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Mandated Studies to Review Costly Bank and Thrift Failures

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The Honorable Alfonse D'Amato
Chairman
The Honorable Paul Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable James A. Leach
Chairman
The Honorable Henry B. Gonzalez
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Committee on Banking and
Financial Services
House of Representatives

This report presents the results of our second review of the compliance of the Inspectors General (IG) offices for the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), and the Department of the Treasury with section 38(k) of the Federal Deposit Insurance Act (FDIA) as amended in 1991.[1] This section of FDIA requires the IGs to issue reports on depository institutions—banks or thrifts[2]—whose failures result in "material losses" (i.e., basically losses that exceed $25 million) to deposit insurance funds. The section directs the IGs to determine why a bank's or thrift's problems resulted in a material loss to an insurance fund and to make recommendations for preventing such losses in the future. Finally, until amended in October 1996, the section required us to annually review reports issued by the IGs, verify the accuracy of one or more of these reports, and make recommendations as needed to improve the supervision of depository institutions.[3]

[1]12 USC Section 1831o(k).

[2]Thrifts are federally insured financial institutions that have traditionally used customer deposits to finance home mortgages.

[3]This requirement was amended by the General Accounting Office Management Reform Act of 1996, which the President signed on October 19, 1996. The amendment requires the Comptroller General of the General Accounting Office to review material loss review (MLR) reports, as the Comptroller General determines to be appropriate, and recommend improvements in the supervision of depository institutions. The amendment discontinues the requirement that GAO review MLR reports on an annual basis. This report was prepared under section 38(k) of FDIA prior to the enactment of this amendment.

In carrying out our responsibilities under section 38(k), our objectives were to (1) summarize the findings of the MLR reports initiated during the second year of the mandate—July 1, 1994, to June 30, 1995—including the verification of the accuracy of one of these reports; (2) make recommendations, if necessary, to improve bank supervisory practices; and (3) assess the economy and efficiency of the current MLR process.

Scope and Methodology

To meet our first objective, we reviewed reports on two banks that failed during the second year of the MLR mandate and two banks that failed during the first year of the mandate but whose losses were not recognized until the second year. In these latter two cases, FDIC's initial estimates of the banks' losses were below $25 million, but the estimates were revised above $25 million at a later date requiring the IGs to initiate MLRs. We chose to verify the accuracy of an MLR report issued by the Treasury IG because we verified reports issued by the FDIC and Federal Reserve IGs in our first report on the MLR process.[4] To verify the accuracy of this MLR report, we reviewed the supporting workpapers, interviewed Treasury IG officials, and met with examiners involved in the failure.

To meet our second objective, we analyzed the MLR reports issued to date to determine whether an adequate base of evidence had been established to make recommendations to the regulators on improving supervisory practices. We asked IG officials to provide us with their views on the MLR process and recommendations for improving its cost-effectiveness. To meet our third objective, we assessed the cost-effectiveness of the current MLR process by reviewing our previous report which discussed this issue.

The IGs for FDIC, the Federal Reserve, and Treasury provided written comments on a draft of this report, which are discussed on page 15 and reprinted in appendixes I, II, and III. We did our work in Washington, D.C., and San Francisco between June and August 1996 and in conformance with generally accepted government auditing standards.

Background

The FDIC, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)[5] share responsibility for regulating banks and thrifts in the United States. FDIC regulates federally insured state-chartered banks that are not members of

[4]Inspectors General: Mandated Studies to Review Costly Bank and Thrift Failures (GAO/GGD-95-126, July 31, 1995).

[5]OCC and OTS are both part of the Department of the Treasury.

the Federal Reserve System while the Federal Reserve regulates state-chartered banks that are members of the system. State regulatory agencies are also responsible for overseeing the operations of state-chartered institutions, in coordination with FDIC or the Federal Reserve. OCC regulates nationally chartered banks, while OTS regulates thrifts.[6] The regulators use a number of devices to carry out their oversight responsibilities, such as conducting periodic examinations and issuing enforcement actions against unsafe and unsound banking practices.

Congress amended FDIA in 1991 after the failures of about 1,000 banks between 1986 and 1990 resulted in about $14.4 billion in losses to the Bank Insurance Fund (BIF) and threatened its solvency.[7] The amendments were designed largely to strengthen bank supervision and to help avoid a taxpayer bailout of the BIF similar to the approximately $124.6 billion[8] in direct taxpayer funds that Congress provided to protect the depositors of thrifts that failed during the 1980s and early 1990s. Among other provisions, the amendments authorize the banking regulators to take specified enforcement actions when they identify unsafe or unsound practices or conditions. For example, the regulators can close banks whose capital levels fall below predetermined levels. Congress also added section 38(k) to FDIA to (1) ensure that the regulators learn from any weaknesses in the supervision of banks whose failures cause material losses and (2) make improvements as needed in the supervision of depository institutions.

The IGs for the Federal Reserve, FDIC, and Treasury—the latter being responsible for auditing OCC and OTS—are responsible for identifying fraud, waste, and abuse and recommending improvements in agency operations. Each IG oversees a staff of auditors and investigators to assist in carrying out its mission. The staff engage in a range of activities, including criminal investigations, financial audits, and audits of the economy and efficiency of agency operations.

Section 38(k) of FDIA requires the IGs to initiate MLRs when the estimated loss of a bank or thrift failure exceeds either $25 million or a specified

[6]State regulatory authorities also share responsibility with OTS for regulating and supervising state-chartered thrifts.

[7]BIF had a deficit balance of $7 billion at the end of 1991 but has since recovered substantially and had a balance exceeding $25 billion in 1995.

[8]In addition to $124.6 billion in direct taxpayer costs, which included funds provided to the Resolution Trust Corporation, there was also $7.5 billion in indirect taxpayer costs, such as tax benefits provided to the acquirers of troubled thrifts. See Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements (GAO/AIMD-96-123, July 2, 1996).

percentage of the institution's assets (see table 1) when that percentage represents an amount greater than $25 million. An MLR report must be completed within 6 months of the date that it becomes apparent that the loss on a bank or thrift failure will meet the criteria established by section 38(k).[9]

Table 1: Percentage Loss of a Failed Institution's Assets That Requires the Initiation of an MLR[a]

Time period[b]	Percentage
1993 - 1994	7
1994 - 1995	5
1995 - 1996	4
1996 - 1997	3
After June 30, 1997	2

[a]The estimated loss must exceed $25 million.

[b]Each time period is from July 1 to June 30 of the following year.

Source: Section 38(k) of the FDIA Act.

In July 1995, we issued our first report on the MLR process, as required by section 38(k). It assessed the plans and procedures that the IGs initiated to comply with the MLR mandate as well as the two reports that were issued in the first year—July 1, 1993, to June 30, 1994. We found that the IGs had effectively positioned themselves to meet the requirement by developing audit guidelines, providing additional training, and hiring staff with appropriate banking expertise. We also found that the two reports issued the first year, one by the FDIC IG and one by the Federal Reserve IG, were generally accurate in describing the causes of the banks' failures and the quality of their supervision. We recommended that the FDIC IG take further steps to assess the adequacy of regulatory enforcement actions, which the IG agreed to implement. We also found that the MLR process as currently structured may not be the most cost-effective means of achieving improved bank supervision because, among other reasons, the limited number of reports issued did not provide a comprehensive basis to recommend overall changes in bank regulatory practices.

[9]The section defines a loss as incurred when (1) FDIC is appointed receiver of the institution and it becomes apparent that the present value of a deposit insurance fund's outlays with respect to the institution will exceed the present value of the receivership dividends or other payments on claims held by FDIC or (2) if FDIC provides assistance to the institution while an ongoing concern and it is not substantially certain that the assistance will be repaid within 24 months after the date on which the assistance was initiated or the institution ceases to repay the assistance in accordance with its terms.

Results in Brief

The Federal Reserve, FDIC, and Treasury IGs issued a total of four MLR reports on banks that failed or whose losses were recognized during the second year of the MLR mandate. Our review of these reports found that the four banks failed for similar reasons including: rapid growth, excessive loan concentrations in the commercial real estate industry, poor internal controls, and violations of laws and regulations. The reports also identified certain weaknesses in the bank regulators' oversight of these institutions; for example, in three of the four cases bank regulators either did not take sufficiently aggressive enforcement actions to correct identified safety and soundness deficiencies or to ensure that troubled banks complied with existing enforcement actions. Our review of the Treasury IG's report on the failure of Mechanics National Bank (MNB) of Paramount, California, found that it accurately described the causes of the bank's failure and the weaknesses in regulatory oversight of the bank.

We are not making any general recommendations to the bank regulators because the relatively small number of reports issued in the first 2 years of the mandate—six—does not provide a sufficient basis to reach overall conclusions about the quality of their supervisory practices. In our view, the limited basis that these reports provide for making recommendations about overall bank supervision raises questions about the cost-effectiveness of the MLR process as currently structured. There are other reasons to question the cost-effectiveness of the current process, including the fact that certain MLR requirements are relatively inflexible and divert IG staff and resources from broader reviews of the quality of bank supervision. In our previous report, we identified options that could improve the efficiency and/or effectiveness of the current MLR process which we believe continue to merit congressional consideration.

IG Reports Found That Banks Failed for Similar Reasons

The four MLR reports that we reviewed (see table 2) found that the banks failed for similar reasons. In particular, the reports found that the banks, primarily during the 1980s, engaged in unsafe and unsound practices, such as rapid growth, significant concentrations in real estate loans, inadequate lending practices, and violations of laws and regulations. When the real estate industry suffered a substantial downturn in the early 1990s, the banks suffered substantial losses which ultimately caused their failures. The reports also identified various shortcomings in bank regulatory practices; for example, the reports on MNB and The Bank of Hartford cited OCC and FDIC for not ensuring that the banks complied with existing enforcement actions, and the Pioneer Bank report cited the Federal Reserve for not taking more aggressive enforcement actions to correct identified deficiencies. However, only the FDIC IG issued recommendations in its two reports to improve bank supervision. The Treasury and Federal Reserve IGs did not issue specific recommendations because, among other reasons, they did not believe that one MLR report provided an adequate basis for such recommendations.

Table 2: Reports Initiated During the Second Year of the MLR Mandate

$ in millions

Bank	Estimated loss to BIF	IG office
Mechanics National Bank, Paramount, California	$ 36.6	Treasury
The Bank of San Pedro, San Pedro, California	28.8	FDIC
The Bank of Hartford, Hartford, Connecticut	31.3	FDIC
Pioneer Bank, Fullerton, California	27.3	Federal Reserve

Source: IG MLR reports on these bank failures.

Mechanics National Bank

OCC closed MNB on April 1, 1994, during the first year of the MLR mandate, but FDIC did not estimate that its total loss on the MNB failure would exceed $25 million until April 18, 1995, which was during the second year of the mandate. Consequently, the Treasury IG initiated its MLR as of April 18, 1995, and issued the report on September 29, 1995. In our view, the report accurately described the causes of MNB's failure and identified shortcomings in OCC's oversight of the institution.

The report concluded that MNB engaged in a variety of unsafe and unsound banking practices between 1988 and 1994 that contributed substantially to its failure. For example, the report found that the bank nearly doubled in size between 1988 and 1991 and made significant loan commitments to the commercial real estate sector. Further, the bank established a substantial inventory of loans guaranteed by the Small Business Administration (SBA); many of these loans were for financing gasoline service stations and highly risky.[10] In addition to credit concentrations in the commercial real estate and service station sectors, MNB suffered from inadequate underwriting practices, weak appraisal procedures, poor loan documentation,

[10]Service station loans are risky because the collateral values for such loans can be significantly reduced by hazardous waste contamination at the site of the property. The bank may also be liable for the costs of cleaning up the environmental pollution on foreclosed properties.

suspected fraudulent activities in the SBA portfolio,[11] and insider abuses. When the California commercial real estate sector suffered a substantial downturn in the early 1990s, many MNB loans defaulted and the bank had inadequate capital to prevent its eventual insolvency and closure in April 1994.

The Treasury IG also identified various deficiencies in OCC's oversight of MNB. For example, the IG found that the limited safety and soundness exams that OCC conducted of MNB in 1989 and 1990 were insufficient to detect the bank's weak underwriting and loan administration practices. Therefore, many of the bad loans that resulted in MNB's eventual failure were already on its books by the time OCC conducted the full-scope examination in 1991 that first identified the severity of the bank's problems. The report also concluded that OCC's enforcement actions proved ineffective in getting MNB management to correct identified unsafe and unsound practices. Specifically, MNB continued to make a substantial number of poorly underwritten commercial real estate loans even after OCC issued a cease and desist order against the bank in 1991 which required substantial improvements in the bank's lending operations. The report faulted OCC for not imposing civil money penalties on bank officials for continued violations of the cease and desist order. However, the IG made no specific recommendations in the report to improve OCC enforcement practices because the IG believed that (1) the passage of laws, such as the 1991 amendments to FDIA, and rules and procedures should address many of the supervisory weaknesses identified in the MNB report; and (2) one report did not provide a sufficient base of evidence for making recommendations.

Our analysis of the MNB report found that it accurately described the causes of the bank's failure and the shortcomings in OCC's oversight activities. This assessment is based on our review of the report's supporting documentation and on discussions with IG staff and OCC officials. We also note that OCC's Senior Deputy Comptroller for Administration agreed with the IG's findings in OCC's official written response to the report.

[11]SBA guarantees between 70 to 90 percent of each SBA loan with the bank liable for the remaining percent. MNB's SBA loan portfolio primarily consisted of the nonguaranteed portion of SBA loans because the bank typically sold the guaranteed portion to the secondary market. In addition, MNB could be liable for the guaranteed portion of the SBA loans that were sold if they were approved based on misrepresentation or fraud.

The Bank of San Pedro

The State of California closed The Bank of San Pedro on July 15, 1994, and the FDIC IG issued its MLR report on December 21, 1994. The report cited numerous causes of the bank's failure, including excessive concentrations in a real estate development subsidiary, poor underwriting practices, inadequate loss reserves and capital, failure to comply with regulatory enforcement actions, and repeated violations of laws and regulations. As was the case with MNB, the substantial downturn in the California real estate economy, coupled with the bank's poor management practices, caused significant losses to San Pedro's loan portfolio that ultimately caused the bank to fail.

The report found that FDIC was in compliance with applicable laws and regulations and properly identified the causes of San Pedro's failure. However, the IG did recommend that FDIC evaluate the need for developing regulations to control the use of money desks by troubled banks.[12] Even though San Pedro was undercapitalized, management used the bank's money desk to raise volatile deposits nationwide by offering above-market interest rates.[13] The use of volatile deposits by irreversibly troubled institutions can delay their failure and potentially increase insurance fund losses, according to the report. The report also reiterated the importance of recommendations that the IG made in a previous MLR report covering such areas as controlling loan concentrations and excessive overhead expenses.[14]

The Bank of Hartford

The State of Connecticut closed the Bank of Hartford on June 10, 1994, but FDIC did not estimate that the associated losses would exceed $25 million until the spring of 1995. The FDIC IG initiated its MLR as of June 6, 1995, and the report was issued on December 1, 1995.

According to the MLR report, The Bank of Hartford failed as a result of several unsafe and unsound practices. In particular, the bank committed a significant percentage of its loan portfolio to the multifamily and commercial real estate sectors; such loans represented 47 percent of the bank's total loan portfolio in 1991, which exposed the bank to significant losses when the Connecticut real estate sector declined. The bank also

[12]A money desk is a mechanism by which orders are executed for bank customers, correspondent banks, or a bank's own account. Banks can use money desks to attract deposits from outside of their geographical area.

[13]Because these deposits were highly sensitive to interest rates, they were considered volatile by the regulators.

[14]FDIC Inspector General, The Failure of the Bank of San Diego (April 29, 1994).

failed to adequately assess the ability of loan guarantors to fulfill their commitments and engaged in poor loan administration practices, such as the failure to obtain updated financial information on large borrowers. Further, within 12 months prior to its failure, the bank purchased $27 million in derivative financial instruments without performing the necessary analysis as required by FDIC policy guidelines. FDIC experienced a loss of $5.8 million on the sale of the derivative instruments after the Bank of Hartford was closed.

The report identified weaknesses in FDIC's oversight of the bank and recommended improvements. For example, the report found that FDIC and state examiners did not identify the bank's credit concentrations in multifamily loans until 1991 even though they were apparent in 1987. By the time FDIC entered into a cease and desist order with the bank in July 1992 that required the bank to reduce its loan concentrations, more than 33 percent of its commercial real estate loans were considered in danger of default. Moreover, the report found that the bank's purchase of $27 million in derivative instruments without a proper risk analysis was contrary to a cease and desist order against the bank and FDIC investment guidelines. However, the report pointed out that FDIC increased its oversight activities when the derivatives purchases were identified. Among other suggestions, the IG recommended that all undercapitalized banks be required to obtain written approval from FDIC prior to purchasing derivative instruments.

Pioneer Bank

The State of California closed Pioneer Bank on July 8, 1994, and the Federal Reserve IG issued its MLR report on January 6, 1995. Like the other three banks discussed above, Pioneer failed primarily as the result of its rapid growth and substantial commitment to the commercial real estate sector. Commercial real estate loans accounted for 44 percent of Pioneer's total loans in 1991 and exposed the bank to substantial losses when the economy deteriorated. In addition, Pioneer suffered from weak liquidity and poor appraisal and underwriting practices.

The report found that the Federal Reserve identified Pioneer's deficiencies during on-site examinations and tried to get bank officials to correct safety and soundness violations through enforcement actions. Further, the report concluded that Federal Reserve's actions, both formal and informal, were within the range of acceptable actions for a bank with Pioneer's problems. However, the report also identified certain weaknesses in the Federal Reserve's supervisory practices. For example, examiners did not always detect appraisal violations, or adequately address underwriting and credit administration weaknesses. Also, enforcement actions taken by the Federal Reserve were not always sufficiently aggressive given the severity of the safety and soundness deficiencies identified. The IG did not make any recommendations in the report since it only assessed one bank failure. However, the IG did suggest that the Federal Reserve take the report's findings on appraisal violations, underwriting weaknesses, and supervisory actions under advisement.

MLR Process Appears to Have Limited Cost-Effectiveness

We believe there are reasons to question whether the time and resources that the IGS commit to the MLR process, as currently structured, are cost-effective. Although the six MLR reports initiated during the first 2 years of the mandate identified important information about individual bank failures, they do not provide us with an adequate base of evidence to recommend cross-regulator improvements in bank supervision. IG officials have also found it difficult to justify recommendations based on a limited sample of reports, and have said that certain MLR requirements, particularly the $25 million threshold for initiating an MLR, are relatively inflexible, resulting in administrative burdens and expenditures. Even if there were a substantial increase in costly bank failures requiring MLR reports, we believe it is questionable whether the labor-intensive demands and short reporting deadlines of the MLR process would make the potential benefits worth the costs. As stated in our previous report on the MLR process, we believe it would make sense for Congress to provide the IGS with more flexibility in initiating MLRS.

Limited Number of Reports Provide Inadequate Basis for Making Recommendations

We stated in our first report on the MLR requirement that reports on individual bank failures provide important information about the causes of individual bank failures and the quality of the banks' supervision. The reports also familiarize IG staff with the examination process and have identified areas that require further investigation. As examples, FDIC IG officials told us that the report on the Bank of San Pedro served as the basis for doing a broader audit on troubled banks' use of money desks, and Treasury IG officials said that the MNB report served as the basis for initiating a study on OCC officials' compliance with certain conflict-of-interest disclosure requirements. Additionally, in March 1996, FDIC Division of Supervision officials in Washington, D.C., disseminated the findings of two IG MLR reports for the benefit of bank examiners in regional offices across the country.

However, we do not believe that the six MLR reports on bank failures issued during the first 2 years of the mandate provide a sufficient basis for identifying trends in bank supervisory practices or making recommendations that would apply equally to the Federal Reserve, FDIC, OCC, and OTS. The limited basis for making overall recommendations is demonstrated by the fact that four of the six failed banks were located in California and only one of the reports applies to OCC while none applies to OTS. IG officials have also found it difficult to justify recommendations to the regulators based on the MLR reports initiated during the first 2 years of the mandate. For example, the Treasury and Federal Reserve IGs did not make recommendations in the MNB and Pioneer Bank reports, respectively, at least in part because the IG officials did not believe that the reports provided a sufficient evidentiary base. We believe that such recommendations, if necessary, should be based on larger samples of failed bank cases located in different regions of the country or on broader reviews of bank supervisory practices.

We recognize that the four MLR reports discussed above identify certain commonalities (e.g., the banks failed due to real estate concentrations and regulators did not take adequate enforcement actions) which suggest potential areas for improvements in supervisory practices. However, we are not convinced that four reports provide an adequate basis for specific recommendations. Further, the reports' major findings address weaknesses in bank supervision during the 1980s, such as the reluctance of the regulators to take strong enforcement actions to address repeated safety and soundness violations, which have already been documented and served as the basis for the regulatory reform amendments to FDIA that were enacted in 1991.[15] For example, FDIA now directs that the regulators require troubled banks whose capital has fallen to preestablished levels to file plans that detail how they will improve their financial condition and correct unsafe and unsound practices. Therefore, to the extent that the reports are focused on historical practices that have been addressed in whole or in part by legislation or changes in supervisory practices, their applicability may be limited.

Although a substantial increase in the number of bank failures requiring MLRs would provide a better base for making recommendations, we believe there are reasons to question whether the benefits of issuing MLR reports under such circumstances would justify the costs. The MLRs initiated to date have been labor-intensive efforts that required substantial interaction between IG staff and regulatory officials as well as several visits to bank

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

failure locations to review loan files and other records. The IG offices are required to initiate these efforts to meet the 6-month deadline established by section 38(k), but the presence of IG staff at bank locations during a wave of bank failures as occurred during the late 1980s and early 1990s may not be desirable. During such periods, bank examiners, FDIC failed-bank resolution officials, and IG staff may not have adequate time and resources to devote to the preparation of in-depth case studies on the causes of individual bank failures. Further, our past reports have found that poorly managed banks tend to make weakly underwritten loans during strong economic periods and that by the time banks begin to experience substantial financial deterioration, the ability of bank managers and regulators to avert failure may be substantially limited. Therefore, a series of MLR reports issued in the midst of a bank crisis may have limited short-term practical effects because the bad loans generating the failures may have been on the banks' books for years. We believe the four MLR reports discussed in this report illustrate this point because they found that the banks engaged in shortsighted and ultimately unsafe real estate lending policies, primarily during the strong economic period of the 1980s, that were directly responsible for their failures when the local economies weakened substantially in the early 1990s.

Certain MLR Requirements Are Relatively Inflexible and Place Administrative Burdens on IG Offices

IG officials we contacted said that certain MLR requirements specified in section 38(k) can place administrative burdens on their offices. In particular, they said that FDIC sometimes underestimates potential insurance fund losses when banks fail, so the IGs must sometimes initiate MLRs months after failures have occurred when FDIC revises its initial loss estimates above $25 million. The Treasury and FDIC IGs did not initiate the MNB and Bank of Hartford MLRs until about a year after their failures, because FDIC's initial loss estimates were revised upward substantially.

Under a Statement of Understanding between the IG offices that coordinates the MLR process, the IGs are to monitor certain bank failures whose estimated losses are below $25 million for five full quarters after the failure date to ensure that FDIC loss estimates do not exceed the statutory threshold over time.[16] IG staff said that monitoring certain failures, which may involve preliminary contacts with regulatory officials and obtaining documents, whose estimated losses could exceed $25 million, proves unnecessary if the estimates stay below the statutory

[16]The initial estimates on the cost of bank failures are based on FDIC officials' best estimates at the time of failure of what the recoveries will be on the sale of a particular bank's assets. They may also be based on FDIC's historical recoveries on the sale of failed bank assets. The initial estimates are revised over time as FDIC actually sells assets and tabulates its recoveries.

threshold. More important, IG officials may experience difficulties obtaining information they believe is necessary to do an MLR when FDIC substantially revises its initial loss estimates upward with minimal warning months after a failure has occurred.[17] For example, in early 1996, FDIC revised the estimated loss on Guardian Bank in California, which failed in January 1995, from $8 million to more than $25 million. This revised estimate required the Federal Reserve IG to initiate an MLR since the bank was regulated by the Federal Reserve. IG officials said they were not fully prepared to initiate the MLR and had some difficulties obtaining required bank records because they had already been shipped to other storage locations throughout the country. In one instance, IG officials said they had to visit an FDIC storage facility in Chicago to review certain records. In addition, the IG officials said that key regulatory personnel involved in overseeing Guardian were no longer available or could not recall certain events due to the passage of time.

We also pointed out in our previous report that the 6-month deadline for MLRS may require IG officials to divert staff from ongoing, broad reviews of bank regulation and other issues. For example, Treasury IG officials said that 30 to 50 percent of their staff resources are already committed to assessing executive agency financial systems as required by the Chief Financial Officers Act of 1990 (CFO). Therefore, MLR audits could place additional workload demands on the Treasury IG staff that are not committed to CFO work, particularly since the organization did not hire additional personnel to do MLRS. Moreover, the FDIC IG office is undergoing a substantial downsizing, which means that MLRS will place more stringent requirements on the organization in the future. FDIC IG officials said the staff responsible for MLRS and other bank supervision work declined from an authorized level of 37 in 1994 to 25 in 1996 and may fall to 11 in 1997. The Federal Reserve IG staff available to do MLRS has remained stable, but officials we contacted said they were not able to initiate all of their planned audits on bank supervision in 1996 due to the Guardian Bank MLR. As discussed earlier, we believe there is reason to question whether the IGS' resource commitments to the MLR process are justifiable, given their limited impact on improving bank supervision.

[17]In March 1994, the FDIC IG issued a report on the FDIC's loss estimation process entitled Audit of the Cost Estimate Process for Failed Bank Resolutions. In September 1996, the FDIC IG issued a related study entitled Follow-Up Audit: Cost Estimate Process for Bank Resolutions.

Providing IGs With More Flexibility Could Improve the Cost-Effectiveness of the MLR Process

We suggested in our previous report that providing the IGs with more discretion on the number and timing of MLRs to initiate each year could improve the cost-effectiveness of the MLR process. For example, more discretion would allow the IGs to focus their efforts on broader reviews of the overall quality of bank supervision rather than diverting staff to conduct mandatory MLRs within the 6-month deadline. Additional discretion could also minimize the current administrative burdens that have been generated by difficulties in estimating the cost of bank failures; for example, the IGs could be allowed to make decisions on whether to initiate an MLR based on their professional judgment rather than a predetermined loss estimate. We did not suggest repealing the MLR mandate entirely because we believe the process holds the regulators accountable for their supervisory practices. Further, IG officials told us that MLRs provide important information that can be incorporated into broader studies of bank supervision.

Conclusions

The four MLR reports we reviewed found that the banks failed for similar reasons. In particular, the banks grew at rapid rates and committed an excessive percentage of their lending portfolios to the commercial real estate sector, primarily during the 1980s. When the real estate industry suffered substantial downturns in California and Connecticut during the early 1990s, the banks' exposure to that industry and poor lending practices caused substantial losses and eventual insolvency. The reports also identified various weaknesses in the regulators' oversight efforts, such as the failure to get banks to comply with existing enforcement actions, and the FDIC IG chose to make recommendations for improvement to FDIC while the Treasury and Federal Reserve IGs did not. Our review of the MNB report verified its major findings.

We are not making any recommendations for improving overall bank supervision in this report because the limited number of MLR reports produced so far does not provide an adequate basis for identifying improvements. As currently structured, there are reasons to question the cost-effectiveness of the MLR process, such as the limited basis it provides for making recommendations to improve bank supervision and the administrative burden and expenditures that the requirement places on the IG offices. As we found in our previous report, providing the IGs with more discretion in choosing the number and timing of MLRs to initiate each year could improve the cost-effectiveness of the MLR process while preserving the congressional intent of section 38(k), which was to hold bank regulators accountable for their actions.

Matters for Congressional Consideration

As we stated in our previous report, Congress may wish to consider whether the current MLR requirement is a cost-effective means of achieving improved bank supervision. If it determines that the requirement is not cost-effective, we suggest that Congress consider amending the requirement so that the IGs have more flexibility in choosing the number and timing of MLRs to initiate each year.

Agency Comments and Our Evaluation

The IGs for the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Department of the Treasury provided written comments on our draft report, which are reprinted in appendixes I, II, and III, respectively. The IGs generally agreed with our findings and conclusions as well as our suggestion that Congress consider amending section 38(k) of FDIA so that the IGs have more discretion in the number, timing, and scope of MLRs to initiate each year. The IGs also provided comments that were generally technical in nature and are incorporated in this report where appropriate.

We are sending copies of this report to the Inspectors General for the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Department of the Treasury, and other interested parties. We will make copies available to others upon request.

This report was prepared under the direction of Susan S. Westin, Assistant Director, Financial Institutions and Markets Issues. The other major contributor was Wesley M. Phillips, Evaluator-in-Charge. If you have any questions or comments about this report, please call me on (202) 512-8678.

Thomas J. McCool

Thomas J. McCool
Associate Director, Financial Institutions
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Abbreviations

BIF	Bank Insurance Fund
CFO	Chief Financial Officers Act of 1990
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
IG	Inspector General
MLR	material loss review
MNB	Mechanics National Bank
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SBA	Small Business Administration

Comments From the Inspector General of the Federal Deposit Insurance Corporation

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Inspector General

September 17, 1996

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Bothwell:

This letter is in response to your draft report entitled *Inspectors General: Mandated Studies to Review Costly Bank and Thrift Failures* (1996 edition). We appreciate the opportunity to review and comment on the draft report as well as the efforts of your staff in conducting this review.

We are pleased that your report concluded that we have fully met our audit obligations for the performance of Material Loss Reviews (MLR), as required under section 38(k) of the Federal Deposit Insurance Act as amended, and that our audits correctly identified the causes of those financial institution failures for which the FDIC's Office of Inspector General has responsibility. We have taken further steps to assess the adequacy of regulatory enforcement actions, and are pleased that your report acknowledges that each of our two MLR reports contain specific recommendations for the improvement of bank supervision. These substantive and constructive recommendations have been well received and appropriately acted upon by FDIC management.

With respect to your general discussion of the MLR requirements, we agree with your analysis of these matters and your suggestion that Congress may wish to consider the issues which you have delineated. However, until such time as Congress amends the law, we will continue to meet our audit obligations required under section 38(k) of the FDI Act. We would also like to point out that, while our audit plans for 1997 have not yet been finalized, we anticipate committing substantially more than 11 staff years to the review of bank supervision activities.

Thank you again for the opportunity to comment on the draft report and for the effort of your staff in conducting this review.

Sincerely,

Gaston L. Gianni

Gaston L. Gianni, Jr.
Inspector General

cc: The Honorable Ricki Helfer

Comments From the Inspector General of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

September 16, 1996

Mr. Thomas J. McCool
Associate Director, Financial Institutions
and Markets Issues
United States General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to comment on your October 1996 draft report entitled *Inspectors General: Mandated Studies to Investigate Costly Bank and Thrift Failures*. You noted in your report that the Federal Reserve, Federal Deposit Insurance Corporation, and Treasury Offices of Inspector General issued four material loss review reports during the second year of the material loss review mandate and that these four banks failed for similar reasons including excessive growth, high concentrations in commercial real estate loans, and poor internal controls. You also noted that, although these reports and the two issued during the prior period identified certain weaknesses in the bank regulators' oversight of these institutions, the limited number of material loss review reports produced to date does not provide an adequate basis for identifying systemic improvements in the supervisory process. We agree with this assessment.

Your 1996 draft report is consistent with your 1995 report on the same subject. Both question the cost effectiveness of the material loss review process and highlight certain limitations of the process including problems with loss estimation, difficulties beginning a review several months after the bank has closed, and the restrictive nature of the six-month reporting deadline. Our latest experience underlines the difficulties with the loss estimation process and with accessing records eighteen months after the bank failed. The reporting deadline is not a problem in and of itself, but does impact our prioritization of workload. The cost effectiveness of conducting material loss reviews is a matter for Congressional consideration. We understand their value, particularly in a high-bank-failure environment, and would conduct those that warrant our review even without the specific mandate.

Sincerely,

Brent L. Bowen
Inspector General

Comments From the Inspector General of the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

October 3, 1996

INSPECTOR GENERAL

Mr. Thomas J. McCool
Associate Director, Financial
Institutions and Markets Issues
General Government Division
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to comment on the General Accounting Office's (GAO) draft report entitled, *Inspectors General: Mandated Studies to Review Costly Bank and Thrift Failures,* October 1996.

We believe the report accurately depicts the Treasury Inspector General's (IG) material loss review (MLR) of Mechanics National Bank of Paramount, California. We generally concur with the draft report's findings, conclusions, and matters for congressional consideration as related to the MLR of Mechanics National Bank. In addition, we would like to bring to your attention a few items for clarification.

Page 13 of the GAO draft report discusses the FDIC's MLR of the Bank of San Pedro. This section cites the similarity between the San Pedro Bank and Mechanics National Bank relative to the cause of significant losses being the downturn in the California real estate economy. As a point of clarification, unsafe banking practices were the primary cause of significant losses at Mechanics National Bank, and the declining economy only precipitated eventual losses.

Page 22 of the draft report notes that the 6 month legislative deadline to complete an MLR might necessitate the IGs to divert staff from other ongoing work. The report cites the Treasury IG as one example relative to our financial statement audits.

We do not believe that MLRs would in anyway divert staff from our financial audits under the Chief Financial Officers (CFO) Act. In fact, our financial audits are handled by a separate unit dedicated solely to CFO work. Although a surge in the number of required MLRs might place resource demands on other program and performance audits, there would not be a diversion of CFO audit staff as suggested in the cited example.

We also would like to offer an additional perspective on the notion that the benefits of MLRs may not justify the costs, as noted on page 20. In support of this view GAO cites the inability of regulators and bank managers to avert bank failures given the lag between the time loans are poorly underwritten and the time loan losses are ultimately recognized.

We generally agree with this observation, but caution against the implication that loan losses (credit risk) of the 1980s will also be the primary cause of future bank failures. This underlying implication does not take into account the dramatic changes currently taking place within the banking industry, and that these changes may well affect the nature of bank risks.

For example, a growing number of banks are focusing on non-lending sources of income such as fee-based services. These types of non-lending activities entail risks associated with contingent liabilities and operational risks rather than credit risk. Other indications of the changing nature of bank risks include the Barrings Bank failure and the problems of Daiwa Bank. In these cases, the associated risks were posed by trading activities and not lending.

We recognize that non-lending activities have not surfaced in the MLRs as a primary cause of bank failures to date. However, growth in these areas coupled with problems experienced at some large banks suggest that the cause of future bank failures may not necessarily be lending.

We have a similar observation relative to the notion that the usefulness of MLRs was largely diminished given the low number of MLRs to date and projected over the next several years, page 23. We agree that the low number of MLRs to date have not provided GAO or the IGs with a comprehensive basis for assessing the overall quality of bank supervision. However, we believe that a few MLRs might provide the Congress, regulators and the IGs an early warning of developing supervisory breakdowns or regulatory gaps.

We see clear benefits of assessing bank supervision through a few MLRs when the banking industry is healthy rather than a rash of MLRs when the industry is under stress. From a prudential perspective, a few MLRs might be the least costly means of prospectively rather than reactively assessing bank supervision, particularly if the nature of bank risks are changing.

Should you have any questions, please contact Benny W. Lee, Western Regional Inspector General for Audit at (415) 977-8810.

Sincerely,

Valerie Lau

Valerie Lau
Inspector General

The following are GAO's comments on the Treasury IG's comments dated October 3, 1996.

GAO Comments

1. The IG stated that unsafe banking practices were the primary cause of MNB's failure while a declining economy precipitated eventual losses. We have clarified the language on pages 6-7 in response to the IG's comment.

2. The IG said that an increasing MLR workload would not affect the office's CFO work since such work is done by a separate unit. We clarified the language on page 13 to make clear that MLRs could place greater resource demands on IG staff not engaged in CFO work.

3. The IG stated that an underlying implication of our argument is that the weak credit losses of the 1980s will also be the primary cause of bank failures in the future. However, the IG said that this implication is not necessarily the case and that banks are moving into new areas, such as fee-based services, that involve risks different from credit risk that could cause future bank failures.

We acknowledge that many banks are moving into new activities that represent risks different from traditional credit risks. Such activities must be carefully managed and monitored to ensure that they do not pose unacceptable risks to the safety and soundness of banking institutions. It is possible that the period between the time these problems arise and losses are ultimately recognized could be shorter.

4. The IG said that doing a few MLRs during strong economic periods may be beneficial in providing important prospective information about bank supervision to Congress, regulators, and the IGs as compared with initiating a series of MLRs during a banking downturn.

We state in our report that MLRs have certain beneficial impacts on bank supervision but raise questions about the cost-effectiveness of the process as currently structured. By allowing the IGs greater discretion in the number, timing, and scope of MLRs to initiate as we have suggested, we believe the benefits of the MLR process will be enhanced while costs will be reduced.

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