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INSPECTORS  
GENERAL

Mandated Studies to  
Review Costly Bank  
and Thrift Failures





**General Government Division**

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July 31, 1995

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  
Ranking Minority Member  
Committee on Banking and  
Financial Services  
House of Representatives

This report presents the results of our 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.<sup>1</sup> This section of FDIA requires the IGs to issue reports on depository institutions—banks or thrifts—whose failures result in “material losses” to deposit insurance funds, i.e., basically those that exceed \$25 million. The section directs the IGs to determine why a bank’s or thrift’s problems resulted in a material loss to a deposit insurance fund and to make recommendations for preventing such losses in the future.<sup>2</sup> Finally, the section requires 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.

In carrying out our responsibilities under section 38(k), our objectives were to (1) assess the adequacy of the preparations, procedures, and audit guidelines that IGs have established for performing material loss reviews

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<sup>1</sup>12 USC Section 1831o(k).

<sup>2</sup>The Treasury IG is responsible for auditing failed national banks supervised by the Office of the Comptroller of the Currency, but did not become responsible for doing investigations of thrift failures that cause material losses until July 1, 1995. On that date, the Savings Association Insurance Fund became responsible for paying, or paying off, the insured deposits of failed thrifts, and the Treasury IG became responsible for reviewing thrift failures whose cost to the Savings Association Insurance Fund meet the criteria specified by section 38(k). Until that date, the Resolution Trust Corporation—which is not an insurance fund as defined by the section—was responsible for paying, or paying off, the insured deposits of failed thrifts.

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(MLR) to ensure compliance with their responsibilities under the section; (2) verify the information contained in the MLR reports upon which the IGS based their conclusions; (3) recommend improvements, if necessary, in bank supervision based on a review of the MLR reports issued between July 1, 1993, and June 30, 1994; and (4) assess the economy and efficiency of the current MLR process.

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## Scope and Methodology

To satisfy our objectives, we discussed the IGS' plans, policies, procedures, and MLR audit guidelines with IG officials and bank regulators. We assessed the MLR audit guidelines for their completeness, detail, and relevance to the IGS' audit objectives. We compared the MLR audit guidelines to audit guidelines that we developed and used in our earlier reports on the causes of bank failures and the adequacy of bank supervision. In addition, we verified the information contained in the two MLR reports completed between July 1, 1993, and June 30, 1994, the first year that section 38(k) was in effect. A detailed description of our objectives, scope, and methodology is provided in appendix I. The IGS for FDIC, the Federal Reserve, and Treasury provided written comments on a draft of this report, which are discussed on pages 21 and 22 and are reprinted in appendixes III, IV, and V.

We did our work between April and October 1994 in Washington, D.C.; Irvine, CA; San Francisco; and Denver in accordance with generally accepted government auditing standards.

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## Results in Brief

The Federal Reserve, FDIC, and Treasury IGS have effectively positioned themselves to satisfy their MLR responsibilities as required by section 38(k) of FDIA, as amended. The IGS have established a Statement of Understanding (SOU) to coordinate their approaches to performing MLRS, initiated and completed several pilot studies, hired staff with banking and audit experience, and developed relevant training programs. Moreover, the IGS have developed comprehensive and detailed audit guidelines for performing MLRS that were refined on the basis of the IGS' experiences in completing the pilot studies. Although these guidelines differ somewhat among IGS, we believe that, if effectively implemented, the guidelines are adequate for determining the causes of bank failures resulting in material losses and assessing the quality of supervision of those banks.

The Federal Reserve and FDIC IGS each issued a MLR report during the first year that the MLR requirement went into effect. The Federal Reserve IG

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issued a report on Jefferson Bank and Trust (JBT) in Colorado, and the FDIC IG issued a report on The Bank of San Diego (TBSD) in California. We found that the IGS fully described and supported the reasons for the failures of JBT and TBSD. The IGS also assessed the adequacy of the banks' supervision, although the FDIC IG could have more fully evaluated the effectiveness of FDIC's supervisory enforcement actions in the TBSD report.

We believe the JBT and TBSD reports provide important information about the causes of these banks' failures and the quality of their supervision. However, the limited number of reports that have been issued to date do not provide a sufficient base of evidence to ensure valid conclusions about the bank regulators' overall performance. Therefore, we do not make any recommendations to the bank regulators to improve supervision in this report.

Meanwhile, the costs associated with producing MLR reports can be considerable and include personnel and financial expenditures and some temporary operational disruptions to the IG offices. Another potential limitation of the current MLR requirements is that they do not always give IGS sufficient time to review reports that are prepared by other FDIC officials who also investigate the causes of bank failures. On the basis of discussions with IG officials, we identified various options that could improve the efficiency and/or effectiveness of the current MLR process.

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## Background

The FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS)—which are part of the Department of the Treasury—share responsibility for regulating and supervising banks and thrifts in the United States. FDIC regulates state-chartered banks that are not members of the Federal Reserve system while the Federal Reserve regulates state-chartered banks that are members of the system. OCC regulates nationally chartered banks, while OTS regulates thrifts.<sup>3</sup> The regulators carry out their oversight responsibilities through, among other things, conducting annual examinations and issuing enforcement actions for unsafe and unsound banking practices.

Congress amended FDIA in 1991 after the failures of about 1,000 banks between 1986 and 1990 had resulted in billions of dollars in losses to the Bank Insurance Fund (BIF). The amendments were designed largely to

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<sup>3</sup>State regulatory authorities share responsibility for regulating and supervising banks and thrifts that they charter with FDIC, the Federal Reserve, and OTS.

strengthen bank supervision and to help avoid a taxpayer bailout of the BIF similar to the nearly \$105 billion in taxpayer funds that Congress provided between 1989 and 1993 to the Resolution Trust Corporation to protect the depositors of failed thrifts. The amendments require the banking regulators to take specified supervisory 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 the Treasury—which is responsible for auditing OCC and OTS—are officials 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 engages in a range of activities, including criminal investigations, financial audits, and audits of the economy and efficiency of agency programs and operations.

Section 38(k) of FDIA requires the IGS to review the failures of depository institutions when the estimated loss to a deposit insurance fund becomes “material”: i.e., when the loss exceeds \$25 million and a specified percentage of the institutions’ assets. (See table 1.)

**Table 1: Applicable Percentage of the Bank’s Assets on a Sliding Scale**

<b>Time period</b>	<b>Percentage</b>
July 1 - June 30	
1993 - 1994	7%
1994 - 1995	5
1995 - 1996	4
1996 - 1997	3
After 1997	2

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

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The MLR reports 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 the section.<sup>4</sup>

Before July 1, 1993, when the section's requirements went into effect, the IGS had each done pilot studies of previous bank or thrift failures to gain experience in this type of audit. Between July 1, 1993, and February 28, 1995, four banks that met the section's requirements failed. The Federal Reserve IG issued MLR reports on JBT in Lakewood, CO, and Pioneer Bank in Fullerton, CA; the FDIC IG issued MLR reports on TBSD and The Bank of San Pedro, CA.<sup>5</sup> The Treasury IG had not initiated any MLRS as of February 28, 1995, because there had not been any failures of nationally chartered banks or thrifts that met the section's requirements.

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## Inspectors General Made Substantial Efforts to Prepare for Material Loss Reviews

Our review indicated that all of the IGS made substantial efforts in preparation for meeting their MLR responsibilities under section 38(k). In a coordinated effort, the IGS entered into a SOU that outlined their approach to conducting the MLRS which, among other things, specified when IGS should initiate a MLR. The IGS also initiated pilot studies of depository institution failures before the effective date of section 38(k) (July 1, 1993) to develop and refine audit procedures and to familiarize their staffs with this type of review. Finally, the Federal Reserve and FDIC IGS hired additional staff with banking and financial audit expertise to meet anticipated demands for conducting MLRS. All three IGS enrolled their staff in relevant training courses.

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## Inspectors General Entered Into a Statement of Understanding

The FDIC, Federal Reserve, and Treasury IGS entered into a SOU in preparation for conducting MLRS. The SOU is intended to ensure that (1) statutory requirements for doing a MLR are met as effectively as possible, (2) the IGS' work is consistent relative to MLRS, (3) mutual

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<sup>4</sup>The section defines a loss incurred as follows:

- when FDIC is appointed receiver of the institution and it is or 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:
- 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.

<sup>5</sup>In this review, we focused our audit work on reports on Jefferson Bank and Trust and The Bank of San Diego since they were issued in the first year that section 38(k) went into effect. Although we read the MLR reports on The Bank of San Pedro and Pioneer Bank, we did not attempt to verify the information contained in these reports.

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cooperation and efficient use of resources are maximized, and (4) privileged and confidential information contained in failed bank records is protected from unauthorized disclosure. The SOU was finalized on August 18, 1994.

Among other provisions, the SOU details how FDIC's Division of Finance (DOF) is to notify each IG office that a bank failure is expected to result in a material loss, thereby documenting that a MLR must be initiated. The FDIC IG is to be the primary liaison between the FDIC DOF and the Federal Reserve and Treasury IGs. The FDIC DOF is to notify the FDIC IG by letter when it "books" a material loss to BIF on a bank failure. If the bank was regulated by FDIC, the date of the letter starts the 6-month clock for the FDIC IG to complete its MLR. If the bank was regulated by the Federal Reserve or OCC, the FDIC IG is to notify the responsible IG by letter of the material loss. The date of this letter starts the 6-month clock for the Federal Reserve or Treasury IG office to complete its MLR.

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### Inspectors General Offices Completed Pilot Studies

Each of the three IG offices we contacted conducted pilot studies on banks or thrifts that failed before July 1, 1993, the effective date of section 38(k). The officials we contacted said they did the pilot studies to develop policies and procedures to do MLRS after section 38(k) went into effect. The officials also said that they wanted to train their new staff in how to do this type of review and to establish contacts with officials in the bank regulatory agencies. The Treasury IG office did pilot studies on two California institutions, the Mission Viejo National Bank and the County Bank of Santa Barbara; the FDIC IG office did pilot studies on Coolidge Bank and Trust, located in Boston, and Union Savings Bank, located in Patchogue, NY; and the Federal Reserve IG office did a pilot study on the Independence Bank of Plano, located in Texas.

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### Inspectors General Hired and Trained Staff to Perform MLRs

The FDIC and Federal Reserve IGs also hired additional staff in 1992 and 1993 to assist in performing MLRS and to fully staff their agency oversight functions. The FDIC IG hired 12 additional staff members for a total of 37 staff members to conduct MLRS and other program audits. In addition to persons with auditing experience, the new staff included four banking specialists. These more experienced staff were hired to provide training to junior staff on banking examination procedures, including loan reviews to assess a bank's asset quality. According to FDIC IG officials, all of the staff had enrolled in the FDIC's examiner training program to learn more about the bank supervisory process.



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The Federal Reserve IG hired 5 additional staff members in 1993 to give it a total of 11 staff for completing MLRS and other audit work on bank supervision. These five staff persons have expertise in areas such as bank loan analysis, consumer compliance regulations, and auditing computer systems. The Federal Reserve IG had also sent these individuals to banking classes conducted by the American Institute of Certified Public Accountants and the Federal Reserve's examiner classes. In addition, two IG officials enrolled in the American Bankers Association banking course at Stonier College in Delaware.

At the time that these hirings occurred, numerous costly bank failures were projected to occur between 1993 and 1995. A FDIC IG official said that additional staff were needed to meet the anticipated workload associated with these potential MLRS. However, the number of bank failures declined substantially in 1993 and 1994 as a result of low interest rates and an improving economy. The number of bank failures fell from 122 in 1992 to 42 in 1993 and 13 in 1994. Only four banks failed between July 1, 1993, and February 28, 1995, with losses exceeding the statutory threshold, thereby prompting the IGs to initiate MLRS. FDIC and Federal Reserve IG officials we contacted said that MLRS represent only a part of their overall efforts to assess bank supervision. The officials plan to use the staff hired in 1992 and 1993 to do future MLRS and other audit work on the economy and efficiency of agency supervisory operations.

Treasury IG officials said that the organization did not receive additional resources to hire more staff for conducting MLRS. Although the Treasury IG office plans to divert staff to work on MLRS as needed, other mandated work could limit their ability to do so. For example, the IG is required to do audit work on the Treasury Department's compliance with the Chief Financial Officers Act of 1990 (CFO).<sup>6</sup> The Treasury IG also has developed a comprehensive training module on how to conduct MLRS for its current staff. The module includes separate student and teacher instructions so Treasury IG staff with banking experience can train staff with limited banking experience. The modules are also designed to be self-taught and can be used without assistance. Some of the issues covered in the training module include an introduction to banking; a section on how to analyze and evaluate causes of bank failures; and an assessment of enforcement

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<sup>6</sup>Among other things, the CFO Act created chief financial officer positions in 23 major federal agencies. These officers must have substantial financial management experience and are responsible for, among other things, developing integrated accounting systems, directing agency financial operations, and approving and managing agency financial management systems. The act also specifies that the Office of Management and Budget establish qualification standards for the CFOs.

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actions, including the effectiveness and timeliness of regulator enforcement actions.

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## Inspectors General Developed Comprehensive MLR Audit Guidelines

We reviewed the MLR guidelines that the IGS had developed for their completeness and relevance for satisfying the MLR objectives and compared the guidelines to our audit guidelines for investigating costly bank failures. On the basis of this analysis, we believe the IGS' audit guidelines, if effectively implemented, represent a comprehensive approach to identifying the causes of bank failures and assessing the adequacy of their supervision. Although many provisions of the guidelines are similar, the Federal Reserve and FDIC IG audit guidelines differ from the Treasury IG guidelines in that they generally call for doing extensive loan portfolio reviews in every case when loan losses are determined to be the primary causes of failure. By contrast, the Treasury IG is to perform such loan reviews on a case-by-case basis.

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## MLR Audit Guidelines Are Adequate for Assessing Causes of Bank Failures

Our review of the IGS' audit guidelines to do MLRs found that the guidelines represent a comprehensive approach for assessing the causes of bank failures. Under established guidelines, senior IG officials are to maintain contact with the bank regulators to identify troubled banks whose failures could cause material losses. The guidelines direct the IG staff to obtain and review basic documents about these troubled banks—such as examination reports dating back several years; enforcement actions; and historical financial data, such as asset growth over time. When a bank fails and causes a material loss, the IG staff are to interview responsible bank examiners and other regulatory officials and meet with former bank officials and FDIC closing personnel. Through reviewing these documents and interviewing knowledgeable officials, the IGS are to identify and document the major reasons for the banks' failures. These reasons may include rapid growth; poor loan underwriting and documentation; loan concentrations, such as in real estate; and insider abuses.

The Federal Reserve and FDIC IGS' MLR audit guidelines differ from the Treasury IG audit guidelines in that they generally call for the staff to review failed bank loan portfolios when loan losses are determined to be the primary cause of failure. FDIC IG officials we contacted said that they need to review loan portfolios to arrive at an independent judgment as to why the banks failed. The officials said that they do not rely solely on documents generated by the bank regulators—such as examination reports and supporting workpapers—to determine the cause of failure.

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Although the Federal Reserve IG follows a similar procedure to the FDIC IG for selecting a sample of loans to review, Federal Reserve IG officials said that they perform loan reviews primarily to assess the quality of bank supervision. These Federal Reserve IG loan review procedures are discussed later in this section.

Under the loan review audit guidelines, FDIC IG staff are to select a sample of the loans on the books of banks whose failures result in material losses. The sample is to include classified (troubled) loans and nonclassified loans as well as a mixture of commercial, real-estate, and consumer loans. Once a bank fails and causes a material loss, the staff are to visit the bank and review the sampled loans. The guidelines direct the staff to comment on, among other things, the quality of the bank's loan underwriting standards. The IG staff are to use lending standards that the regulators have issued to bank examiners to assist in making these assessments.

According to an FDIC IG official, the staff review the loan files to identify the management strategy or lending weaknesses that ultimately caused the bank to fail. By reviewing information in the loan files dating back several years, for example, he said the staff could determine whether bank management had adopted an aggressive growth strategy without adequate regard for maintaining credit standards.

Unlike the FDIC IG guidelines, the MLR audit guidelines developed by the Treasury IG do not call for loan reviews even if loan losses were the primary cause of failure. As a result of the time and resources necessary to complete a MLR, the guidelines state that the Treasury IG staff should generally rely on OCC examination reports and workpapers and discussions with examiners to assess the causes of a bank's failure. However, the guidelines do direct the IG staff to initiate loan reviews similar to those done by the FDIC and Federal Reserve IG staff in certain situations. The Treasury IG staff are to do a loan review if they determine that OCC's records do not adequately address or develop the problem(s) that resulted in a bank's failure. For example, it may be necessary to do a loan review or examine the bank's records if it appears that insider abuse caused the bank to fail and the OCC examiners did not adequately develop the related issues.

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## MLR Audit Guidelines Call for Assessing the Bank Regulators' Supervisory Performance

Our reviews of the IG MLR guidelines showed that they call for the IG staff to assess the timeliness and effectiveness of bank supervisory activities. Based on reviews of examination reports and supporting workpapers, as well as discussions with bank examiners, the IG staff are to assess the adequacy of the supervision of failed banks. For example, the IG staff are to determine whether the regulators complied with their policies and procedures in supervising the banks. Among other requirements, the IG staff are directed to determine whether the bank regulators selected an adequate sample of loans to evaluate at each bank examination and made determinations about the bank's financial condition. The IG staff are also to review the supporting workpapers for each examination to determine whether the regulators had adequate support for their findings on the quality of each bank's loan portfolio.

The guidelines also direct the IG staff to determine whether the bank regulators had taken timely and effective enforcement actions—such as Memorandums of Understanding, Cease and Desist Orders (C&D), and Civil Money Penalties—against banks that engage in unsafe or unsound practices. For example, the Treasury IG guidelines direct the staff to focus their analysis on problems that the bank regulators identified during the course of examinations, particularly those that resulted in the bank's failure. The IG staff are to determine what enforcement actions, if any, were taken against the bank by OCC to get the bank to correct these problems, and the guidelines direct the IG staff to determine why OCC did not take particular enforcement actions against a bank. Moreover, the guidelines call for the IG staff to evaluate OCC's oversight of banks that are subject to enforcement actions to ensure that bank managers comply with the provisions of such actions. Once this analysis has been completed, the IG staff are to reach a conclusion about the timeliness and forcefulness of the OCC's enforcement actions. The FDIC IG and Federal Reserve IG MLR guidelines contain similar provisions.

Federal Reserve IG officials we contacted said they primarily use the loan review process discussed earlier to assess the adequacy of the Federal Reserve's examinations of bank lending activities. In the recent MLR audit of Pioneer Bank, the officials said they reviewed a sample of 40 large commercial and commercial real estate loans in the bank's portfolio. The staff reviewed these loans in a manner similar to that done by bank examiners. For example, the staff determined, from a review of information in the files, whether they believed each loan should be

classified as “substandard,” “doubtful,” or “loss.”<sup>7</sup> The staff used the regulatory examination standards that were in place at the time the loans were originated to make these classifications.<sup>8</sup>

Next, the staff compared their loan review findings to the findings of the Federal Reserve examiners who actually examined the bank in the years before the bank’s failure. The IG officials said they tried to determine the reasons that their loan classifications differed from those of the Federal Reserve examiners and assess whether the examiners had adequate justification for their classifications. The IG staff concluded that the Federal Reserve examiners overlooked substantial weaknesses in the bank’s lending practices over the years. Although the Federal Reserve IG officials said this type of analysis is complicated and time consuming, they believe it is often necessary for assessing the overall quality of the bank’s supervision.

However, FDIC IG officials said that when they conduct a loan review they use it for the purposes of determining the causes of bank failures rather than determining the adequacy of bank supervision. The officials said that they generally do not use loan reviews to assess bank supervision because it is difficult to replicate the conditions that existed when FDIC examined banks in the past.

## JBT and TBSD MLR Reports Fully Describe Causes of Bank Failures, but FDIC IG Could Have Expanded Its Analyses

During the first year that section 38(k) went into effect, the Federal Reserve and FDIC IGs each used the audit guidelines discussed above to do a MLR report. We believe that these reports fully describe and support the causes of the banks’ failures. The IGs also assessed the supervisory efforts of the bank regulators and recommended specific steps the regulators could take to improve their oversight efforts. However, the FDIC IG could have more fully evaluated the effectiveness of FDIC’s supervisory enforcement actions in the TBSD report.

## MLR Reports Fully Describe Causes of Failure

On December 27, 1993, the Federal Reserve IG issued a report on JBT, which failed on July 2, 1993. The report concluded that the bank failed as a

<sup>7</sup>Examiners use classifications to determine the likelihood that a loan will be repaid. “Substandard” refers to loans whose repayment is in question as a result of the weakened financial condition of the borrower or the decline in value of the collateral pledged to secure the loan. “Doubtful” refers to loans that are substandard and whose repayment is highly questionable. “Loss” refers to loans that are generally considered uncollectible.

<sup>8</sup>The Federal Reserve IG staff said they made separate classifications of each loan in the sample for several years before the bank’s failure.

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result of a massive securities fraud perpetrated by its investment adviser; the fraud resulted in a \$43 million loss for the bank. The IG staff decided not to do a loan review for the JBT investigation because trading in government securities, rather than loan losses, caused the bank's failure. Instead, the IG staff focused its investigation on reviewing JBT's securities trading activities and the Federal Reserve's oversight of this trading.

On April 29, 1994, the FDIC IG issued a report on TBSD, which failed on October 29, 1993. The report concluded that the bank failed as a result of poor loan underwriting, excessive real estate lending, high expenses, and poor management. As part of the MLR, FDIC staff reviewed a sample of 60 of TBSD's loans, including 41 real-estate loans. The IG staff identified many of the deficiencies in the bank's lending practices through the loan analysis.

We reviewed the workpapers the IGS developed to support the JBT and TBSD reports to (1) ensure that the IGS complied with the MLR guidelines and (2) verify the basis for the reports' conclusions about the causes of the banks' failures. We also interviewed officials from the IGS' offices, as well as examination officials from the Federal Reserve and FDIC, respectively. On the basis of our review, we believe that the reports fully describe and support the causes for each bank's failure. See appendix II for more information about each report.

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## FDIC IG Could Have Expanded Its Analysis of Enforcement Actions

Our review of the JBT and TBSD reports and their supporting workpapers also found that the Federal Reserve and FDIC IGS generally complied with their guidelines on assessing the quality of bank supervision. As examples, the IGS obtained copies of bank examination reports dating back several years, collected economic data about the regions in which the banks were located, and interviewed bank regulators. In addition, IG audit teams traveled to the banks' locations to review bank records and interview bank officials.

The IGS also identified certain deficiencies in Federal Reserve and FDIC supervisory practices. For example, the Federal Reserve IG, in the JBT report, identified specific steps that the Federal Reserve could take to improve its oversight of bank securities trading activities. Moreover, the FDIC IG, in the TBSD report, recommended that FDIC evaluate on a case-by-case basis the need to collect better data about the quality of bank assets before approving the merger of weak banks. The FDIC IG further recommended that FDIC develop examination guidance to ensure that

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banks place reasonable limits on the financing of speculative real-estate projects.

The IGS also obtained and reviewed copies of enforcement action documents that were taken against JBT and TBSD and summarized those actions in the MLR reports. However, we found that the FDIC IG did not fully evaluate whether FDIC ensured that TBSD complied with outstanding enforcement actions as provided in the MLR audit guidelines. We did such an analysis of FDIC supervision's follow-up efforts of its enforcement actions against TBSD. From our review, we determined that TBSD continued its aggressive real-estate lending activities even though FDIC had initiated an enforcement action intended to limit the bank's exposure. We also found that FDIC supervision did not ensure its enforcement actions were effective to get bank management to better control its real-estate lending. These additional insights may have strengthened the FDIC IG's recommendations to include supervisory follow-up of the effectiveness of actions taken.

In 1985, FDIC issued a C&D against TBSD that, among other provisions, required the bank to improve its lending standards. On May 9, 1988, FDIC lifted the C&D, but the bank continued to have problems, such as high loan losses and high overhead expenses. According to the TBSD report workpapers, in September 1988, a FDIC examiner recommended that FDIC sign a Memorandum of Understanding with TBSD that would require the bank to correct its lending and operational problems. However, in April 1989, FDIC agreed to a resolution by TBSD's Board of Directors, in lieu of a Memorandum of Understanding, that required changes in the bank's operations. For example, the resolution called on the bank to assess its loan exposure to the commercial real-estate construction industry and the financial consequences for the bank in the event of a downturn in that industry. The resolution further directed TBSD management to consider capping its commercial real-estate loans as a percentage of the bank's total loans, assets, and capital.

Despite the board resolution, bank management continued to pursue an aggressive commercial real-estate lending strategy, and FDIC did not take forceful actions to correct these problems for 2 years. The FDIC TBSD report showed that the bank's construction and commercial real-estate loans increased by nearly 75 percent from about \$47 million to \$82 million between year-end 1988 and year-end 1991. Many of these real-estate loans contributed to the bank's failure in 1993. California state banking regulators examined TBSD in 1989 and 1990 and gave its overall operations

relatively high ratings: i.e., an overall CAMEL<sup>9</sup> rating of “2” in 1990. FDIC officials did not begin to discover the extent of TBSD’s loan loss problems until their examinations of the bank in late 1990 and in 1991. On the basis of these exam findings, FDIC signed a Memorandum of Understanding with TBSD in April 1991 that required the bank to improve its operations.

TBSD also disregarded the board resolution’s provisions that it consider capping total commercial real-estate loans as a percentage of its assets and capital. Specifically, commercial real-estate loans grew from 35 percent of banks total assets to 42 percent between year-end 1988 and year-end 1991. In the same period, commercial real-estate loans increased from 423 percent of TBSD’s total capital plus reserves to 597 percent. The insights we gained from this analysis may have been beneficial to the FDIC IG in assessing FDIC’s oversight of TBSD and in making its recommendations for improving bank supervision.

## Limited Benefits of Current MLR Process Are Achieved at Certain Costs

For this report, we focused our assessment on the plans, policies, and audit guidelines that the IGs have developed for complying with the MLR mandate. Although the current MLR process produces important benefits in understanding the circumstances surrounding individual bank failures, the benefits so far may have had a limited impact in improving bank supervision overall. We do not make any recommendations for improving bank supervision in this report since only two MLR reports were issued in the first year that the mandate went into effect and only two more reports had been issued as of February 1995. Further, certain costs associated with producing MLR reports should be considered; these costs include IG financial and personnel expenditures, some temporary disruptions to IG office operations, and duplication of effort among investigators. In addition, our continued annual reviews of the MLR process may not add value beyond this initial assessment. We conclude this section by providing a discussion of the reasons for and against various options that could be considered to address the MLR requirement.

## MLRs Produced Important but Limited Benefits

IG officials we contacted said that the JBT and TBSD reports had produced important benefits. These IG officials said that MLRs initiated to date had generated significant information about the causes of individual bank

<sup>9</sup>The results of an onsite examination by banking regulators are summarized in a report addressed to the bank’s board of directors. The examination usually results in the examiner assigning a numerical rating to each of these bank components—capital, assets, management, earnings, and liquidity (CAMEL). The examiner is to assign a composite CAMEL rating to the bank. CAMEL ratings range from 1, the best rating and the lowest level of supervisory concern, to 5, the worst rating and the most serious level of supervisory concern.



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failures, the quality of these banks' supervision, and the opportunity to train the IG staff in the bank supervisory process. A senior FDIC IG official also said that MLRs provided important information about other areas of bank management and supervision that may need to be evaluated. For example, he told us that as a result of the MLR investigation of the Bank of San Pedro, the FDIC IG may review banks' use of "money desks" to fund their lending operations.<sup>10</sup>

In addition, an IG official said that the MLR process provides the office with a strong justification for assessing other aspects of bank supervision. For example, before the MLR requirement, the office had not yet established an overall program for assessing bank supervision. However, the official said that the MLR process provided the IG with a formal basis for assessing the regulators' supervisory efforts and allowed the IG to establish working relationships with supervisory officials.

Although the JBT and TBSD reports provided valuable information about the circumstances surrounding these banks' failures, we are not making any recommendations for improving bank supervision on the basis of these reports. We do not believe that the two cases done during the first year or the total of four cases that had been completed as of February 1995 represent a sufficient base of evidence to arrive at conclusions about the overall quality of bank supervision. To make recommendations, we would need to review a larger sample of MLR reports. This larger sample would allow us to identify any common problems or trends in bank regulation that need to be corrected.

Some IG officials we contacted said that the MLRs completed to date provide little basis for identifying supervisory trends. For example, a FDIC IG official said that there has not been an adequate number of MLR reports issued to draw overall conclusions about the adequacy of bank supervision. In addition, a Federal Reserve IG official said that it is difficult to convince agency supervisory officials to accept recommendations contained in a MLR report since the recommendations would be based on only one bank's failure. In its MLR report on the failure of the Pioneer Bank, the Federal Reserve IG chose not to make any recommendations for improving overall bank supervision even though the report identified certain supervisory weaknesses.

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<sup>10</sup>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. For example, according to the FDIC IG report, The Bank of San Pedro attracted \$25 million in deposits in the early 1990s by offering above-market interest rates to depositors nationwide.

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It should be pointed out that MLRs are just one part of the IGS' overall efforts to evaluate the quality of bank supervision nationwide. For example, in September 1994, the FDIC IG issued a report on FDIC's efforts to implement provisions in the Federal Deposit Insurance Corporation Improvement Act (FDICIA)<sup>11</sup> that require the prompt closure of capital-deficient banks.<sup>12</sup> At the time of our review, the Federal Reserve IG was doing audits of the Federal Reserve's examinations of commercial real-estate loans and its bank examination program. In addition, the Treasury IG was doing studies on OTS' implementation of various sections of FDICIA and the effectiveness of OCC's examinations of national banks.

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## Costs Associated With the Current MLR Process

The benefits of the MLR reports completed to date have been achieved at certain costs to the IG offices. IG officials said that a significant amount of financial and personnel resources are needed to do MLRs. In the 4 MLRs initiated as of February 28, 1995, by the FDIC and Federal Reserve IGS, between 5 to 11 staff visited the banks' premises within the first several weeks of their failures. These staff conducted initial interviews with regulatory and bank personnel, reviewed bank examination records, and conducted loan reviews. For example, in one recent FDIC IG MLR, six staff spent 2 weeks reviewing loan files on the bank's premises. A FDIC IG official said that the number of staff needed to perform MLRs should decline in the future as the organization gains experience in this type of work.

IG officials also said that the resources necessary to complete a MLR report within the 6-month deadline can have temporary but disruptive effects on their normal operations. Treasury IG officials said that approximately 30 percent of their staff are already dedicated to assessing executive agency financial systems as required by the CFO Act. The Treasury IG officials estimate that 50 percent of their staff resources would be dedicated to CFO work by 1996. Therefore, an increasing MLR workload could hinder the Treasury IG's ability to devote sufficient staff resources to meet its CFO Act and other audit obligations. Similarly, Federal Reserve and FDIC IG officials said that the resources necessary to complete the JBT and TBSD reports within the 6-month deadline caused certain operational challenges. For example, these officials said they had to pull staff from other ongoing studies to assist in the material loss investigations.

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<sup>11</sup>18 USC Section 1811 et seq., as amended by Section 131(a) of the Federal Deposit Insurance Act of 1991. Public Law 102-242, Section 131(a), 151 Stat 2236, 2263-64 (1991).

<sup>12</sup>Federal Deposit Insurance Corporation, Office of Inspector General, Audit of FDIC's Implementation of the Prompt Corrective Action Provisions of FDICIA (Sept. 23, 1994).

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We believe that these disruptive effects on the IGS' operations could be magnified should there be a substantial increase in the number of costly bank failures, particularly in the case of the Treasury IG, which did not receive additional staffing to do MLRS. Although the Federal Reserve and FDIC IGS have increased their staffing in recent years, they could also face substantial pressures to complete MLR reports within 6 months should numerous banks fail simultaneously. For example, a FDIC IG official estimated that the organization could handle a maximum of about 14 MLRS per year.

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## MLRs Do Not Always Allow for Use of FDIC Investigators' Reports

Another potential limitation of the current MLR process is that it does not always allow time for the IGS to review reports prepared by FDIC's Division of Asset Services (DAS) investigators who also investigate the causes of bank failures. Like MLR reports, these reports provide information about individual bank failures. However, Federal Reserve and FDIC IG officials question whether it would be beneficial to review these DAS reports and mentioned that these reports were often not available until months after banks failed.

DAS is responsible for recovering a portion of FDIC's outlays to resolve bank failures by selling each failed bank's assets to private sector bidders. DAS also sends investigators to failed banks to determine whether FDIC could pursue civil claims against any bank officials culpable for the losses to help offset the costs of the failure. It is the policy of the DAS investigators to issue a report within 90 days of a bank failure—although the process can take longer—that documents their findings. This report is called a Post Closing Report (PCR). DAS has issued PCRS on JBT and TBSD.

In our discussions, a Treasury IG official said that PCRS provide information that could be useful in doing MLR reports. The official also said it may make sense for the IGS to wait until DAS has issued PCRS before initiating MLRS. If the IGS initiated MLRS after PCRS, this could allow the IGS to avoid duplicating the work of the DAS investigators and it would allow the IGS to plan the scope of their MLR audit work on the basis of information contained in the PCRS.

However, Federal Reserve and FDIC IG officials said that there is no significant relationship between MLRS and the DAS investigations. The officials said that DAS investigations are more narrowly focused than MLRS and, therefore, have limited use. For example, Federal Reserve IG officials pointed out that PCRS, unlike MLR reports, do not assess the quality of bank

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supervision. IG officials also said that they consult with FDIC DAS investigators during the course of MLRS to obtain information. Finally, the FDIC and Federal Reserve officials said that PCRS were often not available until months after a bank failure. For example, the JBT PCR was completed nearly 4 months after the failure, and the TBSD PCR was completed about 7 months after the failure. As discussed earlier, MLR reports must be completed within 6 months of a bank's failure.

Although the PCR's primary purpose is to assess whether FDIC should pursue civil actions against former bank officials, the reports contain some information that is similar to that found in MLR reports. For example, we reviewed PCRS that were issued for JBT and TBSD. Like the MLR reports, these PCRS provide historical information about each bank and the results of regulator exam findings. The PCRS also established the causes of the banks' failures and documented the provisions in any enforcement actions taken against the banks.

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### Our Annual Reviews May No Longer Be Necessary

As discussed earlier in this report, the IGS have generally positioned themselves effectively to meet their responsibilities under the MLR requirement. In addition, if bank failures continue at a relatively low rate as projected over the next several years, MLR reports will not provide either the IGS or us with an adequate basis for assessing the overall quality of bank supervision and making needed recommendations for improvement. Therefore, our annual reviews of the MLR process may no longer add value to either the MLR or supervisory processes.

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### MLR Options

Several options are available concerning the current MLR process that we discussed with IG officials. Specifically, the current MLR process could be maintained, repealed, or amended so that the IGS have more discretion on the number and timing of MLRS to perform each year. Table 2 presents several reasons for and against each of these options.

**Table 2: Available Options Concerning the Material Loss Review Process**

Option	Reason for option	Reason against option
1. Maintain the current MLR process.	May continue to hold the bank regulators accountable for their performance in supervising individual banks.	May provide an inadequate basis for assessing the overall quality of bank supervision if relatively few banks fail over the next several years.
	May provide the IG staffs with detailed knowledge and understanding of what causes bank failures and how bank supervision works.	May continue to involve costs, such as personnel and travel expenditures.
	May provide the IGs with the ability to identify issues in bank supervision warranting further analysis.	May not permit the IGs to take advantage of other reviews or investigations of bank failures, such as PCRs produced by FDIC DAS investigators.
	May allow for broader assessments of the overall quality of bank supervision if there is a substantial increase in the number of bank failures.	May divert the IG staff from doing broader audits of bank supervision.
2. Repeal the MLR requirement.	Would eliminate the costs associated with performing mandatory MLRs.	May reduce bank regulators' accountability for their supervision of individual banks.
	May allow the IGs to use their resources cost effectively by focusing their efforts on broader aspects of bank supervision and doing individual case studies of bank failures only where determined necessary.	May reduce the IGs' ability to identify issues in bank supervision that require further investigation.
		May decrease the IGs' contacts with bank supervisory officials and current knowledge and understanding of the supervisory process.
3. Amend section 38(k) so that the IGs have the discretion to determine the number, timing, and scope of MLRs to initiate each year.	May allow the IGs to use their resources cost effectively by focusing their efforts on broader analysis of the overall quality of bank supervision, particularly in years when few banks are projected to fail.	May lead to inconsistent approaches and numbers of MLRs performed by the various IGs.
	May maintain the bank regulators' accountability for their supervision of individual banks.	May extend the period of time it takes the IGs to issue reports on costly bank failures.

(continued)

Option	Reason for option	Reason against option
	May allow the IGs to take advantage of other audit and investigative reports.	
	May permit the IGs to do a sample of MLRs in years when there is a substantial increase in the number of bank failures. This could potentially minimize the IGs' resource requirements during such periods.	

Source: GAO.

## Conclusions

Congress added section 38(k) to FDIA so that the regulators would learn from any weaknesses in the supervision of costly bank failures and possibly avoid such weaknesses in the future. We believe that MLR reports can provide important information about individual bank failures and that the IGs have generally positioned themselves effectively to meet their responsibilities. However, the current MLR requirements may not be the most cost-effective means of achieving improved bank supervision.

The Federal Reserve, FDIC, and Treasury IGs have made substantial efforts in preparation for performing MLRs as required by section 38(k). The IGs have also developed detailed and comprehensive MLR guidelines that, if effectively implemented, are adequate for meeting the IGs' responsibilities under section 38(k). The Federal Reserve and FDIC IGs have each used the guidelines to prepare MLR reports that fully described the causes of the JBT and TBSD failures. However, the FDIC IG could have gained greater insights on bank supervision if it had expanded its analysis of the effectiveness of the enforcement actions that FDIC took against TBSD.

Although the MLR process can produce important benefits in understanding the circumstances surrounding individual bank failures, these benefits have been limited and are achieved at certain costs. IG officials we contacted said that the two MLR reports completed during the first year that section 38(k) went into effect did not provide an adequate base of evidence to assess the overall quality of bank supervision.

The limited benefits may have been outweighed by the costs associated with producing the MLR reports, which include IG personnel and financial expenditures; temporary disruptions in IG office operations; and potential duplication of effort among the IGs and FDIC DAS. However, if the IGs had

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more flexibility to determine the number and timing of MLRS to perform each year, they could (1) have more flexibility to utilize their resources, particularly in years when there are numerous bank failures; (2) potentially take advantage of PCRS issued by DAS; and (3) do broader analysis of the overall quality of bank supervision. A more flexible approach could still maintain the original intent of section 38(k), which was to hold the bank regulators accountable for their actions. Thus, Congress may wish to consider whether the currently required approach remains the best available. Similarly, we believe that requiring us to perform annual reviews of MLRS may no longer add sufficient value to the MLR or bank supervisory processes to warrant continuation.

We do not make any recommendations for improving overall bank supervision in this report because we agree with the IG officials that the limited number of reports produced so far does not provide an adequate base for identifying improvements.

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## Recommendation

We recommend that the Inspector General of FDIC, in future MLR reports, take steps to more fully assess the effectiveness of FDIC's enforcement actions.

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## Matters for Congressional Consideration

Congress may wish to consider whether the current MLR requirement, which requires the IGS to report on bank and thrift failures costing the deposit insurance funds in excess of \$25 million, is a cost-effective means of achieving the requirement's intended benefit—to help improve bank supervision. If it determines that the requirement is not cost effective, Congress can choose to either repeal or amend the requirement. Of these options, amending the current MLR requirement may be more desirable because it would allow the IGS to continue their bank supervision work and also provide them greater flexibility in managing their resources. Moreover, Congress should consider repealing our mandate to review MLRS on an annual basis.

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## 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 III, IV, and V. The three IGS agreed with the report's overall conclusions that the IGS have effectively positioned themselves to carry out their responsibilities and have developed

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comprehensive and detailed audit guidelines. In response to our recommendation, the FDIC IG agreed to take steps to more fully evaluate the effectiveness of FDIC's supervisory enforcement actions in future MLRS, even though he did not necessarily agree that our analysis of TBSD's compliance with FDIC enforcement actions provided additional insights into the effectiveness of FDIC's supervision of TBSD.

The IGS also agreed that Congress should consider amending section 38(k) of FDIA so that the IGS have more discretion on the number, timing, and scope of MLRS to initiate each year. The Federal Reserve IG stated that, although MLR reports may not be the most cost-effective means of achieving improved bank supervision, they allow the staff to focus their analysis on the implementation of bank supervision policies and procedures over time relative to a particular bank. He also said that the Federal Reserve IG office may be able to make broader recommendations with respect to bank supervision as additional MLRS are completed and that additional flexibility with regard to the MLR requirement would allow the organization to better manage its resources while preserving the intent of the legislation.

The IGS also provided comments that were generally technical in nature and are incorporated in this report where appropriate.

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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 also make copies available to others upon request.

This report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors to this review are listed in appendix VI. If you have any questions about this report, please call me on (202) 512-8678.



James L. Bothwell  
Director, Financial Institutions  
and Markets Issues



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**Abbreviations**

BIF	Bank Insurance Fund
C&D	Cease and Desist Order
CFO	Chief Financial Officer's Act of 1990
DAS	Federal Deposit Insurance Corporation's Division of Asset Services
DOF	Federal Deposit Insurance Corporation's Division of Finance
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
IG	Inspector General
JBT	Jefferson Bank and Trust
MLR	material loss review
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PCR	Post Closing Report
SOU	Statement of Understanding
TBSD	The Bank of San Diego

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# Objectives, Scope, and Methodology

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In accordance with section 38(k) of the Federal Deposit Insurance Act as amended, our objectives were to (1) assess the adequacy of the preparations, procedures, and audit guidelines that the Inspectors General (IG) have established for performing material loss reviews (MLR) to ensure compliance with their responsibilities under the section; (2) verify the information contained in the MLR reports upon which the IGs based their conclusions; (3) recommend improvements, if necessary, in bank supervision based on a review of the MLR reports issued between July 1, 1993, and June 30, 1994; and (4) assess the economy and efficiency of the current MLR process.

To accomplish these objectives, we interviewed staff from the Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and Treasury IG offices on the plans, policies, and procedures they had established to perform MLRs, including their audit guidelines, staffing, and training programs for employees assigned to perform MLRs. We also conducted a round table discussion session with representatives from each of the IG offices to share their views on some of the MLR issues and concerns. Additionally, we met with bank supervision officials and bank examiners from the Federal Reserve and FDIC to obtain their views on the MLR process. We also reviewed the legislative history of the Federal Deposit Insurance Corporation Improvement Act of 1991, pilot studies completed by the IGs, and our previous reports on bank failures and bank supervision.

To assess the adequacy of the IGs MLR audit guidelines, we reviewed them for their completeness and relevance to the MLR objectives. We also compared the MLR audit guidelines to audit guidelines that we had developed for investigating costly bank failures.<sup>1</sup> We developed these guidelines to (1) understand why so many depository institutions failed in the late 1980s and early 1990s causing substantial Bank Insurance Fund (BIF) losses and (2) recommend improvements in depository institution supervision. These guidelines produced report findings that were praised as complete and accurate even by bank regulators whose examination practices were sometimes criticized in the reports. The guidelines involve obtaining and reviewing copies of

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<sup>1</sup>Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies (GAO/GGD-94-88, Mar. 30, 1994), Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1994), Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991), Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991), Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991), Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991), Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989), and Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

- historical financial data, which is available from the bank regulators, showing information such as the growth in the bank's loan portfolio over time;
- regulatory examinations and their supporting workpapers that had been done on a particular bank 5 to 10 years before its failure;
- enforcement actions that the regulators had taken against the bank for unsafe and unsound practices, such as Memorandums of Understanding or Cease and Desist Orders;
- correspondence between the bank and the regulator primarily responsible for its supervision; and
- the Post Closing Reports that identify both the causes of bank failures and determine whether FDIC should pursue civil claims against bank officials to help compensate the BIF for any losses incurred in resolving the failures.

Moreover, we reviewed the two MLR reports issued by the Federal Reserve IG and FDIC IG during the first year that section 38(k) went into effect: the reports on Jefferson Bank and Trust in Colorado and The Bank of San Diego in California, respectively. We substantiated the accuracy of the MLR reports' findings and recommendations on the causes of the banks' failures by generally following our audit guidelines discussed above. We reviewed the reports' supporting workpapers and interviewed Federal Reserve and FDIC examination officials. We also reviewed the two MLR reports to identify potential recommendations that we could make to improve the overall quality of bank supervision. Although we reviewed the MLR reports on The Bank of San Pedro and Pioneer Bank, we did not verify the information contained in these reports because they were issued in the second year that section 38(k) went into effect.

We did our work between April and October 1994 in Washington, D.C.; Irvine, CA; San Francisco; and Denver in accordance with generally accepted government auditing standards.

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# Summary on the Failures of the Jefferson Bank and Trust and the Bank of San Diego

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In the first year that section 38(k) went into effect—July 1, 1993, to June 30, 1994—two banks failed and caused material losses. The Federal Reserve Inspector General (IG) issued a material loss review (MLR) report on the Jefferson Bank and Trust (JBT), and the Federal Deposit Insurance Corporation (FDIC) IG issued a MLR report on The Bank of San Diego (TBSD). We read these reports, reviewed their supporting workpapers, and interviewed Federal Reserve IG and FDIC IG officials and agency officials responsible for the supervision of these banks. This appendix summarizes the MLR reports' findings and recommendations.

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## Jefferson Bank and Trust

On December 27, 1993, the Federal Reserve IG issued a MLR report on JBT of Lakewood, CO, which failed on July 2, 1993. The report concluded that JBT failed as the result of a massive securities fraud perpetrated by its investment adviser. The investment adviser diverted approximately \$43 million worth of JBT's government securities for his own benefit and provided fictitious records to the bank so that it was not aware of the securities' diversion. In December 1991, JBT liquidated its account with the investment adviser. However, JBT was subsequently sued by the Iowa Trust, another client of the investment adviser, which claimed that a portion of its securities had been diverted to pay JBT. A U.S. District Court ruled in favor of Iowa Trust, and JBT was forced to turn over approximately \$43 million in government securities. Colorado closed JBT on July 2, 1993, because the bank was no longer solvent. The investment adviser pled guilty to defrauding the bank, and other investors, and was sentenced to a federal prison term.

The Federal Reserve IG's report on JBT also recommended steps that the Federal Reserve could take to improve its oversight of bank securities trading. For example, the report recommended that the Federal Reserve ensure compliance with a policy the IG contends limits the percentage of assets, such as government securities, that a bank can keep with a securities dealer. This policy, which is one of the recommendations for a bank's selection of a securities dealer included in the Board of Governors' Commercial Bank Examination Manual, sets guidelines for limiting the aggregate value of securities a bank should keep with a selling dealer. The IG concluded that if JBT had followed this recommendation with respect to the government securities diverted by its investment adviser, the bank would have sustained a loss of approximately \$1.6 million instead of its loss of approximately \$43 million.

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The Board disagreed with the IG's recommendation, contending that the policy does not apply to pure safekeeping arrangements, but only to those involving a credit risk arising from transactions between a bank and a securities dealer. Specifically, the Board maintained that the policy is an attempt to "limit banks' exposures to questionable securities transactions involving credit risks—not safekeeping risks." Thus, according to the Board, the policy did not apply to the arrangement between JBT and its broker-dealer because they had purely a safekeeping relationship, rather than a credit relationship.

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## The Bank of San Diego

On April 29, 1994, the FDIC IG issued a MLR report on TBSD, which failed on October 29, 1993. In December 1992, TBSD, with the approval of FDIC, merged with its two affiliates, Coast Bank and American Valley Bank, to form the consolidated TBSD. The report concluded that TBSD failed as a result of weak loan underwriting; concentrations in high-risk, real-estate loans; high overhead expenses; and inadequate oversight by bank management. The report stated that, in the 1980s, TBSD adopted a strategy of making high-risk loans to real-estate developers in southern California. By 1991, high-risk, real-estate loans comprised more than 50 percent of the consolidated bank's loan portfolio. The IG concluded that many developers defaulted on their loans in the early 1990s when the real-estate market declined in California. TBSD had inadequate capital and loan loss reserves to cover these losses, and California subsequently closed the bank.

The report concluded that FDIC's supervision of TBSD was in compliance with applicable laws and regulations and that it properly identified and addressed the conditions that caused the bank to fail. The report recommended that FDIC issue regulations to implement provisions in FDICIA that are designed to improve bank lending practices. The report also concluded that the FDIC's decision in 1992 to approve the merger between TBSD and its affiliates was reasonable. FDIC approved the merger so that the banks could reduce their expenses and so that managers responsible for their condition could be removed. However, the IG found that it may have been appropriate for FDIC to have obtained more current information about the banks' asset quality problems before it approved the merger. These asset quality problems proved to be more substantial than originally believed in December 1992 and resulted in the bank's failure the following October. FDIC generally concurred with the IGs' conclusions and recommendations.

# Comments From the Inspector General of the Federal Deposit Insurance Corporation

**FDIC**  
Federal Deposit Insurance Corporation  
Washington, D.C. 20429

Office of Inspector General

June 14, 1995

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 Investigate Costly Bank and Thrift Failures. We appreciate the opportunity to review and comment on the draft report as well as the efforts of your staff in conducting this review.

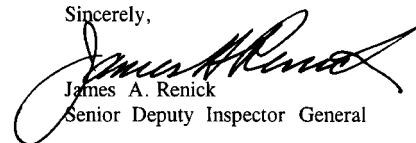
We are pleased that your report concluded that we have effectively positioned ourselves to satisfy our Material Loss Review (MLR) responsibilities as required by section 38(k) of the Federal Deposit Insurance Act (FDIA) as amended. As you stated, we have developed comprehensive and detailed audit guidelines for performing MLRs which represent a comprehensive approach for assessing the causes of bank failures and assessing the adequacy of their supervision and have taken a number of other steps to meet these responsibilities.

Your report also concluded that our report on the Bank of San Diego (TBSD) fully described and supported the reasons for the failure of the bank and provided important information about the causes of the bank failure and the quality of supervision. As you stated we also assessed the supervisory efforts of the bank regulators and recommended specific steps the regulators could take to improve their oversight efforts. It is your opinion that we could have more fully evaluated the effectiveness of the supervisory enforcement actions in the TBSD report and, notwithstanding the subjective nature of this opinion and the fact that two analyses of the same information presented in our report can reasonably result in different conclusions, we will take steps to do so in future MLR reports.

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.

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

Sincerely,



James A. Renick  
Senior Deputy 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

June 13, 1995

Mr. James L. Bothwell  
Director, Financial Institutions  
and Market Issues  
United States General Accounting Office  
441 G Street, NW  
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to comment on your draft report entitled *Inspectors General: Mandated Studies to Investigate Costly Bank and Thrift Failures*. We agree with the report's overall conclusion that the material loss review reports provide important information about individual bank failures and that we and the other Inspectors General have effectively positioned ourselves to carry out our responsibilities. As indicated in the report, we have coordinated extensively with staff from the FDIC and Treasury Offices of Inspector General to develop a common approach for conducting material loss reviews, to share information, and to resolve common problems. This coordination has facilitated the process of planning and implementing material loss reviews and we intend to continue to coordinate our efforts.

Overall, the results of the two material loss reviews that we have conducted to date have been positive. The reviews are an effective adjunct to our regular audits of the quality of banking supervision. While our regular audits are usually much more broad in scope, the material loss reviews allow us to focus on the implementation of the banking supervision policies and procedures over time relative to a particular bank. As additional material loss reviews are conducted, we may be able to make more broad-based recommendations as particular patterns develop either within the Federal Reserve or across the supervisory agencies.

While we agree that the material loss review process may not be the most cost-effective means of achieving improved bank supervision, we support performing the reviews and believe that legislative changes should be considered to enhance the reviews' cost-effectiveness. We believe that allowing the IGs greater flexibility to determine the number and timing of material loss reviews may facilitate the process and allow us to better manage our resources while still achieving the intent of the legislation.

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**Appendix IV  
Comments From the Inspector General of  
the Federal Reserve System**

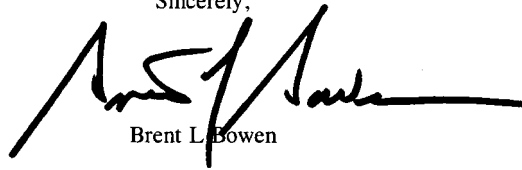
Mr. James L. Bothwell

- 2 -

June 13, 1995

We trust that these comments are helpful. If you wish to discuss any of these matters in more detail, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Brent L. Bowen". The signature is fluid and cursive, with a long horizontal stroke at the end.

Brent L. Bowen

# Comments From the Inspector General of the Department of the Treasury



DEPARTMENT OF THE TREASURY  
WASHINGTON

June 19, 1995

SPECTOR GENERAL

Mr. James L. Bothwell  
Director, Financial Institutions  
and Markets Issues  
General Government Division  
General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to comment on the General Accounting Office (GAO) draft report entitled, *INSPECTOR GENERAL: Mandated Studies to Investigate Costly Bank and Thrift Failures*, May 1995.

We believe the report accurately depicts the Treasury Inspector General's (IG) preparations, procedures, and audit guidelines to complete material loss reviews (MLR) mandated under section 38(k) of the Federal Deposit Insurance Act, as amended in 1991. As your report notes, our office had not completed an actual MLR as of February 28, 1995 because there had not been any failures of nationally chartered banks or thrifts meeting the requirements for a MLR.

Based on our two pilot MLRs however, we agree with your suggested options for congressional consideration as they relate to amending section 38 (k) to give the IGs flexibility in deciding the number, timing, and scope of MLRs. The enclosure discusses in further detail these matters, editorial suggestions, and technical points for clarification.

We would also like to commend your staff for the professional manner in which they conducted the review. Special thanks to Mark J. Gillen, Assistant Director, and Nolani T. Courtney, the Evaluator-in-Charge for giving us and the other IGs the opportunity to participate in a round table discussion to share our thoughts and experiences from conducting actual or pilot MLRs.

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**Appendix V**  
**Comments From the Inspector General of**  
**the Department of the Treasury**

Page 2 - Mr. James L. Bothwell

Again, thank you for the opportunity to comment on the draft report. Should you have any questions concerning the information in the enclosure, please feel free to contact Dennis Schindel, Deputy Assistant Inspector General, Office of Audit at (202) 927-5240.

Sincerely,



Valerie Lau  
Inspector General

Enclosure

**Appendix V**  
**Comments From the Inspector General of**  
**the Department of the Treasury**

**Department of the Treasury**  
**Office of Inspector General Detailed Comments to General**  
**Accounting Office Draft Report, INSPECTOR GENERAL: Mandated**  
**Studies to Investigate Costly Bank and Thrift Failures,**  
**May 1995.**

Now on pp. 4 and 5.

BACKGROUND section, page 7., regarding section 38(k) requiring IGs to "investigate" failures of depository institutions. Reference to investigations is also made in footnote 2, page 2:

The word "investigate" carries certain connotations which may go beyond the actual requirement for the IGs to review and report on the agency's supervision of the failed institution. To avoid any misinterpretation, we suggest using the legislative language in describing what is required of the IGs when completing MLRs.

Now on p. 9.

MLR AUDIT GUIDELINES ARE ADEQUATE section, page 17., notes that the Treasury IG could choose to do loan reviews if they determined that OCC's records did not adequately address or develop the problem(s) that resulted in a bank's failure:

We suggest rephrasing this to avoid the impression that such a review is a matter of staff choice. Our guidelines actually note that such a review will be necessary if OCC had not adequately identified significant causes of bank failure or the impact of a particular cause. While a loan review may be necessary at times, our pilot MLRs suggests that this can be a time consuming process, and that OCC and Office of Thrift Supervision (OTS) records usually provide sufficient leads and information on the causes of an institution's failure. Furthermore, such information can be corroborated with other sources of information without having to independently review loans.

Now on p. 16.

BENEFITS OF MLRs section, page 30., regarding our ongoing studies of OCC's implementation of various FDICIA sections:

This ongoing audit actually covers the OTS and not OCC.

Now on p. 16.

COSTS ASSOCIATED WITH MLR PROCESS section, page 31., regarding the Treasury IG's estimate of 40 percent of the staff being dedicated to CFO work in 1996:

Our most current estimate is now that 50 percent of OIG audit resources will be devoted to financial statement auditing.

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**Appendix V**  
**Comments From the Inspector General of**  
**the Department of the Treasury**

Now on pp. 19-20  
and 21.

Table 2: Option 3. page 36., and the MATTERS FOR CONGRESSIONAL CONSIDERATION section, page 39:

We agree with GAO's suggestion for the Congress to assess the cost effectiveness of MLRs relative to the intended benefit of improving bank supervision. Based on our two pilot MLRs, we believe that greater flexibility would be of benefit as they relate to determining the number, timing, and scope of MLRs. Such flexibility would assist us in the effective and efficient use of limited staffing, and also better ensure that we meet the legislative intent of completing MLRs.

Of particular value would be the timing of MLRs as to when they are started and how long we would have to complete them. Unless the Congress deems MLRs as time critical, starting a MLR within a year after failure rather than the time a material loss is booked by FDIC would facilitate planning and minimize disruptions to ongoing audits. Flexibility on the mandated 6 month period for completing MLRs would provide similar benefits.

# Major Contributors to This Report

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General Government  
Division, Washington,  
D.C.

Nolani T. Courtney, Evaluator-in-Charge  
Wesley M. Phillips, Evaluator  
Phoebe A. Jones, Secretary

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Office of the General  
Counsel, Washington,  
D.C.

Paul G. Thompson, Attorney

---

San Francisco Field  
Office

Bruce K. Engle, Evaluator

---

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