treasury on August 9, 1989, by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). OTS is headed by a Director who is appointed by the President, with Senate confirmation, for a 5-year term. The Director also serves on the boards of the Federal Deposit Insurance Corporation and the Neighborhood Reinvestment Corporation.

OTS Mission - The mission of the OTS is to effectively and efficiently supervise thrift institutions to maintain their safety and soundness in a manner that encourages a competitive industry to meet America's housing, community credit and financial service needs and to provide access to financial services for all Americans.

OTS' Five Major Goals - The OTS has identified five major goals as listed below:

- Maintain and enhance OTS' risk-focused, differential and proactive approach to the supervision of thrift institutions in order to contribute to a safe and sound industry.
- Actively support the thrift industry's efforts to meet its CRA obligations, and to provide safe and sound loans, investments and financial services for low and moderate income individuals, communities, and other areas of greatest need.
- Maintain competitiveness of the thrift industry to ensure its safety and soundness.
- Conduct operations efficiently to keep regulatory burdens on the thrift system at the minimum level consistent with effective supervision.
- Provide exceptional service to all major groups with which we interact, including the

thrift institutions regulated by OTS and members of the public that deal with those thrift institutions, to make government more responsive.

Statutory Authority - The OTS' primary statutory authority is the Home Owners' Loan Act (HOLA). Under HOLA, the OTS is responsible for chartering, examining, supervising, and regulating federal savings associations and federal savings banks. HOLA also authorizes the OTS to examine, supervise, and regulate state-chartered savings associations belonging to the Savings Association Insurance Fund (SAIF) and provide for the registration, examination, and regulation of savings association affiliates and holding companies.

Organization - To carry out its mission, the OTS is organized as follows:

- ◇ The Director, with the assistance of the Deputy Director, determines policy for the OTS and makes final decisions on regulations, policies and administrative adjudications governing the thrift industry and on many measures affecting individual institutions.
- ◇ The Office of Supervision (OS) oversees the Supervision Policy, Accounting Policy, and Examination and Supervision program areas. The responsibilities of the office include: gathering, analyzing and reporting on information and issues relating to the regulation of the industry; managing the applications process; examination consistency; development of examination and supervisory policy; accounting policies and procedures; and examination appeals.*
- ◇ The Office of Compliance Policy and Specialty Examinations (OCP&SE) oversees Community Affairs, Compliance Policy, Consumer Affairs, Trust Programs, and Technology Risk Management. It responds to consumer and

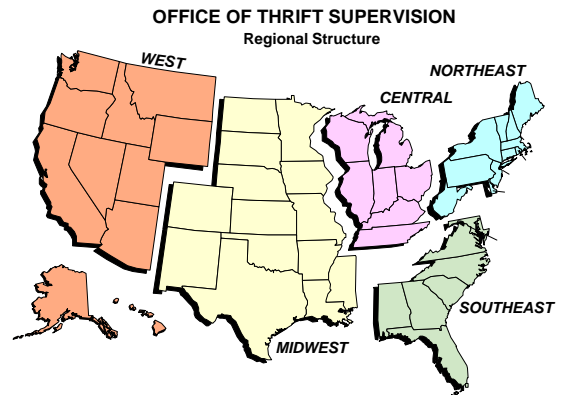
discrimination complaints against savings associations and manages the Community Affairs program, which helps thrifts improve their service to under-served markets and individuals.*

*The policies of both OS and OCP&SE are implemented through OTS' five regions, each headed by a Regional Director reporting directly to the Deputy Director of OTS.

- ◇ The Office of Information Systems is responsible for retaining the bureau's records, providing for the privacy and security of electronic data, fulfilling the requirements of the Freedom of Information Act (FOIA), and the Paperwork Reduction Act, and maintaining the agency's nationwide computer system.
- ◇ The Office of Administration directs policy development for administrative operations including contracting and procurement, facilities management and labor relations, training, human resources, and financial management.
- ◇ The Office of Chief Counsel provides a full range of legal services to the Director, the OTS and other agency staff. The Office provides legal advice and opinions on regulatory and administrative matters, drafts regulations, advises on transactional matters, represents the OTS in court, and prosecutes enforcement actions related to thrift institutions and institution-affiliated parties.
- ◇ The Office of External Affairs communicates information concerning OTS regulations, policies and key developments within the agency to the thrift industry, the public, the press, government agencies and other key constituencies. External Affairs also maintains a liaison between the OTS and Congress and coordinates all Congressional testimony.
- ◇ The Office of Research and Analysis collects and analyzes thrift industry and general economic data. It tracks and reports on the financial condition of the thrift industry, assesses savings associations' interest rate risk exposure, provides

quarterly reports to most thrift institutions describing their exposure, and conducts research related to the thrift industry and housing markets.

The OTS Director, in conjunction with senior staff, communicates OTS' goals and objectives to staff and assigns accountability to managers and staff for the achievement of objectives.

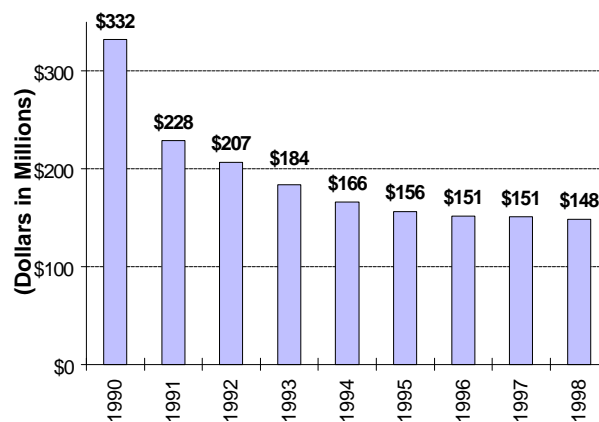


Management's Discussion and Analysis of OTS' Financial Performance

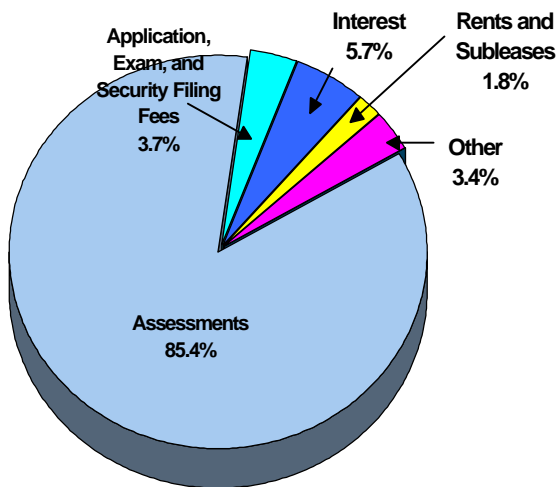
Funding Sources

The OTS receives no appropriated funds from Congress. FIRREA provided the OTS with the authority to fund its operations through periodic assessments charged to the thrift industry. Assessments constitute the largest single component (85.4%) of the total OTS income. The OTS also receives funds from application fees, interest, rents and subleases, exam fees, and other miscellaneous sources.

OTS Revenue (1990 - 1998)



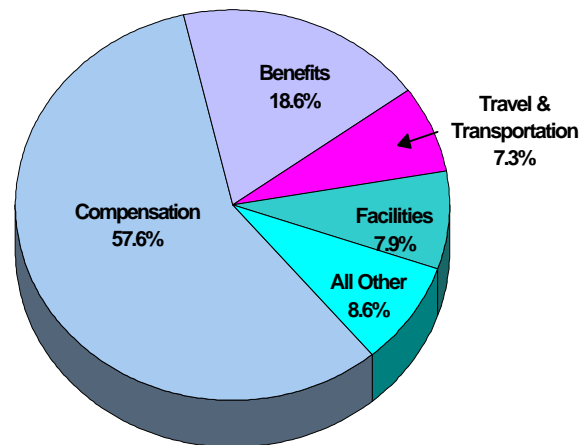
1998 Total Revenue = \$148.1 million



Funding Uses

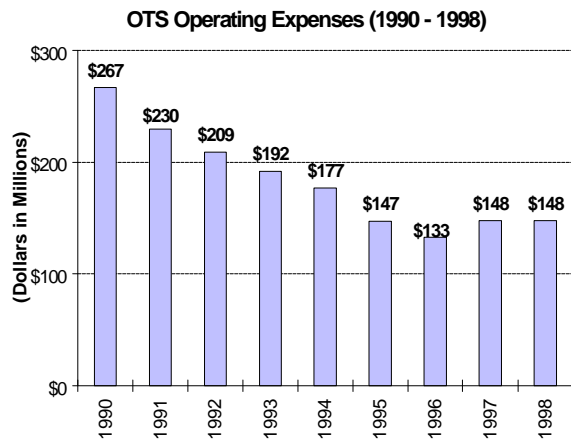
The following chart shows OTS' 1998 operating expenses by major cost categories. Expenses for personnel compensation and benefits comprised 76.2% of total operating expenses in 1998, down from 77.7% as of 1993.

1998 Total Operating Expense = \$148.3 million

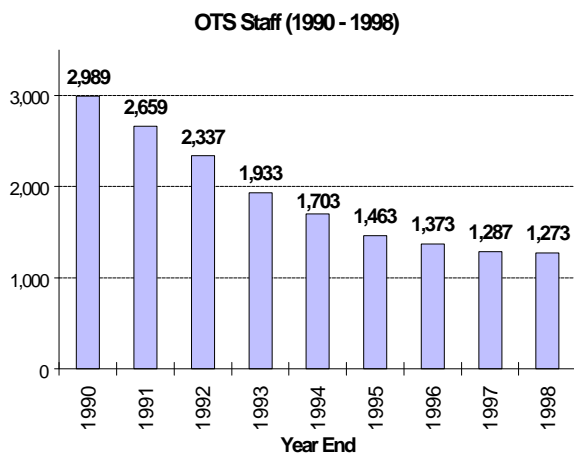


Due to the shrinkage of the thrift industry, OTS' income from assessments has declined substantially. In 1990, assessments totaled \$265.8 million; in 1998 this figure had fallen to \$126.6 million, a decrease of 52.4 percent in nine years. The decrease in assessment revenue has caused a sharp decline in the total OTS income since 1990, but OTS' income has stabilized since 1995.

Total OTS operating expenses in 1998 almost exactly equaled operating expenses in 1997.



Due to the shrinkage of the thrift industry, the OTS has trimmed its staff from 3,379 as of October 1989, to 1,273 as of December 1998, or by 62.3 percent. Since 1995 yearly staff decreases have been minimal and it is projected that staff will not decrease during 1999.



Financial Presentation

The OTS complies with all applicable Generally Accepted Accounting Principles (GAAP), Federal Financial Accounting Standards and internal control principles. The OTS' financial transactions are reported on an accrual basis. The Planning, Budget and Finance Division continually reviews new

Statements of Federal Financial Accounting Standards and modifies accounting policy, procedures, and reporting, as needed.

Internal Controls

The Federal Managers' Financial Integrity Act (FMFIA) mandated the establishment of agency internal control programs and regular evaluations of management controls and accounting systems to protect federal programs from fraud, waste and abuse. The OTS maintains strong internal controls, comprehensive financial management controls, personnel security controls, computer security, and strong asset accountability programs. The OTS maintains budgetary integrity through the continual oversight and monitoring of its annual budget. Generated reports allow the budget staff to regularly analyze the status of all accounts, review all expenditures, and make recommendations to senior management regarding potential savings and/or possible overages in the various accounts.

The foundation of the OTS' financial management control program is its annual financial statement audit. The 1998 audit was conducted by the independent, certified public accounting firm of Deva & Associates, P.C. The audit was completed on March 31. For the ninth consecutive year, the OTS was given an unqualified opinion on its financial statements.

OTS' Annual Assurance Statement for the fiscal year ending September 30, 1998, as required by FMFIA, indicated that OTS' management control systems are adequate and ensure that programs achieve their intended results; resources are used consistent with the OTS mission; programs and resources are protected from waste, fraud, and mismanagement; laws and regulations are followed; and reliable and timely information is obtained and used for decision making.

In addition, none of the quality assurance and other reviews, audits, management studies, or program and annual evaluations conducted during FY 1998

identified any Section 2 (programs and administrative functions) significant or “material” weaknesses, or Section 4 (financial systems) material nonconformances.

Current Status of OTS’ Financial Management Systems

The OTS uses an off-the-shelf accounting system purchased from Computer Data Systems, Inc., as the key component of its financial management system. The accounting system operates on a calendar-year basis and integrates the procurement, budget execution, accounts payable, accounts receivable, general ledger, and financial reporting functions and is directly interfaced with the payroll/personnel system.

The OTS' financial management systems currently produce accurate, relevant, timely, and useful information and meet the requirements of the Federal Financial Management Improvement Act (FFMIA). A review of these systems as part of the Inspector General’s annual audit requirement has produced an unqualified audit for the past nine years. The system utilizes an automated Standard General Ledger (SGL) crosswalk which allows the OTS to meet federal reporting standards while permitting OTS’ internal management to continue receiving a more detailed breakout of accounting information. Financial reports are provided to senior management on a monthly basis to assist them in monitoring their program area.

Year 2000 Progress on IT Systems

OTS completed renovating, testing, and implementing all 15 mission critical application systems as of October 6, 1998. The mission-critical application systems were tested for Year 2000 compliance at the OTS Remote Disaster Recovery Center in Philadelphia in 1998. The OTS VAX computing environment was successfully operated under a full range of Year 2000 conditions. These tests led to Y2K certification of the 15 mission critical application systems. Testing in 1999 is

focusing on end-to-end testing with internal and external data exchange partners.

Eleven telecommunications systems, six voice and five data systems, have been identified as mission critical. Eight systems are Year 2000 compliant; the remaining three will be either replaced or repaired by June 1999. On the client server platform, OTS has completed all Y2K hardware and software upgrades to desktops, laptops and servers. The inventory is Y2K compliant.

Year 2000 Contingency Plans have been developed for the mission critical application and data telecommunication systems to help OTS prepare for the continuity of critical services. Quarterly reviews of contingency plans are scheduled during 1999 to determine their continued effectiveness and to assure staff is prepared to carry out the plan during critical Year 2000 processing.

INDEPENDENT AUDITORS' REPORT

To the Inspector General,
U.S. Department of the Treasury

We have audited the accompanying statements of financial position of the U.S. Department of the Treasury, Office of Thrift Supervision (OTS) as of December 31, 1998 and 1997, and the related statements of operations and changes in net position, and cash flows for the years then ended. These financial statements are the responsibility of OTS' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable Office of Management and Budget (OMB) guidance for audits of federal financial statements. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of 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 used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide 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, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 22, 1999 on our consideration of OTS' internal control and a report dated March 22, 1999 on its compliance with laws and regulations.

INDEPENDENT AUDITORS' REPORT

(continued)

Our audits were conducted for the purpose of forming an opinion on the principal financial statements described above. We have inspected the financial information presented in the accompanying Management's Discussion and Analysis of OTS' Financial Performance. The information presented in the Management's Discussion and Analysis of OTS' Financial Performance is presented for the purposes of additional analysis. Such information has not been audited by us and, accordingly we do not express our opinion on this information.

Deva & Associates, P.C.

Certified Public Accountants

March 22, 1999

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION
STATEMENTS OF FINANCIAL POSITION
(in thousands)**

	December 31	
	1998	1997
Assets		
Federal assets:		
Cash and cash equivalents (Note 3)	\$ 35,569	\$ 25,756
Investments held to maturity (Note 4)	95,340	99,302
Accounts receivable	188	146
Interest receivable	1,194	492
Nonfederal assets:		
Accounts receivable	1,029	1,200
Advances and prepayments	4,991	8,671
Property and equipment, net (Note 5)	38,343	38,628
Total Assets	\$ 176,654	\$ 174,195
Liabilities and Net Position		
Federal liabilities:		
Accrued workers' compensation (Note 6)	\$ 4,241	\$ 4,842
Accrued liabilities (Note 7)	189	151
Nonfederal liabilities:		
Accounts payable	1,394	621
Accrued annual leave	8,011	7,805
Deferred compensation liability	1,345	1,345
Deferred rent credit	2,836	2,513
Postretirement benefit liability (Note 8)	7,200	5,947
Other accrued liabilities (Note 7)	8,555	7,920
Total Liabilities	\$ 33,771	\$ 31,144
Net position:		
Assumed capital (Note 2)	\$ 41,037	\$ 41,037
Retained earnings	101,846	102,014
Total Net Position	\$ 142,883	\$ 143,051
Total Liabilities and Net Position	\$ 176,654	\$ 174,195

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION
STATEMENTS OF OPERATIONS AND CHANGES IN NET POSITION
Years ended December 31
(in thousands)

	<u>1998</u>	<u>1997</u>
Revenues		
Industry assessments	\$ 126,553	\$ 128,209
Examination, application, and security filing fees	5,505	5,674
Interest	8,409	8,009
Rental income (Note 9)	2,615	3,093
Imputed financing - expenses paid by other entities (Note 10)	4,500	4,469
Other	<u>564</u>	<u>1,511</u>
Total Revenues	\$ <u>148,146</u>	\$ <u>150,965</u>
Expenses		
Personnel compensation	\$ 85,365	\$ 84,039
Benefits	27,583	27,486
Rent, communication, and utilities	7,579	7,859
Travel and transportation	10,807	10,102
Services	4,085	3,093
Data processing	3,786	3,637
Building expenditures	4,152	4,201
Office equipment and software	2,517	3,960
Miscellaneous	1,187	1,801
Depreciation	<u>1,253</u>	<u>1,578</u>
Total Expenses	\$ <u>148,314</u>	\$ <u>147,756</u>
Excess of (Expenses over Revenues) Revenues over Expenses	\$ (168)	\$ 3,209
Net Position, Beginning Balance	<u>143,051</u>	<u>139,842</u>
Net Position, Ending Balance	<u><u>\$ 142,883</u></u>	<u><u>\$ 143,051</u></u>

The accompanying notes are an integral part of these financial statements.

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION
STATEMENTS OF CASH FLOWS
Years ended December 31
(in thousands)**

	<u>1998</u>	<u>1997</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Excess of (expenses over revenues) revenues over expenses	\$ (168)	\$ 3,209
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Amortization of net bond discount (premium)	37	(405)
Depreciation	1,253	1,578
Loss on disposal of equipment	6	5
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable	129	(248)
Decrease in other assets	2,978	3,025
Increase (decrease) in accounts payable	773	(68)
Increase in other liabilities	<u>1,854</u>	<u>3,277</u>
Net cash provided by operating activities	<u>\$ 6,862</u>	<u>\$ 10,373</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of investment securities	\$ (90,967)	\$ (56,517)
Maturities of investment securities	94,893	52,000
Purchases of property and equipment	<u>(975)</u>	<u>(763)</u>
Net cash provided by (used in) investing activities	<u>\$ 2,951</u>	<u>\$ (5,280)</u>
Net cash provided by operating and investing activities	\$ 9,813	\$ 5,093
Cash and cash equivalents, beginning of year	<u>25,756</u>	<u>20,663</u>
Cash and cash equivalents, end of year	<u>\$ 35,569</u>	<u>\$ 25,756</u>

The accompanying notes are an integral part of these financial statements.

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION**

NOTES TO FINANCIAL STATEMENTS

1. REPORTING ENTITY

The Office of Thrift Supervision (OTS) was created when the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) abolished the Federal Home Loan Bank Board (FHLBB) and transferred all examination and supervisory activities to OTS under the Department of the Treasury. OTS' primary functions are to: (1) charter federal savings and loan associations; (2) adopt regulations governing the operation of the thrift industry; (3) conduct examinations of federal and state chartered savings institutions and their holding companies; and (4) supervise compliance with federal laws and regulations and OTS directives, taking measures needed to enforce such compliance and rehabilitate troubled institutions.

FIRREA provides that OTS assess the institutions it regulates to recapture operating costs. Assessments are based on OTS' budget and are collected from savings and loans semiannually on January 31 and July 31.

2. SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

OTS is operated substantially as a commercial enterprise and records its calendar year transactions on an accrual basis in accordance with generally accepted accounting principles (GAAP) and certain provisions of Office of Management and Budget (OMB) Bulletin 97-01, "Form and Content of Agency Financial Statements", that have been adopted by OTS. OTS receives no appropriated funds from the federal government and financial activities are recorded on an agency-wide basis versus a program or fund basis. OTS classifies its assets and liabilities as federal and nonfederal. Federal assets and liabilities arise from transactions among OTS and other federal entities. Nonfederal assets and liabilities arise from OTS transactions with persons and organizations outside of the United States government.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of OTS' account at Treasury, various imprest funds and other accounts in Washington, D.C. and at regional offices, and funds invested overnight by Treasury on OTS' behalf.

INVESTMENTS HELD TO MATURITY

Effective January 1, 1994, OTS adopted Statement of Financial Accounting Standards No. 115, "Accounting for Investments in Certain Debt and Equity Securities". Under the statement, OTS is required to classify investment securities under three categories: trading, available for sale, and held to maturity. All of OTS' investments consist of U.S. Treasury obligations. OTS has the intent and ability to hold these investments to maturity. Therefore, all investments are classified as held to maturity and are stated at amortized cost. Premiums and discounts are amortized over the term of the investment using the straight-line method, which approximates the interest method.

POSTRETIREMENT BENEFITS

OTS provides certain health and life benefits for all retired employees that meet eligibility requirements. Effective January 1, 1993, OTS adopted Financial Accounting Standards Board (FASB) Statement No. 106 to account for its share of the costs of those benefits. Under this statement, OTS' share of the estimated costs that will be paid after retirement is being accrued by charges to expense over the employees' active service periods to the dates that they are fully eligible for benefits, except that OTS has elected to amortize the transition amount (unfunded cost at January 1, 1993) over 20 years beginning in 1993 in accordance with the option available in the statement. Prior to 1993, OTS expensed its share of the costs as claims were incurred by the retirees and as premiums were paid by OTS.

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION**

NOTES TO FINANCIAL STATEMENTS

Pursuant to an agreement with the Office of Personnel Management (OPM) in 1994, OTS agreed to pay a one-time fee to OPM in consideration of OPM assuming the health care portion of the postretirement plan liability.

ANNUAL, SICK, AND OTHER LEAVE

Annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. The balance in the accrued annual leave account reflects current pay rates. Sick leave and other types of nonvested leave are charged to operating costs as taken.

PROPERTY AND EQUIPMENT

Fixed assets acquired by OTS were capitalized at cost based on the existing OTS capitalization policy. Fixed assets in excess of \$50,000 were capitalized in 1998 and 1997. In 1996 and prior years, fixed assets in excess of \$5,000 were capitalized. OTS' building is being depreciated over 50 years and furniture, fixtures, and equipment are depreciated over 5 years. Depreciation is computed on a straight-line basis.

ASSUMED CAPITAL

The land and building owned by FHLBB were transferred to OTS under FIRREA. OTS also assumed all of FHLBB's furniture, fixtures, and equipment. These assets were recorded at their existing book values established in FHLBB's accounting records. Their value is included in the Statements of Financial Position in net position as assumed capital.

INCOME TAXES

As an agency of the U.S. Department of the Treasury, OTS is exempt from all federal and state taxes based on income. OTS is also exempt from state and local property and real estate taxes.

3. CASH AND CASH EQUIVALENTS

The following table summarizes the balances of cash and cash equivalents (in thousands):

	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
Cash	\$ 378	\$ 356
Overnight investment with Treasury	<u>35,191</u>	<u>25,400</u>
Total	\$ <u><u>35,569</u></u>	\$ <u><u>25,756</u></u>

Interest earned on overnight investments totaled \$1,174,694 and \$1,279,359 for 1998 and 1997, respectively.

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION**

NOTES TO FINANCIAL STATEMENTS

4. INVESTMENTS HELD TO MATURITY

Investment securities held at December 31, 1998 and 1997 are marketable Treasury securities having maturities through December 2002. The amortized cost and market value of these securities are summarized as follows (in thousands):

	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
Face value	\$ 94,624	\$ 99,517
Unamortized premium, net of unamortized discount	<u>716</u>	<u>(215)</u>
Book value	<u>\$ 95,340</u>	<u>\$ 99,302</u>
Market value	<u>\$ 96,647</u>	<u>\$ 99,085</u>

Effective interest rates range from 5.625% to 8.875%. Interest earned on these investments totaled \$7,234,472 and \$6,729,802 for 1998 and 1997, respectively.

5. PROPERTY AND EQUIPMENT (in thousands)

The following table summarizes the fixed asset balances:

	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
Land	\$ 7,101	\$ 7,101
Building	49,107	48,361
Furniture, fixtures, and equipment	<u>5,453</u>	<u>5,651</u>
Total cost	<u>\$ 61,661</u>	<u>\$ 61,113</u>
Accumulated depreciation, building	\$ (18,387)	\$ (17,350)
Accumulated depreciation, furniture, fixtures, and equipment	<u>(4,931)</u>	<u>(5,135)</u>
Total accumulated depreciation	<u>\$ (23,318)</u>	<u>\$ (22,485)</u>
Property and equipment, net	<u>\$ 38,343</u>	<u>\$ 38,628</u>

6. ACCRUED WORKERS' COMPENSATION

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits for OTS' employees under FECA are administered by the U.S. Department of Labor (DOL) and are ultimately paid by OTS. These future workers' compensation estimates were generated by DOL from an application of

**UNITED STATES DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION**

NOTES TO FINANCIAL STATEMENTS

actuarial procedures developed to estimate the liability for FECA benefits. This DOL estimated actuarial liability for FECA benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability was determined using the paid losses extrapolation method calculated over the next 37-year period. This method utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. These annual benefit payments have been discounted to present value using OMB's economic assumptions for 10-year Treasury notes and bonds. Based on information provided by the DOL, the U.S. Department of the Treasury determined that the estimated liability of OTS as of December 31, 1998 and 1997 was \$4,241,226 and \$4,842,142, respectively. Changes in the actuarial liability related to FECA are reflected as reductions or increases in benefits expense in the appropriate year.

7. ACCRUED LIABILITIES (in thousands)

	December 31	
	1998	1997
Federal accrued liabilities:		
Payroll taxes	\$ 129	\$ 109
Other	60	42
	\$ 189	\$ 151
 Nonfederal other accrued liabilities		
Payroll and withholding	\$ 3,326	\$ 2,828
Relocations	424	119
Goods and services	4,758	4,002
Other	47	971
	\$ 8,555	\$ 7,920

8. POSTRETIREMENT BENEFIT PLAN

OTS sponsors a life insurance plan (the Plan) for all employees that meet eligibility requirements. OTS funds benefit costs principally on a pay-as-you-go basis, with retiree contributions that are adjusted annually based on factors, some of which are discretionary. The Plan is unfunded, with Plan participants paying a portion of the costs. As stated in the Significant Accounting Policies, OTS changed its accounting policy with respect to the Plan as of January 1, 1993. OTS elected to defer recognition of the Plan's transition obligation, and amortize such obligation over twenty years on a straight-line basis.

A Memorandum of Understanding (MOU) was signed in December 1994, between OPM and OTS. The purpose of the MOU was to implement legislation permitting annuitants who retired from OTS prior to January 1995, and who were enrolled in the OTS health plan, to enroll in the Federal Employees Health Benefits Program (FEHB) for coverage effective on or after January 8, 1995. OTS agreed to pay a one-time fee to OPM of approximately \$10,993,000 in consideration of OPM assuming the health portion of the postretirement plan liability. In accordance with FASB 106, the agreement with OPM constitutes a settlement and, accordingly, OTS recognized a gain on the settlement of approximately \$16,694,000 in 1994. Such gain includes the health portion of the transition obligation that OTS elected

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to initially recognize over 20 years in 1993. The postretirement liability of approximately \$7,200,000 in the Statements of Financial Position at December 31, 1998, and approximately \$5,947,000 at December 31, 1997 represent OTS' recognized portion of the remaining liability for participants' future life benefits.

Net periodic postretirement benefit cost for life insurance provisions under the Plan included the following components in 1998 and 1997 (in thousands):

	For the Years Ended	
	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
Service cost - current year	\$ 404	\$ 392
Interest on accumulated postretirement benefit obligation	759	718
Amortization of transition obligation	298	298
Amortization of loss	<u>17</u>	<u>0</u>
Net postretirement benefit expense	<u>\$ 1,478</u>	<u>\$ 1,408</u>

The following table sets forth the Plan's funded status reconciled with the liability recognized in the Statements of Financial Position (in thousands):

	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
Accumulated postretirement benefit obligation:		
Retirees	\$ 3,973	\$ 3,397
Other fully eligible participants	5,049	5,179
Other active participants	<u>2,311</u>	<u>3,209</u>
Accumulated postretirement benefit obligation	11,333	11,785
Unrecognized transition obligation	(4,174)	(4,472)
Unrecognized net gain	<u>41</u>	<u>(1,366)</u>
Total postretirement benefit liability	<u>\$ 7,200</u>	<u>\$ 5,947</u>

The weighted average discount rate used in estimating the accumulated postretirement benefit obligation at December 31, 1998 was 6.5%, and at December 31, 1997 was 7%.

9. RENTAL INCOME

OTS leases a portion of its building space to retailers under noncancellable operating leases expiring at various dates through 2009. Certain of these leases provide renewal options. The leases provide for annual base rent, some of which are subject to contingency rents for increased building costs, annual increases based upon changes in the Consumer Price Index or a percentage of sales in excess of a specified amount. Other leases provide for fixed future increases in rents over the term of the lease. OTS also subleases some of its existing unused leased facilities under similar terms.

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The future minimum rentals to be received under both types of noncancellable operating lease arrangements are as follows (in thousands):

<u>Years ending December 31</u>	<u>Leases</u>	<u>Subleases</u>	<u>Total</u>
1999	\$ 2,220	\$ 534	\$ 2,754
2000	2,192	554	2,746
2001	2,212	543	2,755
2002	2,253	543	2,796
2003	2,011	543	2,554
Thereafter	<u>1,497</u>	<u>779</u>	<u>2,276</u>
	<u>\$ 12,385</u>	<u>\$ 3,496</u>	<u>\$ 15,881</u>

Rental income totaled \$2,615,419 and \$3,092,568 for 1998 and 1997, respectively.

10. IMPUTED FINANCING - EXPENSES PAID BY OTHER ENTITIES

In 1997, OTS adopted Statement of Federal Financial Accounting Standards No. 5 (SFFAS No. 5), "Accounting for Liabilities of the Federal Government." SFFAS No. 5 requires, among other things, current recognition by federal employers of estimated future expenses related to the postretirement costs of pension and health benefits provided to employees under federal programs. The employer portion of postretirement pension and health benefits is paid by the Office of Personnel Management. The value of these future payments is included in the Statements of Operations and Changes in Net Position as imputed financing - expenses paid by other entities. The corresponding expenses are included in benefits.

The amounts charged to benefits under SFFAS No. 5 are as follows (in thousands):

	<u>1998</u>	<u>1997</u>
Pension expense	\$ 1,404	\$ 1,270
Health benefits	<u>3,096</u>	<u>3,199</u>
Total	<u>\$ 4,500</u>	<u>\$ 4,469</u>

11. RETIREMENT PLANS

OTS employees participate in three retirement systems which are classified as multi-employer plans. Two are administered by OPM. For funding purposes, these two plans function as defined contribution plans; however, the retirement benefits accrue in a manner consistent with a defined benefit plan. The third is a private defined benefit plan administered by the Financial Institutions Retirement Fund (FIRF).

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The Civil Service Retirement System (CSRS) is two-tiered. For employees hired prior to January 1, 1984, OTS withholds 7 percent of regular earnings. OTS contributed 8.51 percent of regular earnings in 1998 and 7 percent of regular earnings in 1997 for each employee in this tier; the sum is transferred to the Civil Service Retirement Fund, from which this employee group will receive retirement benefits. Employees do not contribute to, or receive benefits from, the Social Security System.

For employees with more than five years of service (not necessarily continuous), hired on or after January 1, 1984, OTS withholds, in addition to Social Security withholding, 0.8 percent of regular earnings. OTS also contributed 8.51 percent of regular earnings in 1998 and 7 percent of regular earnings in 1997 for each employee in this tier. At the point regular earnings exceed the FICA maximum wages (\$68,400 for 1998), employees covered under this tier of CSRS are required to have 7 percent of their earnings withheld. This employee group will receive retirement benefits from both CSRS and the Social Security System.

Beginning in January 1987, all employees hired since January 1, 1984, either as new employees or having less than 5 years of accumulated service (with a break in service over one year) are included in the Federal Employee Retirement System (FERS). For these employees, OTS withholds 0.8 percent of regular earnings and contributed 10.7 percent of regular earnings in 1998 and 11.4 percent of regular earnings in 1997. This group of employees will receive benefits from FERS as well as the Social Security System, to which they concurrently contribute.

Pursuant to FIRREA, the Office of Regulatory Activities and the twelve examination districts became part of OTS. As a result, OTS assumed the costs of their retirement system, which is part of FIRF. Under this private retirement system, OTS contributes a percentage of total FIRF salary. This percentage varies from year to year. Employees do not contribute to FIRF but do contribute to the Social Security System. Changes in percentages are based on the number of active FIRF OTS employees, the number of people that have retired, the benefits paid out, and adjustments to the actuarial gain or loss.

Although OTS funds either all (FIRF) or a portion (CSRS and FERS) of pension benefits under any of the above retirement systems relating to its employees and makes the necessary payroll withholdings, 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 government retirement systems and are not allocated to the individual agencies.

In years prior to 1997, OTS was not required to fund the FIRF plan due to changes in retirement plan provisions of the Internal Revenue Code and cumulative net actuarial experience gains. OTS established a prepaid asset representing the Future Employer Contribution Offset, and adjusted its balance and the corresponding expense annually according to actuarial valuation reports prepared by the Plan Administrator. In 1997, OTS elected to eliminate this prepaid asset by amortizing the remaining balance over three years. This change was due to the FIRF plan's status as a multiemployer plan and as such, the inherent uncertainty of the OTS' portion of the Future Employer Contribution Offset. The prepaid balances included in the Statements of Financial Position were approximately \$3,261,000 in 1998 and \$6,657,000 in 1997.

In addition to the retirement plans described above, OTS employees have the option of participating in retirement savings plans. Employees covered under CSRS or FERS may participate in the OPM-sponsored Thrift Savings Plan (TSP), a plan with characteristics similar to a private-sector 401(k) plan. Employees covered under CSRS or FERS may also participate in the Financial Institutions Thrift Plan (FITP), a 401(k) plan. Employees covered under FIRF may participate in FITP only. All employees may contribute up to 15% of their earnings to the plans. OTS makes matching contributions of up to 7% to the plans on the behalf of participants.

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The retirement expenses for all OTS plans, included in benefits expense in the accompanying Statements of Operations and Changes in Net Position, were as follows (in thousands):

	For the Years Ended	
	<u>December 31</u>	
	<u>1998</u>	<u>1997</u>
CSRS	\$ 2,828	\$ 2,535
FERS	1,659	1,578
FIRF	3,396	3,396
TSP	697	687
FITP	<u>3,229</u>	<u>2,586</u>
	\$ <u>11,809</u>	\$ <u>10,782</u>

12. DEFERRED COMPENSATION

As part of FIRREA, OTS assumed the Deferred Compensation Plans of the employees working for the Federal Home Loan Banks of Dallas and San Francisco. These plans allowed employees to defer a portion of their income and provided for employer matching contributions. OTS froze these plans and discontinued any deferrals or employer matches to these plans effective January 1, 1991. Benefits under the assumed plans were intended to be provided by cash value of life insurance policies issued by Mutual Benefit Life which went into rehabilitation on July 16, 1991. Under the rehabilitation plan, withdrawal of cash value prior to December 31, 1999 is restricted and subject to substantial withdrawal penalties. Current plan withdrawals have been funded by OTS. The cash value of those policies, included in advances and prepayments in the accompanying Statements of Financial Position, were \$1,725,000 in 1998 and 1997.

13. LEASE COMMITMENTS

OTS conducts most of its regional operations in leased facilities under noncancellable operating leases expiring at various dates through 2005. Many of the leases contain a provision to renew at the end of the initial term for an additional one to ten years. The rental payments are based on a minimum rental plus a proportional share of building operating expenses and taxes.

Some of the operating leases provide for rental escalations or stated annual rental increases in the amount of base rent over the lives of the leases. The accompanying Statements of Operations and Changes in Net Position reflect rent expense on a straight-line basis over the lives of the leases.

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The minimum rental commitments under noncancellable operating leases are as follows (in thousands):

Years ending <u>December 31</u>	
1999	\$ 5,021
2000	4,859
2001	2,742
2002	2,525
2003	2,465
Thereafter	<u>3,177</u>
	\$ <u><u>20,789</u></u>

Rent expense under noncancellable operating leases totaled \$5,069,937 and \$5,376,677 in 1998 and 1997, respectively.

14. COMMITMENTS AND CONTINGENCIES

OTS is defending several lawsuits that could subject OTS to expenditure of funds. In each of these cases, OTS believes it has substantial legal and factual defenses to the claims asserted, and believes it is more likely than not that OTS will prevail.

In addition, there are approximately 122 lawsuits pending against the United States in the U.S. Court of Federal Claims in connection with the elimination of the capital treatment of supervisory goodwill of certain thrift institutions. These cases arise from the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The U.S. Department of Justice is defending these cases on behalf of the United States. The Department of Justice Appropriations Act, 1999, provides a specific appropriation to pay judgments and compromise settlements in the supervisory goodwill cases. Furthermore, 28 U.S.C. Sec. 2517 provides that any judgment issued by the Court of Federal Claims must be paid from appropriated funds. Therefore, OTS funds, which are non-appropriated, cannot be used to pay judgments in these cases. For each of these reasons, OTS has made no loss accrual for these cases.

There are also five "tax benefits" lawsuits (including one case that also contains supervisory goodwill claims) brought by thrifts and thrift investors in the U.S. Court of Federal Claims. In these cases, which are being handled by the Department of Justice, the plaintiffs seek damages from the United States arising from 1993 changes in the tax laws, whereby Congress eliminated the favorable tax treatment of certain thrift acquisitions. There is no specific appropriation for the payment of judgments or settlements in these cases. As noted above, however, any judgment issued by the Court of Federal Claims must be paid from appropriated funds, and therefore OTS funds, which are non-appropriated, cannot be used to pay judgments in these cases. For this reason, OTS has made no loss accrual for these cases.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL

To the Inspector General,
U.S. Department of the Treasury

We have audited the financial statements of the U.S. Department of the Treasury, Office of Thrift Supervision (OTS) as of and for the year ended December 31, 1998, and have issued our report thereon dated March 22, 1999. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable Office of Management and Budget (OMB) guidance for audits of federal financial statements.

In planning and performing our audit, we considered OTS' internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls 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 over financial reporting. Consequently, we do not provide an opinion on internal controls.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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. We noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above.

However, we noted certain matters involving the internal control and its operation that we have reported to the management of OTS in a separate letter dated March 22, 1999.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL
(continued)

This report is intended solely for the information and use of the Inspector General of the U.S. Department of the Treasury, the management of the Office of Thrift Supervision, the Office of Management and Budget and Congress. However, this report is a matter of public record, and its distribution is not limited.

Deva & Associates, P.C.
Certified Public Accountants

March 22, 1999

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
WITH LAWS AND REGULATIONS**

To the Inspector General,
U.S. Department of the Treasury

We have audited the financial statements of the U.S. Department of the Treasury, Office of Thrift Supervision (OTS) as of and for the year ended December 31, 1998, and have issued our report thereon dated March 22, 1999.

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable Office of Management and Budget (OMB) guidance for audits of federal financial statements. 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 complying with laws and regulations applicable to OTS. As part of obtaining reasonable assurance about whether OTS' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of applicable laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in applicable OMB guidance, including the compliance criteria referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996.

The results of our tests of compliance disclosed no instances of noncompliance with laws and regulations discussed in the preceding paragraph exclusive of FFMIA compliance criteria reported below.

Under the FFMIA compliance criteria, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin 98-08 to determine whether OTS' financial management systems substantially comply with the federal financial management systems requirements, federal accounting standards, and the United States Standard General Ledger at the transaction level.

The results of our tests disclosed no instances in which OTS' financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
WITH LAWS AND REGULATIONS
(continued)

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. This report is intended for the information of the Inspector General of the U.S. Department of the Treasury, the management of the Office of Thrift Supervision, the Office of Management and Budget and Congress. However, this report is a matter of public record, and its distribution is not limited.

Deva & Associates, P.C.
Certified Public Accountants

March 22, 1999