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Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate

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BANK SUPERVISION

OCC's Supervision of the Bank of New England Was Not Timely or Forceful

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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request that we review the failure of the Bank of New England Corporation (BNEC).[1] The Federal Deposit Insurance Corporation (FDIC) estimates that BNEC's failure may cost the Bank Insurance Fund (BIF) $2.5 billion. This would make the BNEC failure among the most costly in U.S. history. As agreed with the Committee, we focused our review on the causes of BNEC's failure, including the possible role of insider lending, the safety and soundness problems that the Office of the Comptroller of the Currency (OCC) identified at BNEC, and the enforcement actions OCC took to get BNEC management to correct these problems.

In your request, you raised a number of specific questions about insider lending and other issues and their impact on the failure of BNEC. We address each of these questions individually in appendix II and discuss our findings in this report as part of the story of the bank's failure and the regulator's efforts to get BNEC's management to operate the bank safely and soundly. You also asked that we provide a brief review of the events leading to the failure of the Madison National Bank. We present a summary of this review at the end of this letter with a more detailed account contained in appendix III.

Background

Assets of the BNEC banks grew rapidly in the mid to late 1980s, from $7.5 billion in 1985 to $32.6 billion in 1989.[2] The growth was a result of significant increases in commercial real estate lending and aggressive acquisitions of other banks, notably Connecticut Bank and Trust (CBT) and Maine National Bank (Maine). When the New England economy suffered a severe downturn in the late 1980s, the quality of the BNEC banks' loan portfolios began to deteriorate rapidly, necessitating massive

[1] In this report, BNEC refers to the holding company of the Bank of New England-Boston and all banking subsidiaries of the Bank of New England Corporation, which was the holding company of this banking organization.

[2] By early 1990, The American Banker had designated BNEC as one of the top 25 bank holding companies in the United States on the basis of asset size.

increases in their reserves for loan losses. These increases ultimately significantly reduced the banks' equity capital. BNEC's lead bank in Boston (BNE-Boston), CBT, and Maine were declared insolvent on January 6, 1991.

OCC was the primary federal bank regulator responsible for supervising most of the BNEC banks—that is, those that were national banks. In keeping with its supervisory procedures, the Boston Duty Station of OCC's Northeast District Office (New York) was responsible for the continuous supervision of BNEC banks and maintained an annual presence at the major BNEC bank subsidiaries, focusing on the banks' larger and problem loans. OCC's supervisory guidance suggests that this approach should be followed unless examiners discover significant operational problems that adversely affect the bank's asset quality, earnings, and capital. Under OCC guidance, a discovery of such adverse effects would signal the need to expand the scope of examination and consider enforcement action.

Depending upon the nature and severity of problems identified, the OCC District Office may consider taking informal or formal enforcement actions. In either event, the findings of examiners are to be summarized in examination reports that go to bank management and the bank's board of directors. An informal action may include such things as a meeting with bank officers or board of directors to obtain agreements on necessary corrective actions, having a bank issue a commitment letter specifying what it will do to correct criticized practices, or the regulators' issuance of a memorandum of understanding, which would spell out the specific steps bank management should take to correct identified problems. Informal actions communicate concerns, but they are not administratively or judicially enforceable if bank management does not take corrective actions.

For problems more severe or recurring, examiners may recommend a formal action. Formal actions, which must be approved by OCC's Headquarters Office, include formal agreements (contractual agreements between bank management and OCC to specify corrective actions), cease and desist orders (orders that the bank stop specific unsafe or unsound practices), and assessments of civil money penalties (CMP) against officers, directors, the institution, or other affiliated parties. If banks do not consent to a formal action or fail to comply with its provisions once agreed upon, OCC may enforce the action through administrative or judicial proceedings.

OCC examiners monitor compliance with Federal Reserve System (FRS) Regulation O, which limits loans and credit extensions to bank insiders. The groups subject to these restrictions include principal shareholders, executive officers and directors of both the bank and, in certain cases, of the bank holding company and its subsidiaries.

Some Regulation O provisions prohibit the practice of making loans to insiders on more favorable terms or at more than the normal risk of repayment than those made to other borrowers. Violations of these provisions are treated as substantive by federal bank regulators. In addition, Regulation O includes provisions viewed by regulators as more technical in nature, including those requiring board of director approval for insider loans.

FRS was the federal bank regulator responsible for supervising the BNEC holding company and its nonbank affiliates. There are two ways that a holding company can have an adverse effect on a banking subsidiary. A holding company or its nonbank affiliates may take excessive risks and fail, or they may transfer excessive funds out of the bank subsidiaries through intercompany transactions or dividends. FRS' supervisory concern is to ensure that intercompany transactions for goods or services be made on market terms and that dividends be paid from bank earnings and not cause deterioration of the bank subsidiaries' capital or liquidity position. FRS officials told us that its examiners generally rely on the primary bank regulator to examine the banks of a holding company and to identify operational problems in those banks. However, FRS officials also said their examiners may review banks' operations if the primary regulator has not done so.

This letter contains two chronologies as well as a discussion of how OCC's supervision of BNEC banks compared with OCC's general supervisory practices and the supervisory practices of other federal bank regulators and a discussion of insider lending at BNEC banks. First, we present the history of the BNEC banking organization during the period 1985 to 1991. In this chronology, we discuss BNEC bank strategy for expansion and growth, the growth of the organization's assets and its real estate loan portfolios in the mid- to late 1980s, and the effects on the banks of their lending policies and practices—including insider lending—as the New England economy declined in the late 1980s. We also discuss the extent of payments from BNEC bank subsidiaries to the holding company. Such payments, which include dividends and management fees, are used to fund holding company operations and are regulated to ensure that they are justifiable. In the second chronology, we discuss regulatory supervision of BNEC banks during 1985 to 1991, including OCC's identification of insider lending and the problems BNEC banks had managing expanding operations; what OCC did to try to get bank management to correct those problems; and FRS' supervision at the holding company level. The discussion of regulatory supervision summarizes our findings on the nature and extent of loans to insiders made by BNEC banks in the period 1985 to 1991.

Results in Brief

BNEC banks failed as a result of their (1) liberal lending practices, (2) poorly controlled growth, and (3) concentration in commercial real estate loans in a severely declining regional economy. Between 1985 and 1988, the BNEC banking organization grew through acquisitions and mergers and by aggressively expanding its real estate lending by offering liberal terms to real estate developers. As its loan portfolios grew by more than fourfold, it became more heavily concentrated in commercial real estate loans that were increasingly risky as the market declined. Weaknesses in internal controls and overly aggressive lending practices led to a decline in the quality of the loan portfolios. Moreover, BNEC's growth was not accompanied by adequate reserves for loan losses. The New England economy, and particularly the regional commercial real estate industry, declined severely in the late 1980s. In a rapidly declining real estate market and with inadequate reserves, BNEC banks were unable to absorb through earnings or capital the loan losses they experienced.

During BNEC's expansion, its banks' loans to insiders were substantial in amount, but they did not cause BNEC's failure. Insider loans have already resulted in losses and are likely to result in further losses. As of May 1991, we identified loans to BNEC insiders of at least $330 million in commercial loans, principally real estate-related, of which BNEC banks had written off $30 million. If the acquirer cannot get repayment from borrowers, total cost to BIF from insider loan defaults could amount to as much as an additional $155 million, all from the $300 million remaining balance. OCC found that few of the BNEC insider loans violated Federal Reserve Regulation O. OCC viewed most of the violations found as technical, in that the loans did not always receive prior approval by the full board of directors. OCC identified four loans to two directors as having been made on preferential terms. Our review of the insider loans made by BNEC banks indicates that their terms and handling are symptomatic of the lack of internal controls over lending practices that contributed to BNEC's failure. OCC also identified deficiencies in BNEC's internal controls and systems for identifying insider loans. In our view, these deficiencies were also symptomatic of problems BNEC had in safely and soundly managing its lending operations.

OCC repeatedly identified and reported problems with the BNEC banks' lending operations and strategies throughout BNEC's high-growth period of 1985 to 1988. However, these problems were not characterized in OCC examination reports as seriously affecting bank operations until 1988. We are concerned that OCC did not expand its scope of examinations when these problems were identified. Despite the failure of BNEC banks to correct problems after they were identified by OCC and the increased risk of management's aggressive growth strategy, OCC took no enforcement action to compel corrective measures until 1989. By that time the New England economy was declining, and it was too late for the banks to deal effectively with the conditions of the real estate loan portfolios. Furthermore, OCC did not expand its review of the banks' real estate portfolios until the New England economy was declining. As a result of the 1989 examination, OCC required an increase in that year's provision for loan losses from the $200 million recorded in the first 9 months to $1.6 billion for the full year. This increase, with the additional losses the banks incurred during 1990, reduced the banks' equity capital to less than 2 percent of assets.

During the 1987 to 1989 expansion, BNEC banks' payments to the BNEC holding company also increased dramatically. OCC did not question this increase, and FRS expressed concern only about the method of allocation of management fees to the banking subsidiaries. However, when OCC required the $1.4 billion increase to BNEC banks' loan loss provision, the 1989 reported earnings were depleted. Subsequently, previously announced BNEC bank and holding company 4th quarter dividends were rescinded at the insistence of OCC and FRS, respectively. Nevertheless, dividends paid to the holding company by the banks increased in 1989 by nearly $84 million, an increase of 131 percent over dividends in 1988. This increase was not questioned by OCC or FRS because the dividends had been paid out of reported earnings.

Objectives, Scope, and Methodology

Concerned with the adequacy of regulatory oversight of BIF-insured banks, and particularly with the supervision of actions by bank insiders, the Chairman of the Senate Committee on Banking, Housing and Urban Affairs asked us to review the events surrounding the failures of the BNEC and James Madison Limited (JML) banks. As agreed with the committee, we focused our review on the failure of the BNEC banks. (The results of a less detailed review of JML banks are presented in app. III). Generally, our objectives were to determine (1) what caused the failure of the BNEC banks, (2) whether OCC's efforts to supervise the banks were adequate, and (3) the extent to which insider activity may have contributed to the failures.

To determine the causes of the failures, we reviewed OCC examination reports and related documents, and held discussions with OCC examiners and national office personnel. We began our review with the 1985 examination because we were told by OCC officials that its examiners first identified safety and soundness deficiencies that year. It was also the year that BNEC acquired CBT, which significantly increased BNEC's total assets.

To determine the role of insider loans in the failure of the BNEC banks, we reviewed OCC, FDIC, FRS, and BNEC documents and discussed with OCC officials the extent of loans to BNEC insiders. For the purposes of this review, insiders—to the extent that we could identify them—included directors, executive officers, major stockholders and their related interests, including family members and controlled organizations. To approximate the magnitude of these loans, we compared loan lists from BNEC accounting records with the list of insiders we were able to identify. We also evaluated OCC's analyses of loans to insiders and tried to determine whether the loans have resulted or are likely to result in losses to BNEC banks or BIF. Since BNEC's system for identifying loans to insiders did not provide a complete list of insider loans, and we did not believe our efforts to supplement this list captured all other loans to insiders, we believe our approximation of the amount of loans to insiders may be understated.

In addition, we obtained information from OCC and FRS examination documents and officials about the payment of funds from BNEC bank subsidiaries to BNEC. This information included data on management fees, dividends, interest payments, and tax-sharing arrangements.

We did our work between June 1991 and August 1991 at OCC, FRS, and FDIC in Washington, D.C.; at OCC and FRS in Boston; at the former BNEC in Boston; and at the former CBT in Hartford. We did our work in accordance with generally accepted government auditing standards. (For a more detailed description of our objectives, scope, and methodology, see app. I.) We discussed the contents of this report with OCC and FRS officials and have incorporated their comments where appropriate.

BNEC Grew Rapidly Through Acquisitions and Aggressive Real Estate Lending

In 1985, BNEC changed its banking strategy from that of traditional, local banking to aggressive, regional banking. In 1984, before the acquisition of CBT and Maine, BNEC was a traditional local bank with investments in Treasury securities and a lending portfolio with the greatest concentration in commercial/industrial (non-real estate) lending. As of March 31, 1985, just before the merger with CBT, commercial/industrial lending represented about 31 percent and commercial real estate represented about 8 percent of BNEC's total assets of $7.5 billion. In 1985, with the acquisition of Maine and CBT, BNEC shifted its strategy. At that time, CBT management assumed control over BNEC and its subsidiaries and set the organization on a new course. The new strategy was for BNEC to become a regional force through expansion by acquisitions and mergers and major growth through commercial real estate lending.

Under the new strategy, BNEC grew rapidly from 1985 to 1988, partly through acquisitions of banks, some of which were known to have operating problems. By 1990, BNEC had merged the assets of these banks into three major banks: BNE-Boston, CBT, and Maine. BNEC's 1985 acquisition of CBT added assets of about $7 billion to the organization; the 1985 acquisition of Maine added about $700,000; and the 1987 acquisition of the Conifer Banking Group added $4 billion. BNEC's growth strategy entailed management challenges in effectively integrating the systems and controls of the acquired banks and in administering their loan portfolios.

By 1989, BNEC's bank assets totaled $32.6 billion. Table 1 shows the change in total assets for the period 1985 to 1990, along with the number of banks, which declined due to mergers. The drop in assets in the 1989 to 1990 period occurred with the downturn of the real estate market, supervisory actions requiring the banks to increase their reserves for loan losses, and sales of assets as well as other actions taken by new BNEC management in an attempt to address the banks' operating problems.

Table 1: Combined Assets of BNEC Banks

Dollars in billions

Date[a]	Total assets	Number of banks
03/31/85[b]	$7.5	9
09/30/86	19.8	5
03/31/87	21.3	5
12/31/87	29.5	11
12/31/88	33.1	9
12/31/89	32.6	8
12/31/90	21.7	3

[a] Dates are approximate dates of OCC examinations.

[b] Before BNEC acquisitions of CBT and Maine.

Source: Federal Financial Institutions Examination Council Reports of Condition and Income.

The economic environment appeared to be propitious in 1985 for BNEC's new strategy. At that time, the New England region had an expanding economy driven by growth in high-technology manufacturing and defense-related industries and supported by a rise in the value of commercial and residential real estate. In fact, during most of the 1980s, the New England economy outperformed the rest of the United States. Unemployment rates were consistently below the national average, reaching a decade low of 3.1 percent (compared to 5.5 percent nationally) in 1988. Construction employment clearly shaped these statistics; between 1982 and its peak in 1988, construction employment increased 76 percent in New England. During the period 1985 to 1988, the annual rate of growth in commercial real estate and construction loans—for both residential and commercial developments—for all New England banks averaged 36 percent while the average for all banks nationwide during the same period was 16 percent.

However, the rapid expansion of the real estate industry proved unsustainable because the New England economy was not expanding enough to absorb the new residential and commercial construction. Even with the rise in construction employment, overall employment in New England in the 1980s was growing at only the national average, and population growth was barely half that of the national average.

According to BNEC and OCC officials, BNEC's participation in commercial real estate lending in a competitive market required BNEC banks to make loans with extraordinarily liberal terms, including 100-percent financing, interest-only payments from loan proceeds, and interest rates set at favorable rates such as prime plus 1/4 or 1/2 of 1 percent. Multimillion dollar loans were frequently collateralized by only the real estate venture, with repayment of the funds based exclusively on the expected cash flow from the project's sale or rental income. A BNEC bank official we interviewed characterized the bank in these ventures as more like a partner than a lender, since often the only funds at risk were the bank's.

BNEC banks offered these liberal terms in numerous multimillion dollar real estate loans to developers with whom the banks sought to develop a financial relationship. Some of these developers also served on the board of directors of one or more of the BNEC banks. Several directors who received loans were reputed to be highly successful developers who borrowed from major banks throughout the Northeast. As of May 1991, BNEC banks held commercial loans to insiders of at least $300 million (representing less than 2 percent of total BNEC assets at the end of 1990, just prior to the insolvency), with a large proportion going to a small number of insiders who were major real estate developers.

The dollar amount of BNEC banks' commercial real estate loans increased steadily and dramatically year by year in the 1985 to 1988 period, from $2.4 billion in 1985 to about $7 billion in 1988. The percentage of total loans that these real estate loans represented went from about 17 percent in 1985 to about 28 percent in 1988.

Even with the sharp increase in real estate loans in New England, we found that BNEC's participation in commercial real estate was above that of other New England banks. Table 2 compares the ratio of commercial real estate loans to all loans for BNEC banks in 1985 to 1988.

Table 2: Comparison of BNEC Commercial Real Estate Loans to All Loans

Dollars in billions

Year	Total BNEC commercial real estate loans[a]	Percent of commercial real estate loans to BNEC total loans
1985	$2.4	16.9%
1986	3.9	20.8
1987	5.4	25.1
1988	6.9	27.9

[a] To eliminate the effects of growth due to acquisitions, amounts shown for BNEC have been restated to include banks that were acquired by BNEC in subsequent years.

Source: Federal Financial Institutions Examination Council Reports on Condition and Income.

In 1988, as noted above, 28 percent of BNEC's loans were in commercial real estate. This compares to 21 percent for all other New England banks. In 1985, the corresponding figures were 17 percent and 15 percent, respectively.

Payments of Funds by Subsidiary Banks to the BNEC Holding Company

During this growth period for BNEC banks, the subsidiary banks' payments to the BNEC holding company increased dramatically. For calendar years 1987 to 1989, the portion of the holding company's operating income that came from its banks included dividends, interest payments, and management fees. This income, along with other holding company income, was used to fund holding company operations, service holding company debts, pay dividends to shareholders, and assist subsidiaries having liquidity problems or other financial difficulties. As shown in table 3, the total of these payments nearly tripled over the 3-year period. Particularly noteworthy are the increased payments in 1989, which occurred as the real estate market was in decline and nonperforming assets[3] of BNEC banks were on the rise.

Table 3: Annual BNEC Revenue From Subsidiary Banks

Dollars in thousands

Sources of funds	**1987**	**1988**	**1989**
Dividends	$31,134	$64,100	$148,000
Interest	28,293	21,730	30,600
Management fees	19,833	46,245	56,500
Totals	**$79,260**	**$132,075**	**$235,100**

Source: Federal Reserve examination work papers.

Real Estate Market Softened in 1988 and Collapsed in 1989

The New England real estate market began to soften in 1988. The collapse of that market, which is generally regarded as having been precipitous, became evident in the period of mid-1988 to mid-1989. Even today, however, experts differ in their opinions of the exact timing of the collapse. BNEC appears to have been caught by surprise by the sudden downturn in the real estate market. As the New England real estate market began to soften in 1988, BNEC banks had nearly 28 percent of total loans in commercial real estate and strikingly inadequate loan loss reserves.

[3] Nonperforming assets are loans that are not performing according to the original terms of the borrower's loan agreement. Generally, loans 90 days or more past due are considered to be nonperforming.

Table 4 shows the dramatic increase in nonperforming assets and the relative size of the loan loss allowance.

Table 4: Growth in BNEC Nonperforming Assets, 1986-1989

Dollars in millions

Time period	Total nonperforming assets	Allowance as a percent of nonperforming assets
4th qtr. 1986	$254.7	94.7%
4th qtr. 1987	338.4	140.7
4th qtr. 1988	419.4	77.5
1st qtr. 1989	550.8	61.5
2nd qtr. 1989	667.4	51.2
3rd qtr. 1989	900.0	38.0[a]

[a]This percentage was calculated before OCC's requirement for BNEC to increase its loan loss allowance as a result of the 1989 examination.

Source: OCC Supervisory Report, March 16, 1990.

By December 1989, OCC had determined that the quality of BNEC banks' assets had deteriorated significantly, and had entered into a formal agreement with BNEC to get management to correct problems. With the deterioration in asset quality, OCC disallowed BNEC national banks' 4th quarter 1989 dividends to their holding company. BNEC banks rescinded the 4th quarter 1989 dividends they had paid to the BNEC holding company, and the BNEC holding company, at the insistence of FRS, did not pay previously announced dividends to its shareholders. Also in December 1989, OCC informed BNEC's executive committee that the banks' management should use its best efforts to strengthen the capital and liquidity of each BNEC bank. In 1989, after increases to the loan loss reserves that were required by OCC, BNEC suffered a loss of $1.1 billion.

In 1990, BNEC banks' assets continued to deteriorate as a larger proportion of their assets became nonperforming. In February 1990, BNEC banks consented to an OCC cease and desist order that, among other things, directed the banks to improve their equity capital condition (which had fallen below 2 percent of assets), restricted the banks' ability to extend credit for commercial real estate and land acquisition, and required the banks to develop and implement major improvements to their lending programs.

BNEC management tried for about 1 year to sufficiently improve the capital condition of its banks, but failed. Their efforts, among others, included installing a new chief executive and raising funds through the sales of a leasing subsidiary, credit card operations, and various other assets. By the time the banks were declared insolvent on January 6, 1991, their total assets had dropped to about $22 billion, down from $32 billion at year-end 1989.

OCC Recognized Problems at BNEC Banks But Acted Too Late to Prevent or Minimize Failures

Throughout BNEC's high-growth period from 1985 to 1988, OCC examiners repeatedly identified and reported problems with the BNEC banks' lending operations and strategies. Despite the repetition of problems and the increased risk of management's aggressive growth strategy, OCC took no enforcement action to compel corrective measures until 1989, after BNEC's loan portfolios were too heavily concentrated in liberal real estate loans to allow the banks to withstand the downturn in the real estate market.

1985 Examination Identified Asset Quality Problems

During the 1985 safety and soundness examination (which covered the period just before BNEC's acquisition of CBT),[4] OCC reviewed asset quality, earnings, and capital at BNE-Boston. The OCC supervisory report noted that, while the overall condition of the bank was satisfactory, asset quality was only fair due to the number of criticized assets.[5] The report noted that this was the fourth consecutive examination in which asset quality had declined. It also noted that the bank's internal loan review process—the process by which the bank rated its loans for risk—was informal and needed to be strengthened and formalized. OCC views the sufficiency of the loan review process as important in determining the amount of reserves the bank should set aside for potential losses on their loans. Largely as a result of the inadequacies of BNEC's loan risk rating system, OCC found the documentation and justification of the allowance for loan losses to be inadequate.

Even though OCC had identified significant problems, the supervisory agency took no enforcement action to compel correction of these weaknesses. In addition, OCC took no action to compel the banks to increase their loan loss provisions, even though its examiners had identified problems in asset quality and in the loan risk rating system. The problems were merely noted in the examination report that went to bank directors. In addition, as was typical of the supervisory reports

[4] Following customary OCC usage, we refer to an examination by the date of the financial data OCC used in the examination. Thus, the 1985 examination was as of March 29, 1985. However, OCC's actual examination work was done from May 6, 1985 to August 1, 1985.

[5] Criticized assets are assets (loans) that are rated as having a less-than-satisfactory likelihood of repayment.

that followed in 1987 and 1988, the criticisms in the 1985 report were embedded within a generally positive assessment of bank management and the banks' future prospects.

The 1986 and 1987 OCC Examinations Identified New and Continuing Problems

By the time of the September 30, 1986, examination, BNEC had $20 billion in assets. The examination report noted continuing problems in the loan risk rating system, with inconsistent use of the system by various banks. Management promised to have BNE-Boston personnel review the loan departments at all the subsidiary banks and correct the inconsistencies. This examination also identified the following significant new problems:

- Lack of independence of the loan review function. Individuals responsible for managing loan portfolios were also responsible for risk-rating loans made by their direct supervisors.
- Overly optimistic growth projections for corporate earnings. Asset expansion was exceeding capital generation.
- Out-of-date credit documentation in the construction lending portfolios.
- Incompatible hardware and software systems among BNEC and the acquired banks, which caused difficulties. For example, BNEC had major problems in reconciling accounts among its banks following the consolidation of six affiliated banks into BNE-Boston in 1986. This compatibility problem was particularly troublesome, since further acquisitions were planned at the time of the 1986 examination. BNEC was then poised to acquire the $4 billion Conifer Banking Group.

In spite of the recurring problems in the BNEC banks' loan rating system and the major additional problems identified, OCC determined that no informal or formal enforcement actions were necessary to compel the banks to correct these problems. Once again, the problems were identified in the examination report, and OCC relied on management's assurances that the problems would be addressed.

OCC conducted two examinations of BNEC banks in 1987. In the quarter ended March 31, 1987, just prior to the May 31, 1987, examination, BNEC's assets had grown to $21 billion. This examination focused on internal controls and the loan loss allowance. Again, OCC criticized the loan review function, stating that the banks had not yet implemented a BNEC-wide uniform loan rating system. In addition, OCC noted the continued conflict of interest in bank officials both managing and rating loans made by their direct supervisors. In fact, bank management informed OCC that it did not agree that there was a conflict-of-interest problem and declined to address this OCC concern. In response, OCC suggested that it would be sufficient for management to obtain concurrence of the Board of Directors with this decision. As in its earlier 1985 report, OCC raised concerns about the adequacy of the documentation needed to calculate the loan loss reserve. In the May 1987 report, OCC stated that the allowance documentation was either suspect or nonexistent.

The May 1987 examination report also mentioned the wide variation in the health of the loan portfolios at the BNEC banks. While OCC regarded Maine's portfolio to be of high quality, it called the portfolio at BNE-Old Colony, another bank subsidiary, less than satisfactory. OCC also noted a substantial increase in the number of CBT's criticized assets. Nevertheless, OCC did not require an increase in the allowance for loan loss reserves. Nor did OCC take any informal or formal enforcement action to compel the banks to correct problems. Once again, the criticisms were embedded in an examination report whose main message was that BNEC had no major problems. In fact, the report stated that internal controls were generally adequate.

At the time of the second examination, December 31, 1987, BNEC bank assets had grown to $29 billion. Although OCC noted that the banks had made some improvements in lending operations, the supervisory agency again identified continuing problems in the loan rating system and the loan loss allowance account—essentially the same problems identified previously. At BNE-Boston, OCC cited numerous deficiencies in loan ratings, including the following:

- Large numbers of loans had not been evaluated for risk.
- The quality of many less-than-satisfactory loans was overrated.
- Because of the heavy volume of loans in their individual portfolios, many bank analysts were unable to review the risk ratings of their loans in a timely manner.

OCC also noted continuing inadequate support for the amounts reserved in the loan loss allowance for all the BNEC banks but, again, did not require an increase in the allowance for loan losses.

The December 1987 OCC examination also found new problems with the banks' lending policies and practices, including violations of FRS Regulation O. While again characterizing the banks' general lending policies as adequate, the examination report stated that BNEC needed more underwriting criteria for the banks' specific types of lending. Moreover, the report noted the significant growth in commercial real estate lending, weak documentation in the credit files, and aggressive underwriting characterized by such terms as 100-percent financing. Over half of the commercial real estate loans reviewed at BNE-Boston during this examination were 100-percent financed, and nearly half of the loans reviewed had inadequate or stale credit information on borrowers. With regard to violations of FRS Regulation O, OCC identified three loans to insiders—for $28 million, $250,000, and about $466,000—as not having received the required prior approval of the board of directors.

OCC neither took nor considered taking any enforcement action to compel correction of Regulation O violations or any new or continuing problems with lending practices and policies criticized in the report. OCC only noted in its report management's repeated failures to address old problems that had persisted and spread with the growth of the banks' commercial real estate lending.

OCC Took Action After Adverse Effects of Problems Became Evident in Late 1988 and 1989

OCC conducted two types of examinations of BNEC banks in 1988—a compliance examination[6] and a safety and soundness examination. In the August 1988 compliance examination at BNE-Boston and two other BNEC subsidiary banks, OCC reviewed insider activities and found Regulation O violations at BNE-South, one of the subsidiary banks. The violations involved the failure to obtain prior board of directors approval of $3.3 million in loans to three directors. Once again, OCC took no action to compel corrective action. This was the only examination during the period 1985 through 1990 where we found that OCC specifically planned to focus part of its examination on insider activities. Earlier concerns OCC raised about insider lending activities were identified from routine reviews of the banks' loan portfolios.

In the December 31, 1988, safety and soundness examination of the BNEC banks, which was not completed until March 1989, OCC noted that the previously identified problems with the loan risk rating system appeared to have worsened and the loan allowance documentation continued to be deficient. OCC also noted a significant deterioration in asset quality at BNE-Boston since the examination 1 year earlier, rated the loan portfolio only "fair," and questioned the bank's classification of many of its loans. According to OCC, uncorrected problems in BNE-Boston's loan rating system had resulted in the bank having an overly

[6] Compliance examinations, as distinguished from safety and soundness examinations, generally concentrate on consumer issues. Some regulators may include other, miscellaneous activities, such as trust department activities or insider activities, in their compliance examinations. At the time of this compliance examination, insider activities were included as part of compliance examinations by OCC.

optimistic valuation of its portfolio. This condition was exacerbated by current lax accounting rules for recognition of loan losses, which may have contributed to the BNEC banks' understatement of the deteriorating condition of their loan portfolios over several years.[7] In the March 1989 examination report, for the first time, OCC questioned the adequacy of the BNEC banks' reserves for loan losses. While acknowledging that the New England real estate market had experienced some softening, OCC's report stressed that this softening illuminated the long-standing inadequacies of the controls over lending and loan administration. OCC also noted that the trend in asset quality was one of an accelerating deterioration.

The 1988 examination resulted in the first formal enforcement action by OCC to compel BNEC banks to correct their broad and worsening problems. OCC and BNEC entered into a formal agreement on August 10, 1989.[8] The agreement required BNEC to, among other things, adopt a program aimed at (1) improving its criticized assets, underwriting standards, and loan administration and (2) reviewing and improving its loan loss allowance and its loan rating system. The agreement did not, however, address the Regulation O violations OCC identified in the 1987 and 1988 examinations. OCC also scheduled a follow-up examination for the 4th quarter of 1989.

During the early stages of the 1989 examination, OCC determined that the banks' condition had deteriorated even further and that the level of nonperforming assets had increased dramatically. As shown previously in table 4, nonperforming assets increased rapidly from the December 1988 examination ($419 million in the 4th quarter of 1988) to just before the start of the 1989 examination ($900 million in the 3rd quarter of 1989). BNEC had not increased its allowance provision sufficiently to keep pace with the growth in nonperforming loans.

In the early stages of the 1989 examination, OCC identified severe deterioration in the loan portfolios. This information was communicated to OCC's Washington, D.C., Multinational Banking Unit (MBU). MBU was concerned with the management of this examination by the New York and Boston offices and because of the evident severe deterioration at the

[7] See Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991). We reported that accounting rules are flawed in that they allow bank management considerable latitude in determining carrying amounts for problem loans and repossessed collateral. We recommended that the Financial Accounting Standards Board tighten the accounting rules.

[8] The delay in finalizing the formal agreement was shorter than apparent. This examination, while dated December 31, 1988, actually concluded on May 24, 1989.

BNEC banks, became concerned about the identification of problems during prior examinations. As a result of these concerns, MBU now took responsibility for supervision of BNEC. This change resulted in the assignment of a new examiner-in-charge and an increase in both the number of examiners assigned and real estate lending expertise of the examination staff. Many of the more experienced examiners were brought into the BNEC examination from MBU and the Southwest Region, where they had reviewed similar liberal real estate lending practices. According to OCC officials, these changes were made to provide much closer attention to the supervision of the BNEC banks in the declining regional economy. At this time, FRS and FDIC were alerted to BNEC'S problems. These agencies assisted OCC in the direct supervision of the banks.

During the 1989 examination, which was not completed until February 1990, OCC drastically expanded its depth of coverage of the banks' loan portfolios with roughly 70 percent of the loans reviewed. We noted that, in prior examinations, the depth of coverage was usually less than 30 percent of the banks' total loan portfolios.[9] Because of increased penetration of the loan portfolio, OCC identified substantially more loans with underrated credit risks. As a result, OCC required the banks to increase their loan loss provision for 1989 by $1.4 billion, from $.2 billion to $1.6 billion. This loan loss reserve increase had the effect of reducing the banks' equity capital to less than 2 percent of assets. The OCC examination report indicated that the banks were in imminent danger of failing.

The expanded examination of the loan portfolios also uncovered several Regulation O violations, most of which were viewed by OCC as technical violations. However, four violations for loans totaling $4,300,000 were viewed as substantive. These were violations of Regulation O provisions prohibiting the practice of making loans to directors or their related interests on more favorable terms or at more than the normal risk of repayment than those made to other borrowers. These loans were criticized by OCC at the time of the 1989 examination, and one of them had been cited for a technical violation in the 1988 compliance examination. The examiner who identified the substantive Regulation O violations recommended the assessment of civil money penalties against the bank

[9] OCC's Examination Handbook requires sampling of loan portfolios during safety and soundness examinations but does not specify the amount of sampling required. In the BNEC bank examination reports and work papers we reviewed, OCC examiners generally reviewed large and problem loans in the portfolios thought to expose the banks to the greatest vulnerability, like commercial real estate. The depth of coverage in these portfolios was rarely calculated for the banks reviewed, much less for the total BNEC banks' portfolios. From information available in the reports and work papers, we and OCC agreed that the coverage was usually less than 30 percent of BNEC banks' portfolios.

subsidiary's directors, but this recommendation was not acted upon until we inquired about the status of the recommendation during our review. According to OCC officials, while a final decision has not yet been made, OCC is pursuing the recommendation through the administrative process for taking such formal enforcement actions.

The 1989 examination resulted in OCC and BNEC management entering into a cease and desist order on February 26, 1990, because of the deteriorating condition of the banks and because the banks had not satisfactorily complied with the provisions of the August 10, 1989, formal agreement. The cease and desist order prohibited BNEC banks from declaring or paying dividends without prior OCC approval. The order also required the banks to immediately address the problems in the loan portfolios and to devise a plan for augmenting earnings.

During 1990, BNEC changed bank management and struggled to reduce the volume of problem assets and improve the capital ratio through, among other things, the sale of assets. The volume of problem assets, however, continued to grow with the collapse of the New England real estate market. In late 1990, both the banks and the holding company faced increasing liquidity problems as bad news about BNEC continued to spread. By this time, the BNEC banks had been consolidated into three banks—BNE, CBT, and Maine. OCC declared the three banks insolvent on January 6, 1991.

Regulator's Approach at BNEC Banks Was Not Dissimilar to That Taken at Other Troubled Banks

The weaknesses evident in the supervisory history of BNEC banks are inherent in the supervisory practices of all federal bank regulators. The story of BNEC's failure is similar to other recent troubled banks we have reviewed: banks engage in unsafe lending practices, with inadequate systems and controls to manage key bank operations. Regulators identify and report such problems but do not take enforcement actions that would compel banks to improve the safety and soundness of operations until the banks' capital levels are adversely affected. Taken together, these stories point to the need to reform the bank regulatory process.

One of the major problems in the supervisory process is the lack of standard measures for unsafe and unsound practices and conditions. Federal bank regulators have wide discretion in deciding both the timing and nature of enforcement actions they take to ensure safe and sound bank operations. Banking laws, regulations, and agency guidelines generally delineate the conditions that must be present for regulators to use available enforcement actions. However, except for minimum capital standards, the delineation does not provide specific measures or standards defining a threshold level of an unsafe practice or condition.

Another problem is that regulators tend to avoid taking forceful action. In an earlier study, we found that the philosophy of OCC and the other federal bank regulators was to work cooperatively with bank managers to resolve safety and soundness concerns.[10] Generally, this means that the regulator communicates its concerns through bank examination reports or in meetings with bank officers or boards of directors, but the regulator does not take the most forceful action available. We also found in that study that better supervisory outcomes were associated with the most forceful actions taken, and worse outcomes were associated with not taking the most forceful action.

Under agency guidelines, regulators may use formal enforcement actions if (1) informal actions have not been successful in getting bank management to address supervisory concerns, (2) bank management is uncooperative, or (3) the bank's operating weaknesses are serious and failure is more than a remote possibility.

OCC's supervision of BNEC banks from 1985 to 1991 illustrates the inadequacy of the cooperative philosophy of bank supervision and the need for reform of supervisory procedures. In the case of BNEC banks, our proposed "tripwire" approach to bank supervision[11]—which, in essence, is in the bank reform bills reported by the Senate and House Banking Committees—would have required OCC to take more forceful enforcement action (such as issuing a board commitment letter) when OCC identified internal control problems in loan administration as early as 1985. Given BNEC's problems with internal controls, management systems, and asset quality, OCC would also have been able to impose restrictions on growth. The subsequent failure of BNEC to correct these problems would have triggered the second tripwire. It would have required OCC to initiate a more forceful action—perhaps a formal agreement—possibly as early as 1986 and certainly by 1987. Such an agreement might have imposed further limitations on dividend payments or the types or amounts of lending. We believe that earlier and more forceful intervention was clearly warranted in the case of BNEC banks and that such

[10] Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

[11] See Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

intervention could have compelled the banks to correct problems before they adversely affected earnings and capital.

In order to more fully evaluate the need for reform in the supervisory process, we are currently reviewing the quality of bank and thrift examinations. Among other issues, we are concerned that OCC and other regulators are not adequately expanding the scope of examinations in a timely manner when problems are identified.

BNEC Insider Loans Were Substantial But Did Not Cause the Failure of BNEC Banks

Our review of bank records revealed an aggregate amount of outstanding loans to BNEC directors and officers of about $300 million as of May 1991. In addition, $30 million was recorded as having been already written off as a loss to BNEC. Of the $300 million on the books, about $200 million was classified as "current" as to payments. The remainder, about $100 million in loans, was noncurrent, thus a more likely cause of future losses. However, even under a "worst case" assumption that all insider loans would result in losses to BNEC, we found that the total amount, $330 million, would represent about 1.5 percent of assets at the time of BNEC banks' failures.

Amounts for nonaccruing loans and those that had been written off (partially or fully) were concentrated in relatively few borrowers' accounts. Seven major borrowers owed BNEC banks a total of $227 million, including two who owed about $70 million each. This $227 million represented 75 percent of the $300 million total due from insiders in May 1991. An additional $18 million due principally from two of these borrowers had been previously charged off, representing 60 percent of the total amount noted as due from insiders and charged off. Finally, some of these loans to the seven major insider borrowers were complex financings of large projects involving borrowers other than the indicated insiders and often other large lending banks.

The Terms of Insider Loans Were Generally Not Preferential

In its 1989 review of nonperforming assets, OCC examiners found four insider loans that had been made with terms more favorable than those of loans made to noninsiders or that had been made at more than the normal risk of repayment. One of these loans, which was for about $500,000, was given to a director/developer with an above-normal risk of nonpayment to assist him in making interest payments on other obligations made to him at the same BNEC bank. At the time the $500,000 loan was made, the director's earlier loan was listed as a criticized asset. A second loan was for $300,000 and was made to the same director/

developer based on a 100-percent loan-to-value ratio, which OCC determined was a preferential term when compared to 219 other loans made by the same bank subsidiary. The two other loans were also made on preferential terms. One involved unreasonably low interest rates, given the risk level of the loans, and both loans involved longer-than-normal interest-only payments. These four loans totaled $4,300,000.

To determine whether such loan terms were prevalent, we judgmentally selected the loan files of 23 major loan commitments and transactions involving insiders and looked particularly at larger loans. We believe that, although BNEC's lending practices were liberal and aggressive, insider loans generally did not have significantly different terms than was the practice for loans made to outsiders as those described by OCC in its examination work papers.

In our review of loan files of 23 major loan commitments and transactions involving insiders, we noted no instances among these loans of significant variation from BNEC's policies and procedures as we understand they were usually applied. In our discussions with regulators and BNEC personnel, we learned that BNEC's general lending approach was aggressive. BNEC's objective was to grow rapidly, and, apparently, it was common to compete aggressively on loan terms in order to win business. In the loan files of noninsiders we examined, we noted loans with 100-percent financing; interest-only payments for several years; and favorable interest rates at, for example, 1/4 percent or 1/2 percent over prime. Also, in contrast to more conservative practices, many of these loans were for commercial real estate or construction with the only collateral being a first mortgage on the construction site and structure yet to be built. Frequently, funds for repayment of BNEC's real estate development loans were based on the anticipated future sale or rental proceeds or an assumed long-term refinancing upon completion. Bank officials, regulators, and FDIC examiners confirmed that the BNEC banks' liberal lending practices were extended to major borrowers, regardless of their affiliations with the bank, to establish relationships for current and future business.

Insider Activity Was More Prevalent In James Madison Limited Banks

Insider loans accounted for a significant percentage of the lending activity at James Madison Limited (JML) affiliate banks and nearly a quarter of their criticized assets. According to OCC, JML banks had nearly $500 million in loans as of January 31, 1991, of which approximately $83 million (about 17 percent) were to insiders. We reviewed the criticized assets lists of loans held by the major JML banks as of March 31,

1991. Of the approximately $213 million in criticized assets held, we were able to associate approximately $50 million (about 23 percent) with holding company and bank directors and executive officers.

OCC examiners found few substantive violations of insider laws or regulations. Instead, violations reported were treated as technical, often involving failure to obtain proper board approval. Since JML banks had such liberal lending practices, all borrowers, including insiders, received highly favorable terms.

OCC maintains that the failure of JML banks was more the result of poor management and supervision by the board than lending to insiders. According to OCC, this is evidenced by the failure of bank management to respond to and correct OCC's early criticisms in spite of numerous managerial changes, and the banks' poor policies and procedures with regard to credit administration, underwriting, liquidity management, the allowance for loan and lease losses and other bank functions.

Conclusions

OCC clearly should have been more aggressive in ensuring that the BNEC banks corrected system and control problems OCC examiners identified as early as 1985. Even under its current supervisory guidelines, management's repeated failures to improve critical bank lending operations by 1987 would have enabled OCC to take formal enforcement actions to compel bank management to correct problems. The expansive growth strategy pursued by BNEC bank management should have caused OCC to conduct a more thorough and aggressive examination, expanding its work to develop evidence demonstrating the adverse affects of the banks' practices on asset quality, earnings, and capital. Since OCC did not expand its examination coverage until 1989, we do not know the exact time that this adverse effect would have become sufficiently evident for OCC to believe that it had a sufficient basis for more forceful enforcement actions. However, we believe OCC could have recognized the asset quality deterioration as early as 1987, and could have demonstrated the banks' risk exposure by the time the New England real estate market softened in 1988. With such evidence, even under today's supervisory process, enforcement actions could have been taken earlier and more forcefully.

With regard to insider lending, we believe insider loans were symptomatic of the liberal underwriting standards and poor management that caused the failure of both the BNEC and JML banks. While insider loans were far more prevalent at JML banks, we do not believe insider loans caused either banking organization's failure. They were, however, significant problems in both organizations. We believe there is a conflict of interest when a banking organization's directors, who have responsibility to the depositors, are among the major beneficiaries of the organization's poor underwriting practices.

OCC and FRS officials reviewed a draft of this report. These officials generally agreed with the contents of this report. We have incorporated their clarifications and comments where appropriate.

We will provide copies of this report to other Committee members, interested congressional committees, agencies, and the public.

Major contributors to this report are listed in appendix IV. If you have any questions about the report, please call me on (202) 275-6059.

Sincerely yours,

Richard L. Fogel
Assistant Comptroller General

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Abbreviations

BIF	Bank Insurance Fund
BNE	Bank of New England
BNEC	Bank of New England Corporation
CBT	Connecticut Bank and Trust
CMP	civil money penalty
DOL	Division of Liquidation
FDIC	Federal Deposit Insurance Corporation
FRS	Federal Reserve System
JML	James Madison Limited
MBU	Multinational Banking Unit
OCC	Office of the Comptroller of the Currency
TT&L	Treasury Tax and Loan

Objectives, Scope, and Methodology

Our objectives for this assignment were to assess the Office of the Comptroller of the Currency's (OCC) efforts to supervise the Bank of New England Corporation's (BNEC) banks and to determine the reasons for the failure of the BNEC banks. Specifically, we were asked to determine

- the extent of loans to insiders and related parties, the extent to which these loans resulted in losses to the banks, whether these loans were granted on preferential terms, the extent to which insider loans may have to be assumed by FDIC as a result of the settlement with the banks' acquirer, and the role that these loans had in the failure of the banks;
- the extent of loans to providers of professional services to BNEC and its bank subsidiaries;
- OCC's accuracy in assessing the health of BNEC banks, including our assessment of safety and soundness deficiencies at the banks and any apparent deficiencies in OCC's examination process, staffing, or policies;
- the extent BNEC banks that became undercapitalized used Treasury Tax and Loan (TT&L) accounts and borrowed from the Federal Reserve discount window; and
- the amount in dividends and other payments for services BNEC subsidiary banks paid to BNEC from 1987 through 1989.

Overall Methodology

In order to achieve our objectives we reviewed OCC examination reports and related documents for Bank of New England-Boston (BNE-Boston) and BNEC's other bank subsidiaries for 1985 through 1990. We began our review of examination reports with the 1985 examinations because OCC told us that it first identified safety and soundness deficiencies at BNE-Boston in 1985. That was also the year that BNEC acquired Connecticut Bank and Trust (CBT), which resulted in significant changes in BNEC's management and substantially increased its asset size.

In reviewing the examination reports, we sought to obtain information on the condition of the banks at the time of each examination and the significance of deficiencies or violations of laws or regulations identified by OCC. We reviewed OCC's examination workpapers, correspondence files, and entries in its supervisory management system to gain a broader understanding of the problems OCC identified, the approach and methodology OCC examiners used to assess the conditions of BNEC banks, and the actions OCC took to promote corrective actions by the banks. The examination workpapers were also used to compile lists of directors, executive officers, major shareholders and their related interests, including family members and controlled organizations, for comparison with loans made at BNEC banks.

We interviewed the OCC examiner-in-charge for the 1988 compliance examination and for each of the safety and soundness examinations done from 1985 through 1990 to obtain their perspectives on the conditions found at the BNEC banks. We also interviewed OCC National Office officials to obtain their views on OCC's oversight of the banks.

Finally, we reviewed Federal Deposit Insurance Corporation (FDIC) and Federal Reserve System (FRS) records of examinations and supporting documents, and discussed issues relating to BNEC with FDIC and FRS officials. Our specific methodologies to address the above objectives are discussed below.

Objective 1: Loans to Insiders

To achieve the first objective we initially obtained a list of loans as of May 31, 1991, from BNEC. The list included all commercial loans, including commercial real estate, that met one or more of the following criteria: the principal of the loan was greater than $250,000, the loan had been classified as nonaccruing by the lending bank, or some portion of the loan had been charged off in the past. The list did not include personal loans, such as automobile and home mortgage loans, because we were told by BNEC personnel that the banks' systems could not readily obtain data on these loans. We did not believe that the apparently minimal impact of such loans on the condition of the banks was sufficient to warrant the effort necessary to extract and analyze the data from BNEC's computer systems.

We asked BNEC's legal department to generate a list of names of insiders and related parties. To supplement this list, we developed our own list of insiders from our review of OCC supervisory reports, work paper files, and correspondence files. Our list provided the names of several additional insiders and related parties that did not appear on BNEC's list. We then merged the two lists of names and compared the merged list of insiders with the list of commercial loans to identify the amounts of loans to insiders. For those names appearing on the loan list that were similar, but not identical, to names on the list of insiders, we asked the Senior Vice President for Credit Review to verify whether the loans were made to insiders. We included the additional amounts he identified as having been loaned to insiders in our total. Since BNEC's system for identifying loans to insiders did not provide a complete list of insider loans, and we do not believe our efforts to supplement this list captured all other loans to insiders, we believe our approximation of the amount of loans to insiders may be understated.

To determine whether some insider loans were granted on preferential terms, we reviewed OCC examination reports for information on insider violations, judgementally sampled and reviewed loan files for 23 of the largest loans to insiders to identify loan terms, and discussed the banks' lending operations with BNEC officials and with the examiners-in-charge for the OCC examinations done from 1985 through 1990.

To determine the extent to which insider loans may have to be assumed by FDIC as a result of the settlement with the banks' acquirer, we compared the list of insiders and their related interest with loans subject to the put option. To determine the impact of these loans on the failure of the BNEC banks, we determined the proportion of these loans in relation to the entire loan portfolio and as a percentage of the banks' assets.

Objective 2: Extent of Loans to Service Providers

From OCC work papers we identified a limited number of individuals associated with the accounting firm for BNEC and its larger bank subsidiaries. We compared this listing with the list of loans that BNEC provided. We also reviewed the examination reports and related documents and discussed these loans with OCC officials to determine whether OCC had identified problems with loans to service providers at BNEC banks.

Objective 3: Assessment of OCC's Supervision

To assess the adequacy of OCC's oversight, we attempted to establish (1) when OCC first identified deficiencies relating to the safe and sound operation of BNEC banks, (2) the significance of these deficiencies, and (3) the actions OCC took to get the banks to correct these deficiencies.

Generally, our assessment of the adequacy of OCC's oversight was made on the basis of whether we considered its efforts to compel corrective action by bank management to have been sufficient. In making this assessment we considered (1) the potential adverse effects of the deficiencies on the conditions of the banks, (2) the recurrent nature of the deficiencies, (3) BNEC's response to OCC's criticisms, and (4) the environment (the New England economy and the asset growth and loan concentrations of the banks) in which the deficiencies were identified.

To determine the adequacy of OCC's staffing for the examinations of BNEC banks, we reviewed OCC examination work papers, correspondence files, and supervisory management system entries for references to staffing needs, and we discussed staffing with officials from OCC's National Office and the examiners-in-charge of the safety and soundness examinations done from 1985 through 1990. Because of time constraints and the limited scope of our review, we did not attempt to assess the adequacy of staffing for OCC examinations on a nationwide basis.

Objective 4: TT&L and Discount Window Borrowing

We obtained information from Treasury Department and FRS documents and personnel on TT&L and discount window borrowing. In response to a request from your office, we had been reviewing the Treasury Department's policies concerning TT&L and FRS policies on discount window borrowing to determine whether these policies were adhered to in the case of BNEC. We also reviewed FRS examinations and work papers as well as related FRS documents. We spoke with officials from the Federal Reserve Bank of Boston and the Federal Reserve Board of Governors to determine whether FRS had concerns about BNEC's discount window borrowing when BNEC had liquidity problems in late 1989 through mid-1990.

Objective 5: Payment of Funds by Subsidiaries to BNEC Holding Company

We obtained information on the payment of funds by BNEC banks to BNEC, through dividends, management fees, interest payments, and tax-sharing arrangements, from FRS examinations, work papers, and discussions with Federal Reserve Bank of Boston and OCC officials. We compared data on these payments for 1987 through 1989. We also reviewed FRS examinations and related documents and discussed the upstreaming of funds with FRS and OCC officials to determine whether these regulators considered the payments excessive. Finally, we considered the size of the payments in relation to the conditions being identified by OCC to evaluate whether regulators may have had cause to question the payments.

Answers to Chairman Riegle's Questions About the Bank of New England

(1) How many millions of dollars of loans were made to directors, officers, shareholders, or partnerships or corporations in which such insiders or their relatives had an interest?

Our review of bank records revealed as of May 1991 an aggregate amount of about $300 million in outstanding loans to insiders. In addition, $30 million was recorded as already having been written off as a loss to BNEC. Together, these amounts totaled $330 million.

We reviewed various BNEC and regulator records and interviewed several BNEC and OCC personnel. Our review was limited due to time and resource constraints. Since OCC had only once (in the 1988 compliance examination) sought to specifically identify insider activity, we worked through OCC to get information from bank officials, recognizing that OCC had previously criticized BNEC's system for identifying insider lending. Also, we relied upon BNEC's information systems and representations, since within the time available we did not have access to sufficient information to reconcile the data furnished to the banks' financial accounting records. Therefore, the $330 million we found in insider loans should be viewed as the minimum amount loaned to insiders.

Several observations can be made concerning the $300 million in loans to insiders remaining on the books. First, about $200 million was classified "current" as to payments. The remainder, about $100 million was classified noncurrent and thus more likely to produce future losses. Some insiders held both "current" and defaulted loans. Also, some of the larger insider loans were complex project financings originated by a BNEC bank as part of a total loan commitment with other banks "participating." Additionally, the loans may have involved borrowers other than the BNEC insiders. Amounts for nonaccruing loans and those that had been written off were concentrated in relatively few accounts in difficulty because of the New England real estate market. Seven major borrowers owed BNEC banks a total of $227 million (75 percent of the total due from insiders as of May 1991). An additional $18 million due principally from two of these borrowers had been previously charged off, representing 60 percent of the total amount noted as due from insiders and charged off.

(2) What are the aggregate estimated losses on these insider loans?

As mentioned above, $30 million was identified as having been written off as a total loss. In addition, about $100 million of the loan balances remaining on the books had been classified as noncurrent (overdue or nonaccruing). As discussed in the response to question 3, FDIC and the acquirer (Fleet/Norstar) agreed that losses from both noncurrent and current but high-risk loans could amount to $155 million. Thus, considering the $30 million already written off, the losses on insider loans could total $185 million.

(3) How many of those insider loans have either been purchased by the FDIC or will be subject to the put option being extended to the acquirer?

To establish the amounts subject to the put option, FDIC Division of Supervision and acquirer officials reviewed all BNEC loans, including those to insiders, and agreed on those in which repayment was in question. As of May 1991, at least $155 million of loans made to BNEC insiders and their related interests were among those FDIC and Fleet/Norstar agreed would be subject to the put option. If Fleet/Norstar cannot obtain repayment from the borrowers on loans subject to the put option, BIF will ultimately bear the cost of losses.

(4) Were there any major borrowers now in default who received loans that were not granted in accordance with the bank's own lending procedures? Did any of these borrowers have any business, financial or other relationship with any bank personnel?

In its 1989 review of nonperforming assets, OCC found four insider loans either made with terms more favorable than those of loans made to noninsiders or involving more than the normal risk of repayment. One of these loans (for about $500,000) was given to a director/developer with an above normal risk of repayment, to assist him in making interest payments on a real estate development loan the same bank made to the developer earlier. The second loan was for $300,000 and was made to the same director/developer based on a 100 percent loan-to-value ratio, which OCC determined was a preferential term when compared to 219 other loans made by the same bank subsidiary. OCC found two other loans for a total of $3.5 million, one of which was granted with an interest rate more favorable than that available to noninsiders, particularly considering the level of risk of the loan. Both loans had greater-than-normal interest-only payment periods.

We believe that, although BNEC's lending practices were liberal and aggressive, insider loans generally did not have significantly different terms than were the overall lending practices described by OCC in its examination work papers. To determine whether such loan terms were prevalent, we judgmentally selected the loan files of 23 major loan commitments and transactions involving insiders. We were particularly interested in larger loans. In our review of these loan files, we noted no instances of significant variation from BNEC's policies and procedures as we understand they were generally applied. To win business, BNEC competed aggressively on loan terms. In the loan files we examined, we noted loans with 100 percent financing; interest-only payments for several years; and favorable interest rates at, for example, 1/4 percent or 1/2 percent over prime. Also, many of these loans had as collateral only a first mortgage on the construction site and structure yet to be built. Frequently, funds for repayment were the anticipated future sale or rental proceeds, or an assumed long-term refinancing upon completion. This refinancing, usually several years in the future, would depend upon the future creditworthiness of the borrower and upon market conditions.

(5) Did the bank provide any loans to persons or entities that provided professional services to the banking organization? If so, what is the current status of those loans?

We were unable to identify loans to persons or entities providing services to BNEC banks because information was not readily available from bank records. In reviewing OCC examination reports, we found no mention or concern about loans to persons or entities that provided professional services to BNEC banks. However, we did identify from OCC work papers nine partners and senior managers of BNEC's outside accounting firm. We found no record of loans to these nine individuals from our list of commercial loans as of May 31, 1991. We did not determine whether these individuals had personal/consumer loans because bank records for these loans were not readily available. Similarly, we did not attempt to determine whether any of the related interests of directors, executive officers, and major stockholders with bank loans had also provided services to the bank.

Although we were unable to identify BNEC bank loans to service providers, we did determine from bank records total bank payments to nonbank subsidiaries for services rendered. We identified 19 separate nonbank subsidiaries in which banks had financial dealings. Bank payments to nonbank subsidiaries netted $29.8 million in 1988. In 1989, these payments more than doubled to $79.5 million. Most of this increase could be attributed to one nonbank subsidiary that provided computer services. This unit was created in September 1988 and closed in March 1990. In 1990, bank payments to nonbank subsidiaries dropped to $37 million. Much of this drop could be attributed to the decline in computer service expenditures. In 1990, bank payments to this nonbank subsidiary totaled $24.7 million, down from $71.6 million in 1989.

We did not assess the propriety of bank expenditures to nonbank subsidiaries. In reviewing regulators' examination reports and the underlying work papers, we found that regulators did not mention or raise concerns about these specific bank expenditures or the large increase in computer service charges in 1989. However, FRS officials informed us that they closely monitored all bank expenses after the 1989 4th-quarter loss.

(6) What was the regulatory response of the banking regulators to any perceived violations of law or regulation? What, if any, resources is the federal government currently devoting to any investigation of potential administrative, civil or criminal actions involving the failure of the Bank of New England?

OCC initiated civil money penalty (CMP) actions against directors of one bank subsidiary in July 1991. The CMPs were in response to Regulation O (insider loans) violations. However, this enforcement action was not taken until nearly 1½ years after the original violation had been discovered. From a review of OCC work papers and examination reports, we found that OCC cited technical violations of Regulation O beginning with the 1986 examination. In a December 1987 examination, OCC examiners reviewed a sample of loans to assess asset quality and found Regulation O violations at BNE-Boston. These violations entailed loans and commitments to one director totaling $28.7 million. In an August 1988 compliance examination, OCC targeted insider loans for review and found violations at BNE-South, another BNEC bank subsidiary. These lending violations involved three directors with loans totaling $3.3 million.

OCC viewed these violations as technical rather than substantive, in that they primarily involved the failure to obtain advance Board approval of loans rather than preferential terms to insiders. Consequently, OCC did not pursue enforcement actions such as CMPs against the bank or its directors. OCC did, however, question bank controls for identifying insider loans and ensuring compliance with applicable laws and regulations.

In a late 1989 examination targeting asset quality, OCC again found insider lending violations at BNEC banks. The violations involved two directors with 4 loans totaling $4.3 million. OCC characterized these violations as substantive in that they were either granted on more favorable terms than loans made to noninsiders or involved more than the normal risk of repayment. The $4.3 million included one loan to one director for $300,000 that had been cited in the 1988 examination as being a technical violation. Two of the other loans, totaling $3.5 million, were to one director and were identified only as part of the 1989 examination.

In January 1990, an examiner recommended to the examiner-in-charge that CMPs be assessed against directors at BNE-South where repeated Regulation O violations had occurred. At that time, the examiner-in-charge did not act on the CMP recommendation because of the higher priority OCC gave to determining the severity of BNEC's asset problems and the banks' continued viability after the year-end 1989 examination. After we inquired about the CMPS in June 1991, OCC resumed the administrative process for assessing the CMPs. As of September 1991, OCC had notified the directors of the impending CMPs, received their responses, and was continuing the administrative process for taking such formal enforcement actions.

We also found that the Federal Reserve Bank of Boston had found a violation of section 23A of the Federal Reserve Act as reported in an examination completed in February 1990. This violation entailed checking account overdrafts by the holding company and one of its nonbank subsidiaries. Both the holding company and the nonbank subsidiary held checking accounts at BNE-Boston. Overdrafts by the holding company at one point exceeded $8 million whereas the nonbank subsidiary overdrafts averaged about $140,000 per day. In effect, these overdrafts represented unsecured loans to the holding company and nonbank subsidiary by BNE-Boston. The Federal Reserve Bank of Boston did not initiate enforcement action because the violations were not viewed as willful or material and BNEC management assured FRS that this practice would be discontinued.

At the time of our review, the U.S. Attorney's Office in Massachusetts was investigating BNEC for possible criminal activities. This effort was part of the Justice Department's overall probe into fraud at banks in the Northeast. Justice Department officials would neither confirm nor deny that an investigation is ongoing.

Finally, FDIC's Division of Liquidation (DOL) was also assessing other administrative options. In the normal process of handling failed banks, DOL assesses various avenues to recoup funds, such as through director and officer liability insurance policies and from loans that the failed bank had previously written off. At the time of our review, DOL was in the early stages of assessing possible collections and could not provide an estimate of future recoveries from the BNEC failure.

(7) Why was the OCC so mistaken in its assessment of the health of the Bank of New England in 1988 and early 1989?

OCC had raised concerns about BNEC banks' controls and systems for their loan operations as well as concerns about their liberal lending practices in earlier examinations. OCC was also well aware of BNEC's growth and concentration in real estate lending. Nevertheless, not until 1988, when the New England economy began to soften, did OCC deepen its coverage of the loan portfolios.

In two examinations (1985 and 1986), OCC identified problems in internal controls and increases in criticized assets. In the 1987 examination report, OCC expressed concern about the rapid growth in real estate loans and shortcomings in the risk rating process. OCC stated that BNEC was particularly vulnerable to any downturn in the regional real estate market. However, because such a downturn had not occurred, and the level of criticized and nonperforming loans was considered manageable, OCC continued to view the overall quality of the loan portfolios as satisfactory. In 1985, 1986, and 1987 examinations, however, OCC's penetration of the loan portfolios was typically less than 30 percent. We believe that OCC should have had sufficient concern, given the internal control problems it identified in previous examinations, to expand its coverage of the loan portfolios, at least by the 1987 examination. Had OCC done so, we believe OCC would have identified more serious problems in the portfolios, although clearly not as serious as the problems that were to come as a result of the reversal in New England's economic fortunes.

In the late 1988 examination, the problems identified were more severe. The New England economy had, by then, begun a downturn, particularly in the real estate market. The examination noted a continuing downward trend in asset quality and problems in internal controls over lending. At that time, the examiner-in-charge asked for additional staff for the examination, but due to problems in the Southwest, the staff were not made available. As a result, the coverage of the examination, and particularly the loan portfolios of all bank subsidiaries, was not as deep as it might have been otherwise. Had this examination been expanded, we believe that OCC would have found more severe problems.

In any event, we believe that OCC's concerns for this examination should have been heightened by its awareness of BNEC's long-standing history of internal control problems.

By 1988, BNEC banks had experienced explosive growth both through an aggressive campaign to acquire other banks and through a dramatic growth in their loan portfolios. This growth caused a number of additional problems for BNEC. First, integration of bank systems among the acquired banks and BNE-Boston did not occur. This made it difficult for management to obtain and evaluate accurate information, particularly about the condition of the loan portfolios. Second, the growth lead to an unhealthy concentration in commercial real estate.

The 1988 examination report lowered BNE-Boston's performance rating and led to a follow-up examination in the fall of 1989. As a result of the 1988 examination, OCC also initiated its first formal action against the bank—a formal agreement. Even so, the 1988 examination report for BNE-Boston indicated that asset quality, although deteriorating, was still fair. Also, the report for CBT bank indicated that the bank was in good shape, with a satisfactory level of asset quality and sound underwriting policies.

Nine months later, the 1990 examination concluded that both banks were on the verge of insolvency. We believe that the problems identified—inadequate internal controls, bank management's failure to take corrective action even after four examinations repeatedly raised concerns, strongly concentrated growth, and inadequate management information systems—when taken together, should have alerted OCC, at least by 1987, of the potential for serious difficulties for BNEC. However, OCC took no enforcement actions until August 1989, having relied on bank management's representations that it would address the problems. By 1989, when serious deterioration of the loan portfolios became evident, we believe OCC continued to underestimate the severity of the banks' problems. In the examination conducted in the fall of 1989, the severity of the banks' problems were realized but by this time it was too late to save the banks.

(8) Were there any deficiencies in the examination process or supervision procedures in general?

We found little evidence of regulatory supervision of the numerous BNEC subsidiaries. Overall, the BNEC family had approximately 100 subsidiaries with most of them being subsidiaries of the banks. Many of these bank subsidiaries were leasing and real estate-related companies. We found only a few instances in OCC's examination reports or work papers where the bank subsidiaries had received any attention in OCC examinations. Similarly, in the FRS examination reports, we found limited coverage of the holding company subsidiaries.

We noted few differences between OCC's supervision of BNEC banks and other OCC-examined banks we have reviewed. OCC uses a portfolio approach to bank supervision in which an examiner has responsibility for continuous oversight of a bank with examinations performed when considered necessary and expanded only when problems are identified. Otherwise, OCC's examination and supervision process does not differ significantly from those of the other bank regulators. OCC and the other regulators (FRS and FDIC) frequently have not taken prompt and forceful actions to get banks to correct underlying management or asset problems before capital is adversely affected. As we noted in our recent report on bank supervision—Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991)—all the regulators had a philosophy of working cooperatively with bank management even when management repeatedly failed to address identified problems. In that report, we noted that in 15 of 22 banks that improved their capital positions and addressed underlying management and/or asset problems, regulators had taken the most forceful regulatory actions available to them. On the other hand, in 14 of 20 banks that neither improved their capital positions nor the underlying conditions, regulators had not taken the strongest actions available to them. Although a cooperative approach to regulation may have some advantages, we believe this approach is not warranted if management repeatedly promises, but fails, to correct unsafe underlying practices. Such was clearly the case with BNEC banks.

In large part, the failure of regulators to take prompt and forceful enforcement actions to compel bank management to correct problems was caused by the liberal discretion that procedures allowed regulators in determining the nature and timing of actions to correct bank practices. We have recommended tightening that discretion by having the regulators adopt procedures that would require specific and increasingly forceful enforcement actions upon discovery of specific conditions at a bank. This "tripwire" approach, which we discussed in our recent report Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991), would consist of a system of four tripwires.

The tripwire approach would have prompted earlier and more forceful enforcement action for BNEC banks. The first tripwire—unsafe practices in seemingly healthy institutions—would have been triggered in BNEC banks by 1985, when OCC recognized the banks' weak internal controls. The tripwire approach would have required the banks to develop a written plan to address the problems. During the 1987 examination, the second tripwire would have been triggered by evidence of further asset deterioration. This tripwire would have required more severe enforcement action on the part of OCC, such as requiring a plan to minimize the damage from criticized assets. While OCC eventually did institute a formal agreement with BNEC banks that contained a provision similar to this, the agreement was not effective until August 1989. We cannot say with certainty that the additional years of close supervisory scrutiny would have saved the banks. However, we believe they would have given both OCC and the banks significant lead time to address the banks' problems and could have reduced the losses to BIF when the banks failed.

(9) Did OCC have enough resources to adequately monitor the condition of all national banks?

When OCC found serious asset deterioration problems at BNEC banks during the 1988 examination, OCC's northeast district asked for examiners from OCC's national office to increase the staff of approximately 25 already assigned to the examination. The OCC national office refused the request, chiefly because of the competing need to provide a high level of staffing in the Southwest to deal with the very serious problems OCC had identified in MCorp. The examiner-in-charge at BNEC told us that without the additional staffing he was unable to include CBT and other subsidiaries in the review. During the initial phase of the 1989 examination, OCC increased the level of staffing at BNEC banks from approximately 50 full-time examiners to about 125. It was during this examination that OCC identified the severity of the problems that led ultimately to BNEC's demise.

OCC officials told us of general staffing and management problems in the northeast district. First, we were told that not enough examiners in the district had the real estate expertise needed to adequately assess the problems of BNEC banks. Because of this, many examiners for the 1989 examination, including the examiner-in-charge, were assigned to the BNEC bank examination from the Southwest, where they had gained experience in analyzing significant real estate-related problems. The OCC Director of Multinational Bank Supervision also told us that, during the

1987 to 1988 period, OCC management believed that the northeast district was not taking an aggressive enough approach to identifying and addressing bank safety and soundness problems. OCC management had concerns that the explosive growth in commercial real estate in the region mirrored that which occurred in the Southwest shortly before that region's economic collapse and attendant dramatic rise in bank failures.

As a result of the OCC national office's assessment of the early results of the 1989 examination, OCC made several changes in the northeast district. New management was installed. OCC also significantly increased the number of examiners in the region. Finally, OCC hired several individuals from banks who had extensive experience in real estate portfolios. This was made possible by the staffing reductions at banks following the overall downturn in the banking industry in the northeast region. As for the overall level of OCC staffing nationwide, we did not assess its adequacy.

(10) Was the failure the result of an isolated occurrence, or were there some policies of the OCC that contributed to the failure?

As discussed previously in this and other reports, we believe the supervision process followed by all three federal bank regulators was flawed. Generally, the regulators have been reluctant to take forceful actions to correct unsafe or unsound conditions and practices until they see adverse affects on earnings or capital. The regulators have told us that this is primarily because they would encounter substantial resistance from bank management while the bank is profitable and has high capital levels.

With regard to specific policies at OCC, we believe that the lack of concrete safety and soundness standards for growth and concentration in the asset portfolio, similar to capital level standards, probably contributed to difficulties in OCC's ability to take effective enforcement action in a timely manner. Although OCC may have recognized that the problems it identified could worsen, OCC and the other federal bank regulators generally believe that they would have difficulty, under the current supervisory process, acting forcefully until they find adverse effects on bank capital. OCC examiners may have been aware that BNEC was experiencing excessive growth, but the absence of any standard for an unsafe and unsound rate of growth delayed OCC action.

Also, we noted some inadequacies in OCC's succession planning when one examiner-in-charge departed and a new one took over. We found little in the OCC work papers on how previous examinations were planned or how the scope of examinations was decided. Such information would be important to a new examiner-in-charge, who would be otherwise unfamiliar with the bank and the previous examinations. We also found some evidence of too little communication between the old and new examiners-in-charge. While specific information about a bank's condition or corrective action management may have promised to take may have been discussed by bank management and the examiner-in-charge, this information was often not mentioned in supervisory reports or work paper summaries. To enable new examiners-in-charge to understand the bank they are supervising, communication between examiners needs to be improved.

(11) What specific internal control measures would have diminished the cost of the failure?

Recognizing that BNEC banks' internal controls were inadequate, OCC specifically cited problems in underwriting policies and practices as well as loan review and administration. We believe that earlier strengthening of these internal control deficiencies could have lessened the severity of BNEC banks' problems, or at least lessened the cost of the failure.

Before 1989, BNE-Boston did not have detailed lending policies in place that covered specific types of lending. Instead, they had only general lending guidelines. As one examiner-in-charge told us, lending activities were generally uncontrolled if the bank lacked firm policies on levels of required collateral for specific types of loans or documentation required for allowed exceptions. Loans were issued with favorable terms, such as 100-percent financing, no collateral except the development project on which the loan was made, and interest-only payments for a number of years.

OCC identified several internal control problems with the BNEC banks' programs to assess the level of risk of their loans. First, OCC found a potential conflict of interest in loan officers managing loans being permitted to rate the risk of loans approved by their direct supervisors. OCC found that this presented a danger of overvaluation of assets. In addition, OCC found that up until 1990, BNEC banks used inadequate criteria to classify their loans according to risk.

As discussed previously, the banks' rapid growth and heavy concentration in the commercial real estate market was particularly troublesome. Had OCC emphasized the potential seriousness of such growth and concentration, and had the banks established policies and internal controls to slow that growth and concentration or taken steps to manage the growth better, the banks' problems might have been less severe.

(12), (13) Did the bank borrow from the discount window or receive Treasury Tax & Loan Account deposits ("TT&L accounts") after it became undercapitalized? Were the discount window or TT&L accounts used to keep the bank open? Did their use increase the costs to the Bank Insurance Fund of the bank's eventual failure? Were TT&L accounts used as a substitute for discount window borrowing by the bank? Was the collateral used to secure the bank's TT&L accounts insufficient in any way? Is there evidence that any form of preferential treatment was granted to the bank with respect to the withdrawals from TT&L accounts?

The BNEC banks' use of TT&L account deposits and FRS discount window borrowings during their liquidity crises in 1989 and 1990 followed the larger-than-anticipated increase of $1.4 billion in the 1989 loan loss provision required by OCC.

FRS recognized multiple simultaneous efforts by BNEC banks to get through their liquidity crisis in 1989 and 1990. At the holding company, liquidity was strained due to the company's inability to turn over its commercial paper, and BNEC banks experienced massive deposit withdrawals because of the loss of public confidence in their financial stability. The banks' response to this liquidity crisis included increased TT&L deposits, increased FRS discount window borrowings, IRS tax refunds in anticipation of 1989 operating losses, and payment of funds from the subsidiaries to the BNEC holding company. FRS examiners closely monitored the TT&L deposits and discount window borrowings without taking exception to them. The only concerns of FRS about the payment of funds by subsidiaries involved a portion of the management fees that FRS questioned but did not require to be changed. Although FRS recognized the significantly large $84 million increase in dividends in 1989, it did not question the dividends because they were still being paid out of reported bank earnings.

Our review of TT&L activity at BNE-Boston[1] found that the Federal Reserve Bank of Boston properly applied Treasury's regulations during calendar year 1990 to BNE-Boston's TT&L account and that no preferential treatment was provided. Despite financial instability, BNE-Boston increased the maximum amount of TT&L funds it was permitted to hold from $350 million in January 1990 to a high of nearly $1.8 billion in March 1990 and pledged collateral in accordance with Treasury regulations to secure the TT&L funds it obtained. Such increases are permissible for any financial institution in the TT&L program.

The average balance in BNE-Boston's TT&L account during 1990 was nearly $400 million and, along with other funding initiatives, helped the bank through its liquidity crisis. However, the daily TT&L account balance fluctuated widely and, therefore, could not be relied upon alone to satisfy a major liquidity crisis. From our review of FRS files and discussions with FRS and OCC officials, we found that BNE-Boston continued its FRS discount window borrowings throughout its liquidity crisis, later reduced those borrowings throughout its liquidity crisis, later reduced those borrowings, and ultimately stopped them by mid-1990. BNEC officials credited these borrowings along with other bank initiatives for getting them through the liquidity crisis.

One clear advantage to obtaining the additional TT&L funds is that they can be used to repay FRS discount window loans or reduce any future borrowings from the window. This would have reduced BNE-Boston's cost of funds for these amounts by 3/4 of a percentage point (75 basis points) and resulted in savings of $1.7 million.

We cannot speculate on whether the ultimate costs to BIF were affected by BNEC banks' use of TT&L accounts. However, Treasury regulations require the TT&L funds to be fully collateralized at all times, and our review found that during 1989 and 1990 the banks did not have any collateral deficiencies that would have caused them to be suspended from the TT&L program or led to a reduction in the banks' investment limit under Treasury regulations. On January 6, 1991, when BNE-Boston failed and was taken over by FDIC, it had $213 million in its TT&L account, which was backed by collateral with a face value of about $1.1 billion. These assets were valued by the Boston FRS at $739 million for

[1] Financial Management: Treasury Tax and Loan Account Activity at Two Troubled Banks (GAO/AFMD-91-87, September 1991).

TT&L collateral purposes. An FDIC DOL official advised us that Fleet/Norstar, as part of its overall acquisition of BNEC banks, assumed all liabilities, including TT&L balances. The official also said that these TT&L balances do not necessarily represent losses to the acquirer in that Fleet/Norstar also assumed the underlying collateral securing these balances.

(14) How much money in dividends, management fees, tax-sharing payments or otherwise, did the banking subsidiaries upstream to the holding company in calendar years 1987, 1988, and 1989? Is there any evidence suggesting that such fees were excessive?

Bank subsidiary dividends and management fees were the holding company's primary source of income. Total upstreamed funds nearly tripled from 1987 to 1989. Tax sharing payments and tax refunds were particularly large in 1989 and played a significant role in BNEC avoiding a liquidity crisis that year. Regulators questioned the propriety of management fees, and we found that the dividend payments were surprisingly large given the banks' increasing risk exposure in real estate coupled with continued operating and control weaknesses over the period.

From a review of FRS examination reports and the underlying work papers, we found that subsidiary banks upstreamed funds to the holding company in several ways. For calendar years 1987 to 1989, most of the holding company's operating income was composed of dividends, interest payments, and management fees from the banking subsidiaries. As table II.1 shows, these payments nearly tripled over the 3-year period.

Table II.1: BNEC Sources of Funds

Dollars in thousands

Operating income	Year-end 1987	Year-end 1988	Percent change	Year-end 1989	Percent change
Dividends	$31,134	$64,100	106	$148,000	131
Interest	28,293	21,730	(23)	30,600	41
Management fees	19,833	46,245	133	56,500	22
Subtotals	**$79,260**	**$132,075**	**67**	**$235,100**	**78**

The holding company relied on these funds to cover its debt service and to provide capital support to some of the banking subsidiaries. About $77 million in capital infusions were made to three bank subsidiaries in

1989. Bank subsidiary funds were also used to support corporate dividend payments to public shareholders, which amounted to $92 million in 1988 and $71 million in 1989. After the 4th quarter operating loss in 1989 resulting from the increase in the allowance for loan losses, FRS precluded any further corporate dividend payments. The increased loan loss provision decreased capital to less than 2 percent of assets, below the regulatory requirement of 6 percent.

As for the propriety of these payments, neither OCC nor FRS questioned subsidiary bank dividends to the holding company prior to the 4th quarter of 1989. Up to that time, dividends were paid from current period earnings. The $148 million dividends in 1989 is net of $17 million that OCC had directed subsidiary banks to recover from the holding company in the 4th quarter. OCC's action was based on their projected loan loss provision exceeding $1 billion for the quarter, which exceeded the banks' planned provision of $365 million. FRS took similar action to get the holding company to rescind the announcement of 4th quarter dividends to holding company shareholders.

Despite the suspension of dividends by regulators in the 4th quarter of 1989, these upstreamed payments were significantly larger compared to payments in prior years. The $148 million in dividends in 1989 were nearly 5 times larger than 1987 dividends. We believe regulators would have had a basis for questioning bank subsidiary dividends to the holding company before the 4th quarter of 1989 if OCC had earlier addressed the adequacy of the loan loss provision. Beginning in at least 1987, OCC expressed concern over the banks' increasing risk exposure in real estate lending coupled with the lack of internal controls and management systems to minimize this risk. OCC questioned the banks' methodology for calculating the loan loss provision but did not question the adequacy of the size of the loss provision until the 1989 examination.

FRS found no basis for questioning the interest payments. These payments represented the interest on bank subsidiary debt obligations held by the holding company.

FRS questioned management fees upstreamed to the holding company. In a 1989 examination report, FRS noted that management fees improperly included interest and goodwill. Examiner work papers did not, however, reflect how much of the charges were improper. Based on holding company financial information, we estimated that improper charges amounted to about $17 million in 1988. Neither FRS nor OCC attempted to get the holding company to reverse these charges. Enforcement action was not taken because the improper charges were not viewed as material and the practice was discontinued the following year.

Another source of funds upstreamed to the holding company involved income taxes. In the 4th quarter of 1989, the holding company received $57 million in intercompany tax settlement proceeds from the bank subsidiaries. These tax proceeds consisted of subsidiary estimated taxes, which were upstreamed to the holding company each quarter. The holding company also received from IRS a total of $108 million in tax refunds in January 1990. These refunds consisted of two types: $23 million for estimated taxes paid in 1989, and $85 million for tax loss carrybacks generated from the 1989 operating loss. The loss carrybacks were for federal income taxes paid over the prior 10 years. The holding company retained about $20 million of the $85 million in tax refunds and downstreamed the remaining $65 million to the bank subsidiaries.

Beginning in December 1989, the holding company experienced a liquidity crisis due to its inability to refund about $34 million in commercial paper borrowings and pay interest on debt. This crisis occurred after market perceptions of its financial difficulties precipitated a drop in the company's credit rating. Although not the only source of funds used at the time, the $43 million in tax refunds ($20 million in loss carrybacks and $23 million in estimated tax payments) was critical to the holding company in resolving its cash flow crisis.

An indirect source of subsidiary funds to the holding company by one bank subsidiary involved overdrafts on the holding company's checking account. As discussed on page 34, the holding company had been cited for violating section 23A of the Federal Reserve Act for these overdrafts. These overdrafts, in effect, represented unsecured loans to the holding company by the subsidiary bank. From FRS documents, we found that these overdrafts were large at times. For example, they exceeded $8 million for one weekend in December 1989. The holding company used these overdrafts to fund interest-bearing, short-term investments. Upon being cited for these violations, BNEC management assured FRS that this practice would be discontinued.

Overview of the Madison Failure

Background

Madison National Bank (Madison) was chartered in 1963. Its founding board of directors was composed largely of real estate developers, and its business was real estate lending. Madison established a tradition of real estate lending in the Washington, D.C., area. For more than 2 decades Madison experienced modest earnings and growth.

Our review of Madison and the other James Madison Limited (JML) affiliate banks[1] focused on the years of rapid expansion, beginning in 1985, to its failure on May 10, 1991. In the mid-1980s, JML—which was Madison's holding company—began to expand rapidly. At year-end 1985, JML's total assets were just over $460 million, and by year-end 1989, total assets had grown to nearly $930 million. This expansion was fueled by aggressive pursuit of real estate lending and acquisitions of other banks.

Objectives, Scope, and Methodology

As agreed with the Committee, we are providing a brief review of the events leading to the failure of Madison. Our objectives were to (1) determine the reasons for the failure of Madison, (2) assess OCC's oversight of Madison during the years leading up to the failure, and (3) determine the extent to which insider activity contributed to the failure.

To achieve these objectives we reviewed OCC's examination reports, work papers, and related documents on examinations done from 1985 through 1990. We also discussed the failure with the OCC examiner who was in charge during the years just prior to Madison's insolvency. To determine the extent of loans to insiders, we generally relied on OCC-generated figures. However, we independently determined the amount of loans to insiders that were criticized by comparing our independently developed list of insiders and their related interest with a list of JML's criticized assets.

Conditions Leading to the Failure

For much of the 1980s, the Washington, D.C., area economy, including real estate development, experienced significant growth. Madison, which had long been active in real estate lending, was aggressively pursuing new opportunities in the expanding real estate market. OCC estimates that by 1990 JML banks had a real estate-related loan concentration of about 60 percent. According to OCC, however, this concentration was not much greater than that of other area banks. Why

[1] Madison National Bank of Virginia, United National Bank of Washington, and Madison Bank of Maryland, all of which were acquired in 1986.

then did the JML banks fail when other Washington area banks have been able to weather the economic downturn?

According to OCC, poor management, lack of internal controls, and liberal underwriting left JML banks more vulnerable to an economic downturn. The banks' liberal underwriting practices, which permitted instances of 100-percent financing, unsecured lending, and inadequate credit analysis, allowed JML to attract large borrowers and expand rapidly during the economic boom, but such terms also left JML banks with massive amounts in criticized loans when the economy faltered.

OCC's Supervision

OCC examined Madison[2] at least annually from 1985 up until its failure in 1991. Examination results from 1985 indicate that OCC considered Madison to be in satisfactory overall condition, but was concerned about the adequacy of the bank's internal loan review. Still, OCC found loan quality to be satisfactory and required no response from bank management. The 1986 examination found no change in Madison's condition, but OCC did require Madison to respond to concerns identified in the examination report, including the need to improve credit administration. The 1987 examination continued to rate Madison as satisfactory, although Madison was then required to report quarterly in response to problems identified during the examination, including its methodology and documentation for determining the allowance for loan and lease losses. These quarterly reports never materialized, and we found no evidence to indicate whether OCC followed up on them.

In 1988, OCC's concern over recurrent problems within Madison's lending functions and other deficiencies identified by examiners resulted in a lowering of Madison's safety and soundness rating. During the examination, OCC was particularly critical of Madison's management and supervision. In three previous examinations management had been considered adequate to meet the needs of Madison, but the 1988 review rated management as unsatisfactory. Other problems cited included inadequate methodology for the allowance for loan and lease losses, violations of insider regulations, and weaknesses in credit administration.

As a result of the 1988 examination, Madison's board signed a commitment letter on April 20, 1989, to correct the problems identified. The

[2] Our discussion of OCC's supervision of JML banks will focus on Madison. Madison was the largest of the JML banks, and OCC indicated that the banks were managed similarly and had common problems.

letter targeted several corrective actions. By signing the letter, the board agreed to analyze the management needs of the bank and ensure that positions were filled by qualified individuals. The board also agreed to ensure adherence with commercial real estate policies, review the adequacy of the loan and lease loss provision, and develop a capital plan.

When examiners returned in 1989, they again found many of the same problems. Further, asset quality had begun to show significant deterioration, heightening OCC's concern. Still, OCC did not enter a formal agreement with Madison to correct these problems until November 20, 1990. This was apparently the result of delays in processing the examination report, which was not presented to Madison until July 1990, and time required for subsequent negotiations between OCC and JML concerning the contents of the formal agreement.

According to OCC, CMPs were considered as a result of violations of insider regulations OCC examiners identified beginning in 1988. Because the violations generally did not meet OCC thresholds for intent and effect, OCC did not pursue CMPs. In 1988, a CMP referral was made to the district office concerning an affiliate transaction between Madison and JML, but delays in processing the CMP and bank management's corrective actions resulted in OCC dropping the CMP and issuing a letter of reprimand.

OCC's lead examiner at Madison during this time told us that many of Madison's deficiencies were tied to senior management at JML and Madison. The examiner believed that pressure from senior officers was the driving force behind Madison's overaggressive pursuit of expansion through liberal lending practices and its failure to respond to OCC's criticisms. However, OCC indicated that it could not sufficiently substantiate this view to warrant formal action against the officers. OCC's lead examiner believed that the need for OCC to take such enforcement action was mitigated to some degree by management changes that could potentially correct many of the deficiencies. Perhaps the most promising of these changes was the February 1991 appointment of a new JML Chief Executive Officer, who, according to the lead examiner, OCC considered to be a capable banker.

Concerned about Madison's deteriorating liquidity, OCC began biweekly liquidity monitoring in September 1990, and by early 1991 OCC was monitoring liquidity daily. A targeted review in January 1991, which concentrated on the allowance for loan and lease losses and liquidity, led to OCC classifying Madison as being in danger of insolvency. It also caused

OCC to move up an examination that had been scheduled for the 2nd quarter of 1991. This examination resulted in Madison being declared insolvent on May 10, 1991.

Amount of Insider Activity

According to OCC, JML banks had nearly $500 million in loans as of January 31, 1991.[3] As shown in table III.1, approximately $83 million (about 17 percent) of these loans were to insiders.[4] We reviewed the criticized assets lists of loans held by JML banks as of March 31, 1991. Of the approximately $213 million in criticized assets held, we were able to associate approximately $50 million (about 23 percent) with JML holding company and bank directors and executive officers.

Table III.1: Percentage of JML Loans to Insiders

Dollars in millions

	Amount[a]	Criticized amount[b]	Percent
All loans	$499	$213	43%
Insider loans	83	50	60%
Percent	17%	23%	

[a]As of 1/31/91.

[b]As of 3/31/91.
Source: OCC work papers.

At year-end 1990, JML's primary capital had fallen to just over $46 million, making the ratio of insider loans at JML banks to primary capital approximately 180 percent ($83 to $46 million).

Impact of Insider Activity on Banks' Conditions

Insider loans accounted for a significant percentage of the lending activity at JML banks, and nearly a quarter of their criticized assets. However, OCC examiners seldom found substantive violations of insider laws or regulations involving loan terms or conditions. Instead, OCC viewed violations as technical, since they often involved failure to obtain proper board approval. Since JML banks had such liberal lending practices, all borrowers—including insiders—received highly favorable terms.

[3] Loan amounts are for loans held by the three largest JML bank subsidiaries: Madison National Bank, Madison National Bank of Virginia, and United National Bank, which accounted for approximately 90 percent of loans held by JML.

[4] OCC included only loans to JML holding company and bank directors or executive officers and their related interests, and loans for which a director or executive officer was a guarantor in its calculation of the amount of loans to insiders. To allow for comparison, we used the same definition.

OCC said that the failure of Madison and its affiliates resulted more from poor management and supervision by the board than the banks' lending to insiders. According to OCC, this is evidenced both by the failure of bank management to respond to and correct OCC's early criticisms in spite of numerous managerial changes and by Madison's poor policies and procedures for credit administration, underwriting, liquidity management, allowance for loan and lease losses, and other functions.

Conclusions

On the basis of our review of events leading to the failure of Madison, we believe that earlier, more aggressive action by OCC was warranted by JML's recurrent deficiencies, dramatic growth, loan concentration, liberal lending practices, and the extent of insider loans. As early as the 1985 examination, OCC examiners were aware of problems in Madison's lending functions. However, the problems identified at that time were not considered serious enough to compel bank management to respond because the overall condition of the bank was sound. Still, we believe the repetitive nature of OCC's concerns and the failure of bank management to correct systemic deficiencies during a period of rapid growth, particularly in the lending area, should have called for greater pressure on bank management to correct problems in basic banking operations brought to its attention by OCC.

With regard to insider lending, we believe insider loans were symptomatic of the lax underwriting standards and poor management that caused the failure. While we do not believe these loans caused the failure, they were a significant problem—constituting 17 percent of the loan portfolio and 23 percent of the criticized assets. Further, we believe there is a conflict of interest when an institution's directors, who have a responsibility to the depositors, are among the main beneficiaries of the institution's poor underwriting practices.

Appendix IV

Major Contributors to This Report

General Government Division, Washington, D.C.

Craig A. Simmons, Director, Financial Institutions and Markets Issues
Mark J. Gillen, Assistant Director
Charles G. Kilian, Assignment Manager
Frederick T. Evans, Senior Economist
Richard A. Sherman, Evaluator
Desiree W. Whipple, Reports Analyst

San Francisco Regional Office

Benny W. Lee, Evaluator-in-Charge

Office of the General Counsel

Maureen A. Murphy, Attorney Advisor

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