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## OCC's Supervision of the Bank of New England

Statement of
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Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

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# OCC's Supervision of the Bank of New England

SUMMARY OF STATEMENT BY
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GAO is testifying today on its findings about the failure of the Bank of New England and the effectiveness of the Office of the Comptroller of the Currency in supervising the bank's safety and soundness. These topics are examined in greater depth in GAO's recent report on OCC's supervision of the Bank of New England.[1]

The subsidiary banks of the Bank of New England Corporation (BNEC) failed due to liberal lending practices and poorly controlled growth and concentration in commercial real estate loans in a troubled regional economy. Between 1985 and 1989, BNEC more than quadrupled its size. Weaknesses in internal controls and overly aggressive lending practices led to a decline in the quality of the banks' loan portfolios which was not adequately reserved for. Lacking adequate loan loss reserves when the regional commercial real estate industry plummeted in the late 1980s, BNEC banks were unable to absorb loan losses through earnings or capital.

While the liberal terms of insider loans at BNEC banks were clearly symptomatic of problems BNEC had in operating the banks safely and soundly, insider loans did not cause the banks' failure. Nevertheless, the loans to insiders were substantial in amount--totaling at least $330 million.

OCC's supervision of BNEC banks was not as timely or forceful as needed to compel management to operate the banks safely and soundly. From 1985 to 1988, OCC repeatedly identified and reported problems with BNEC banks' lending operations, including various issues involving their loan loss reserves, but took no formal enforcement action to compel corrective measures. Moreover, OCC did not expand the scope of its examination to determine the actual severity of the problems until 1988. By the time OCC entered into a formal agreement with BNEC in 1989, the real estate loan portfolios were deteriorating rapidly, and it was too late for the banks to deal effectively with the system and control problems.

OCC's supervision of BNEC banks from 1985 to 1991 illustrates the need for reform of the supervisory process, including fully assessing the adequacy of internal controls. In the case of BNEC


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[1]Bank Supervision: OCC's Oversight of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

banks, GAO's proposed tripwire approach to bank supervision[2] would have required OCC to take enforcement action as early as 1985, and required OCC to initiate a more forceful action possibly as early as 1986 but certainly by 1987. Such intervention could have compelled BNEC management to correct problems before they adversely affected earnings and capital. The bank reform bills reported by both the Senate and House banking committees contain provisions that basically incorporate GAO's tripwire approach and critically needed accounting and auditing improvements. These reforms will assist the regulators and the Congress in properly monitoring the $70 billion in assistance contemplated for the industry.

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

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss work we did at your request to identify the causes of the failure of the Bank of New England and the effectiveness of the Office of the Comptroller of the Currency (OCC) in supervising the banks' safety and soundness. I will also discuss insider lending at the Bank of New England and James Madison Limited (JML) banks. More detailed information on these and other issues, including answers to your specific questions, are in our report[1] which was issued on Monday, September 16, 1991.

Immediately upon receipt of your May 23, 1991 request, we began our review of the Bank of New England, its holding company--Bank of New England Corporation (BNEC), and its banking subsidiaries. In that review, we focused on OCC work papers and examination reports to identify the causes of the banks' failure and evaluate the regulator's supervision of the banks. Since OCC had not regarded loans to insiders as a major problem, we did an independent analysis, to the extent possible, to address your concerns about insider lending.

## BNEC BANKS FAILED DUE TO LIBERAL LENDING PRACTICES, POORLY CONTROLLED GROWTH, AND CONCENTRATION IN COMMERCIAL REAL ESTATE

We began our review with OCC's 1985 examination because OCC

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[1]Bank Supervision: OCC's Oversight of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

officials told us that its examiners first identified safety and soundness deficiencies in that year. In 1985, BNEC acquired Connecticut Bank and Trust (CBT). Before the acquisition of CBT, BNEC was a traditional local bank, with investments in Treasury securities and a lending portfolio with the greatest concentration in commercial/industrial lending. In 1985, after BNEC's acquisition of CBT and Maine National Bank (Maine), CBT management assumed control over BNEC and significantly changed the corporate strategy. The new strategy set BNEC on a course of rapid growth into a regional banking power through acquisitions, mergers, and commercial real estate lending.

Under the new strategy, BNEC acquired numerous banks throughout the New England area. BNEC's 1985 acquisition of CBT added assets of about $7.7 billion to the organization, virtually doubling its size. The 1985 acquisition of Maine added about $741,000, and the 1987 acquisition of the Conifer Banking Group added another $4 billion. By 1989, as a result of further acquisitions and its strategy of expansion through aggressive real estate lending, BNEC's assets had grown to $32.6 billion.

BNEC's aggressive competition for commercial real estate loans led BNEC banks to make loans with quite liberal terms, including 100-percent financing, interest-only payments from loan proceeds, and favorable interest 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 on the expected cash flow from the project's sale or rental income. A BNEC bank official we interviewed characterized the participation of the bank in these ventures as being more like a partner than a lender, since often the only funds at risk were the banks'.

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

During this period of growth for BNEC banks, the subsidiary banks' payments to the BNEC holding company increased dramatically. Between 1987 and 1989, subsidiary banks' payments of dividends, interest, and management fees to the holding company increased from $79.3 million to $235.1 million. Of particular note, the banks' dividend payments to their holding company more than doubled from $64.1 million to $148 million between 1988 and 1989--the period corresponding with the decline in the real estate market and deterioration of the BNEC Banks' loan portfolios.

## As the New England Real Estate Market Softened, Deterioration in BNEC's Loan Portfolio Became Apparent

BNEC's growth paralleled rapid growth in the New England economy in the mid-to-late 1980s. But the regional growth in the real estate industry proved unsustainable. The collapse of the regional real estate market, which is generally regarded as having been precipitous, became evident in the period of mid-1988 to mid-1989--although experts differ in their views on the exact timing of the collapse. As the New England real estate market began to soften in 1988, the deterioration of BNEC's real estate loan portfolios' became apparent to OCC examiners. The portfolios' deterioration is illustrated in Table 1, which shows the increase in nonperforming assets and the growing inadequacy of the allowance for loan and lease losses.

Table 1: Growth in Nonperforming Assets (1986-1989) (Dollars in millions)

| Time period | Total nonperforming assets | Allowance as a percentage of nonperforming assets |
|---|---|---|
| 4thQ 1986 | $254.7 | 94.7% |
| 4thQ 1987 | 338.4 | 140.7 |
| 4thQ 1988 | 419.4 | 77.5 |
| 1stQ 1989 | 550.8 | 61.5 |
| 2ndQ 1989 | 667.4 | 51.2 |
| 3rdQ 1989 | 900.0 | 38.0[a] |

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

Source: OCC Supervisory Report, May 16, 1990.

You can see that the allowance for loan loss reserves expressed as a percentage of nonperforming assets had fallen by the 3rd quarter of 1989 to 38 percent from a high of 140 percent nearly two years earlier.

## OCC RECOGNIZED PROBLEMS AT BNEC BANKS BUT ACTED TOO LATE TO PREVENT OR MINIMIZE FAILURES

Between 1985 and 1988, OCC maintained an annual supervisory presence at BNEC, largely in the major banking subsidiaries. This supervision, provided by the Boston Duty Station of OCC's Northeast District Office, focused on the banks' larger and problem loans. Throughout this period, OCC repeatedly identified and reported problems with the BNEC banks' systems and controls over such key operations as their lending activities, but did not characterize these problems as serious until the 1988 examination report. In 1989 for the first time, OCC took a formal enforcement action to compel BNEC bank management to address the problems. Despite its knowledge of problems, OCC's examination penetration of loan portfolios during this period was usually less than 30 percent.

Not until the 1989 examination, when the regional economy was clearly declining, did OCC significantly expand its penetration of the loan portfolios to roughly 70 percent. On the basis of this examination, OCC found evidence of the adverse effects of BNEC's aggressive growth strategy and internal control weaknesses

on asset quality, earnings, and capital. As a result of the 1989 examination, OCC issued a cease and desist order to compel BNEC bank management to address problems that had become quite serious.

OCC Recognized Significant Problems Years Before Their Adverse Effects Became Evident

As early as 1985, OCC noted that the banks' internal loan review process--the process by which the bank rated its loans for risk--needed to be strengthened and formalized. Largely as a result of the inadequacies of BNEC's loan risk rating system, OCC found the documentation and justification for the allowance for loan losses to be inadequate. However, OCC took no enforcement action to compel correction of these weaknesses. The problems were identified in the examination report, and OCC relied on management's assurances that problems would be addressed.

At the September 30, 1986 examination, when the BNEC banking organization had grown to $20 billion in assets, OCC found continuing problems in the loan risk rating system, as well as inconsistent use of the system by various subsidiary banks. OCC also found several new and significant problems, such as (1) lack of independence of the loan review function; (2) overly optimistic growth projections for corporate earnings; (3) out-of-date credit documentation in the construction lending portfolios; and (4) incompatible hardware and software systems in BNEC banks.

We believe the ADP compatibility problem to be 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.

Once again, OCC determined that no informal or formal enforcement actions were necessary to compel bank management to correct these problems. As before, the problems were identified in the examination report, and OCC relied on management assurances that it would address the problems.

In the first of two examinations of BNEC banks in 1987, when BNEC's assets had grown to $22 billion, OCC again criticized BNEC for not yet having a uniform corporate-wide system for rating loans. In addition, OCC noted a conflict of interest in bank officials both managing and rating loans of their direct supervisors. As in its earlier 1985 report, OCC raised concerns about the adequacy of the documentation accompanying the loan loss reserve calculations. In the first 1987 report, OCC stated that the allowance documentation was either suspect or nonexistent. 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 bank management to upgrade documentation procedures or correct other problems.

At the time of the second 1987 examination, in December, when BNEC bank assets were $29 billion, OCC again identified continuing problems in the loan rating system and the loan loss allowance account--essentially the same problems identified before. At BNE-Boston, OCC found that (1) large numbers of loans had not been evaluated for risk; (2) the quality of many less-than-satisfactory loans was overrated; and (3) because of the volume of loans, many bank analysts could not do timely reviews of risk ratings. 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.

At this time, OCC also found that BNEC needed more specific underwriting criteria for the banks' various types of lending. Moreover, the report noted the significant growth in commercial real estate lending, weak documentation in the loan files, and aggressive underwriting. Over half of the loans reviewed during this examination were 100-percent-financed, and nearly half of the loans reviewed had inadequate or stale credit information on borrowers. OCC also identified three loans to insiders--for $28 million, $250,000 and $466,000--that had not received the required prior approval of the Board of Directors. OCC neither took nor considered taking any enforcement action to compel correction of any new or continuing problems, despite bank

management's repeated failures to correct problems previously identified.

OCC conducted a compliance examination and a safety and soundness examination in 1988. It is noteworthy that the compliance examination was the only one conducted during the 1985-1990 period that was designed to directly assess the banks' insider lending activities. In that August 1988 compliance examination, OCC found violations of insider lending regulations involving the failure to obtain prior board approval of $3.3 million in loans to three directors. Once again, OCC took no action to compel corrective action.

In the December 31, 1988 safety and soundness examination of BNEC banks, OCC found that previously identified problems with the loan risk rating system appeared to have worsened, the loan loss allowance documentation continued to be deficient, and asset quality at BNE-Boston had significantly deteriorated. Then, for the first time, OCC questioned the adequacy of the banks' reserves for loan losses.

This 1988 examination resulted in the first formal enforcement action taken by OCC to compel BNEC bank management to correct their broad and worsening problems. OCC and BNEC entered into a

Formal Agreement in August 1989[2] that required BNEC to adopt a program to improve its criticized assets, underwriting standards, and loan administration. OCC also required BNEC to review and improve the banks' controls over the loan loss reserve account and the loan rating system.

During the early stages of a follow-up 1989 examination, OCC determined that the banks' condition had deteriorated even further and the level of nonperforming assets had increased dramatically. Because of the severe deterioration in loan portfolios and concerns about the regional office examinations, OCC's Washington, D.C., Multinational Banking Unit took responsibility for supervision of BNEC. A new examiner-in-charge was assigned and OCC increased the number of examiners with real estate lending expertise. It became clear to OCC that BNEC had not increased its allowance provision sufficiently to keep pace with the growth in nonperforming loans. The Federal Reserve 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 the depth of coverage of the banks' loan portfolios so that roughly 70 percent of the loans were reviewed. As I mentioned earlier, the depth of

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

coverage in earlier examinations was usually less than 30 percent of the banks' portfolios. As a result, OCC determined that the assets of BNEC banks had deteriorated significantly and loan loss reserves were inadequate. OCC then required the banks to increase their loan loss reserves by $1.4 billion, from $.2 billion to $1.6 billion. This had the effect of reducing the banks' equity capital to less than 3 percent of the assets. OCC required BNEC banks to rescind the 4th quarter 1989 dividends that they had paid to BNEC, and the Federal Reserve did not allow BNEC to pay previously announced dividends to its shareholders. The 1989 OCC examination report also indicated that the banks were in imminent danger of failing.

The expanded examination of the loan portfolios also uncovered several technical violations of insider lending regulations comparable to those found in 1988. However, four violations for loans totalling $4,300,000 were viewed as substantive based on having more favorable terms or more than normal risk of repayment. While the assessment of civil money penalties was recommended by the examiner for these violations, the recommendation was not acted upon at that time. However, OCC is now pursuing civil money penalties through the normal administrative process.

The 1989 examination also resulted in OCC and BNEC management entering into a cease and desist order (C&D) on February 16,

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 C&D, among other things, prohibited BNEC banks from declaring or paying dividends without prior OCC approval. It also required the banks to address immediately the problems in the loan portfolios and to devise a plan for augmenting earnings and capital.

During 1990, BNEC changed bank management and tried, unsuccessfully, to improve the capital condition of its banks. The volume of problem assets continued to grow with the collapse of the New England real estate market. In late 1989 and in 1990, both the banks and the holding company faced a liquidity crisis as continued bad news about BNEC spread. By this time, the BNEC banks had been consolidated into three banks--BNE, CBT, and Maine. BNEC's condition continued to deteriorate, and on Sunday night, January 6, 1991, OCC declared the three banks insolvent.

## OCC'S APPROACH AT BNEC BANKS WAS SIMILAR 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 three federal bank regulators. The story of BNEC's failure is similar to other recent troubled bank 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 expand the scope of examination to determine the severity of the problems. Neither do they take forceful enforcement actions that 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 or conditions. Banking laws, regulations, and agency guidelines generally delineate conditions that must be present for regulators to use available enforcement actions, but bank regulators have wide discretion in deciding both the timing and forcefulness of enforcement actions. Except for minimum capital standards, the delineation does not provide specific measures or standards for 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,[3] 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. Generally, this means that the regulator communicates

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

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 the same earlier 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.

In the case of BNEC banks, our proposed "tripwire" approach to bank supervision[4] and internal control reporting requirements--which are in essence incorporated 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. Subsequent failures of BNEC to correct these problems would have triggered the second tripwire. This would have required OCC to initiate a more forceful action, perhaps a formal agreement, possibly as early as 1986 but certainly by 1987. Such an agreement might have imposed further limitations on the types or amounts of lending. We believe that earlier and more forceful intervention was clearly warranted in

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

the case of BNEC banks and that such intervention could have compelled the banks to correct problems before they adversely affected earnings or capital.

INSIDER LOANS WERE SUBSTANTIAL

Our review of available BNEC 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 remaining $100 million in loans were noncurrent, and therefore, likely to result in future losses. Most of the noncurrent loans and those current insider loans viewed as having a higher-than-normal risk of repayment, which together total $155 million, are eligible to be sold back to FDIC by BNEC's acquirer, Fleet Norstar. If this occurs, FDIC could lose a substantial portion of that $155 million.

Insider loans were more prevalent in James Madison Limited affiliate banks (JML), accounting for a significant percentage of the banks' lending activity--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 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 directors and executive officers.

OCC maintains that the failure of the 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 JML's 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 BNEC banks corrected system and control problems examiners identified as early as 1985. Even under its current supervisory guidelines, management's repeated failures to improve critical bank lending operations would have enabled OCC to take formal enforcement actions to compel bank management to correct problems. The ambitious growth strategy pursued by BNEC bank management should have prompted OCC to conduct more thorough and aggressive examinations to develop evidence necessary to demonstrate 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 more forceful enforcement actions were warranted. However, we believe OCC could have recognized the asset quality deterioration as early as 1987, and OCC certainly could have demonstrated the banks' risk exposure by the time the real estate market softened in 1988. With such evidence, even under today's supervisory process, forceful enforcement actions could have been taken earlier and more forcefully.

However, OCC's supervision of the BNEC banks from 1985 to 1991 also illustrates the need for reform in the supervisory process. Our proposed tripwire approach to bank supervision would have required OCC to take enforcement action as early as 1985, and required OCC to initiate a more forceful action possibly as early as 1986 but certainly by 1987. Such intervention could have compelled BNEC management to correct problems before they adversely affected earnings and capital. The bank reform bills reported by both the Senate and House banking committees contain provisions that basically incorporate GAO's tripwire approach and critically needed requirements for bank management and auditor reporting on internal controls.

With regard to insider lending, we believe that insider loans at

BNEC banks and JML banks were symptomatic of the lax underwriting standards and poor internal controls that caused the failures of these banks. While the insider loans were substantial in amount, we do not believe that these loans caused these banks to fail. We believe that a conflict of interest exists when an institution's directors, who have a responsibility to the depositors, are major beneficiaries of the institution's poor underwriting practices.

That concludes my prepared statement. We would be pleased to respond to questions.

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