Compendium Report

SAFETY, SOUNDNESS, AND ACCESSIBILITY OF FINANCIAL SERVICES: Summary of Treasury OIG's Material Loss Reviews of Failed National Banks and Thrift Institutions Between 1993 and 2002

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Abbreviations

ALLL	Allowance for Loan and Lease Losses
BIF	Bank Insurance Fund
CEBA	Competitive Equality Banking Act
C&D	Cease and Desist
DIDMCA	Depository Institutions Deregulation and Monetary Control Act
DRR	Division of Resolutions and Receiverships

Contents

EV	Examiner View
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FFIEC	Federal Financial Institutions Examination Council
FHLBB	Federal Home Loan Bank Board
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FRB	Federal Reserve Board
FSLIC	Federal Savings and Loan Insurance Corporation
MLR	Material Loss Review
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
SAIF	Savings Association Insurance Fund
SBA	Small Business Administration
Treasury	Department of the Treasury

May 28, 2004

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In this report, we summarize the results of the 7 Material Loss Reviews (MLRs) of failed financial institutions that our office performed between 1993 and 2002 pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Collectively, the current estimated amount of losses to the deposit insurance funds for these 7 failed institutions totals approximately $1.7 billion. This report was prepared to provide bank regulators, Treasury officials, congressional oversight committees, and other interested parties a historical perspective on: (1) the circumstances that led to the 7 failures resulting in material losses, (2) our observations on the supervision exercised over these institutions, and (3) our recommendations to improve supervisory policies and practices. *It is important that this report be read with the understanding that the supervisory weaknesses noted relate only to the 7 failed institutions reviewed, and may not reflect the supervisory practices in place today at the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS).*

We are also providing as appendices: (1) our general audit approach and methodology for conducting an MLR (Appendix 1), (2) background on significant legislation during the 1980s and early 1990s impacting regulation of the financial industry (Appendix 2), (3) a summary of recommendations to the Treasury regulators

resulting from the 7 MLRs (Appendix 3), and (4) a list of our MLR reports (Appendix 4).

Background

The thrift industry crisis of the 1980s resulted in losses of approximately $153 billion.[1] During that time, or shortly thereafter, commercial banks were also failing in record numbers. Many of the circumstances surrounding the earlier thrift failures were also being manifested in the bank failures. In response, FDICIA was enacted to provide measures to sustain the bank insurance fund (BIF) as well as provide for regulatory changes to strengthen the banking industry. Included in Section 131 of FDICIA was a requirement for the Office of the Inspector General (OIG) of the primary federal banking regulator to conduct a review of the failed financial institution when the deposit insurance funds incur a material loss. Currently under FDICIA, a loss is considered material when it is the greater of $25 million or 2 percent of the institution's assets.

For an MLR, FDICIA requires that the respective OIG: (1) ascertain why the institution's problems resulted in a material loss to the deposit insurance fund; (2) review the primary regulator's supervision of the institution, including the requirements of Prompt Corrective Action (PCA); and (3) make recommendations for preventing any such loss in the future.

To date, the Treasury OIG has conducted 7 MLRs at 5 national banks and 2 thrift institutions. The first 2 MLRs were considered "pilots" since the losses occurred before such reviews were required by law. Table 1 on the next page lists the 7 MLRs we conducted along with the dates of failure, initial estimated losses, and the most current, or in some cases the final loss amounts incurred by the BIF or the Savings Association Insurance Fund (SAIF) as a result of the failure.

[1] As of December 31, 1999, the cost to taxpayers was approximately $124 billion and the cost to the thrift industry was another $29 billion (*FDIC Banking Review 2000).*

Table 1: MLRs by Treasury OIG (Dollars in Millions)

Institution/Location	Date of Failure	Initial Loss Estimate	Loss Estimate (as of February 28, 2004)
County Bank, Federal Savings Bank (FSB) Santa Barbara, CA (Pilot MLR)	3/27/91	$176	$103 (Final Loss Amount)
Mission Viejo National Bank, Mission Viejo, CA (Pilot MLR)	2/28/92	$47	$31 (Final Loss Amount)
Mechanics National Bank Paramount, CA	4/1/94	$36	$48 (Final Loss Amount)
First National Bank of Keystone (Keystone) Keystone, WV	9/1/99	A range of $750 to $850	$651
Superior Bank (Superior), FSB Oakbrook Terrace, IL	7/27/01	A range of $426 to $526	$436
Hamilton Bank, N.A. Miami, FL	1/11/02	A range of $350 to $500[(a)]	$149
NextBank, N.A. Phoenix, AZ	2/7/02	A range of $300 to $400[(b)]	$259
Totals		**A range of $2,085 to $2,535**	**$1,677**

Source: Treasury OIG MLRs, Federal Deposit Insurance Corporation (FDIC) Division of Finance.

(a) By June of 2002, the initial loss estimate for Hamilton Bank was reduced to a range of $175 million to $225 million.
(b) In November 2002, the initial loss estimate for NextBank was revised to a range of $300 million to $350 million.

Circumstances Leading to the Material Losses

Analysis of our MLRs indicate that deficient management at the institutions was often identified as a factor in the failures. However, the Keystone failure had an added dimension. Although management deficiencies were also evident at Keystone, fraudulent acts committed by the institution's management contributed to the institution's failure.

For the 6 other failed institutions, management developed either new high-risk products/services or high-risk variations for existing business strategies and implemented them without appropriate safety and soundness standards. These business strategies were then aggressively pursued with little or no regard to the necessary managerial expertise, adequate oversight by the institutions' boards

of directors,[2] or adequate risk management strategies. When problems arose, management was unable to restore the institution to profitability and avert further capital depletion. This strategy of investing heavily in high-risk activities without appropriate safeguards ultimately proved costly to the institutions and the deposit insurance funds.

Despite regulatory efforts at these institutions, a reversal of the trends proved impossible due to a heavy concentration[3] in inferior quality assets. In order to effectively manage high-risk activities, institutions must address the increased risks with increased controls. In each case, management did not develop or implement adequate policies, procedures, or managerial expertise prior to engaging in higher-risk activities and, in some instances, were non-responsive to regulators' efforts to correct these unsafe and unsound practices. The broad categories of deficiencies associated with the failed institutions are shown in Table 2.

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[2] Since the term "management" covers the board of directors as well as the executive managers of financial institutions, we will collectively refer to both of them as "management" throughout this report.

[3] A concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets in the aggregate may present a substantial risk to the safety and soundness of an institution.

Table 2: Failed Institutions – Common Deficiencies

Deficiency	Institution/Treasury Regulator						
	County Bank, FSB (OTS)	Mission Viejo National Bank (OCC)	Mechanics National Bank (OCC)	First National Bank of Keystone (OCC)	Superior Bank, FSB (OTS)	Hamilton Bank, N.A. (OCC)	NextBank, N.A. (OCC)
Deficient Management and Management Practices	X	X	X	X		X	X
Inferior Asset Quality	X	X	X	X	X	X	X
Accounting Weaknesses	X			X	X (1)	X	X
Over Reliance on Continued Growth in the Economy	X	X	X				
Fraud			(2)	X		(2)	

Source: OIG MLR Reports.

(1) Improper application of accounting principles for the valuation of asset securitizations and residual interests directly related to the failure of Superior Bank.
(2) The Small Business Administration (SBA) recently indicted several former officials at Mechanics National Bank. Charges were also recently handed down by the Securities and Exchange Commission in connection with the Hamilton Bank failure.

The broad categories of deficiencies identified in Table 2 are described below:

Deficient Management and Management Practices. At 6 of 7 institutions, some form of managerial deficiency was evident. We found that many of the institutions were headed by a passive board of directors, such as County Bank and Mission Viejo National Bank, and 5 of the institutions (County Bank, Mission Viejo National Bank, Mechanics National Bank, Keystone,[4] and Hamilton Bank) were dominated by one individual. Although each of the institutions had its own set of business practices, the absence of established prudent banking practices led to the decline of the asset structures. Examples of the lack of prudent banking practices included, but were not limited to, adopting speculative growth strategies, failing to implement adequate policies and procedures, engaging in poor loan underwriting, neglecting to establish limits on concentrations, and failing to implement an

[4] Although not specifically cited in our MLR report, OCC documents we reviewed during the MLR indicated that the institution was dominated by one individual until his death in 1997, and by another individual afterwards.

adequate system of internal controls. Management of the institutions generally embarked in areas where they possessed little or no experience or expertise, such as asset securitization.[5] Furthermore, management did not implement appropriate internal controls to mitigate the risks associated with the high-risk asset structures.

Inferior Quality Assets. Management engaged in aggressive growth, high-risk activities such as subprime lending and securitization. However, management did not implement safeguards to mitigate the risks associated with these activities, which resulted in, among other things, excessive concentration of high-risk assets. As a result, when problems developed, management was unable to stem the deterioration of the asset structure or curb the ensuing losses.

Accounting Weaknesses. Management at several of the institutions misapplied various accounting standards. The misapplication of the standards resulted in overstated earnings, which, in turn, inflated the institutions' capital accounts. For example, Superior Bank misapplied the provisions of Financial Accounting Standards No. 125, *Transfers of Financial Assets and Extinguishment of Liabilities*, which overstated its earnings and capital. When adjustments to income were required at this and other institutions to apply the standards correctly, the capital accounts were significantly affected by the reduction in income. In some cases, such as Superior Bank, the institution was unable to recover from the required capital reduction for the overvaluation of its assets. Other examples of accounting weaknesses included the failure to provide adequate funds for the Allowance for Loan and Lease Losses (ALLL), which occurred at Superior Bank, Hamilton Bank, and NextBank; and improperly recording expenses as assets, which occurred at NextBank.

Over Reliance on Continued Growth in the Economy. Although economic factors may have appeared to have adversely affected several of the institutions, the changes did not cause the

[5] Securitization is the process where interests in loans, generally mortgages and other receivables including credit cards and automobile loans, are packaged, underwritten, and sold in the form of asset-backed securities. A benefit of the securitization process is that it converts relatively illiquid assets (loans) into readily marketable securities with reasonably predictable cash flows.

institutions' failures. The economic downturns merely exacerbated the over reliance by management on a strong economy to support the institutions' high-risk activities. For example, County Bank relied on the robust real estate market to generate high-risk, high-yield loans. As long as the economy was flourishing, management continued to engage in speculative initiatives without implementing adequate safeguards. However, once the economy deteriorated, the inferior nature of the assets surfaced. Similarly, Mission Viejo Bank amassed profits as long as the real estate market was strong. However, once the economy declined, the effects of poor management surfaced. In cases like these, during cycles of economic decline, the already tentative abilities of some borrowers to repay further hamper management's efforts to restore profitability and maintain capital at regulatory minimums.

Fraud. Although fraud was only responsible for contributing to the failure of one institution, Keystone, it was also evident in two other institutions, Mechanics National Bank and Hamilton Bank. The existence of the frauds and related consequences at these 2 institutions were not known at the time we conducted the MLRs. Although the fraudulent activities at Keystone were known at the time of the MLR, the full extent of the activities was not known until after the MLR was completed. However, as we reported in our MLR of Keystone, examiners declared the institution insolvent after they were unable to verify $515 million in recorded loans. Another aspect of the frauds that came to light after our MLRs had been completed was that in all cases, the sources of the frauds were internal as opposed to external parties defrauding the institutions. This post-MLR discovery of a material contributing cause of an institution's failure does point to one limitation of an MLR. That is, the statutory requirement that a MLR be completed in 6 months upon determination of a material loss. In most cases, it was several years later that law enforcement and regulators surfaced the facts surrounding the fraud that resulted in losses.

Supervision Exercised Over the Failed Institutions

As part of an MLR, we assessed the regulators' supervision of the failed institution, including the implementation of the PCA requirements of Section 38 of the Federal Deposit Insurance Act (FDI Act). In this section, we discuss recurring supervisory

weaknesses noted in our MLRs. These weaknesses are summarized in Table 3 and described in more detail in Appendix 3. It is important to note, however, that these supervisory weaknesses relate only to the 7 failed institutions reviewed, and may not reflect the supervisory practices in place today at OCC or OTS.

Table 3: Supervisory Weaknesses

Regulator Weaknesses/ Difficulties Encountered	County Bank, FSB (1)	Mission Viejo National Bank	Mechanics National Bank	First National Bank of Keystone	Superior Bank, FSB	Hamilton Bank, N.A.	NextBank, N.A.
Non-identification or attribution of banks' problems	X	X (2)	X	X	X	X	X
Failure to review "red flags"		X	X	X	X	X	X
Failure to determine banks' true condition		X	X	X		X	X
Delayed supervisory response due to institution's apparent profitability		X	X	X		(3)	
Failure to expand scope of examination		X	X	X			X
Failure to implement enforcement action above the examiner level.		X	X	X		X	
Failure to recommend enforcement actions			X	X	X	X	
Failure to implement or pursue more stringent enforcement actions	X		X	X	X		X
Lack of examiners and/or experience	X				X	X	X
Failure to follow-up on past examination criticisms					X	X	X
Failure to verify information				X	X		X

Source: OIG MLR Reports-1993 through 2002.

(1) The Federal Home Loan Bank Board (FHLBB) regulated thrifts until the creation of OTS in 1990. Our MLR found that the FHLBB needed to be more proactive in its examinations of County Bank. Also, we noted that FHLBB examination conclusions did not match its underlying examination workpapers and other information. OTS did not regulate County Bank until the final year of its operations. In this regard, our only observed weakness of OTS' supervision was that it did not follow-up on certain actions taken against parties affiliated with the institution.
(2) Examiners did not identify management as the source of the institution's problems.
(3) The institution's capital level rather than profitability delayed actions.

By the regulators not identifying and/or acting on the early warning signs and the underlying causes of the problems, management at these institutions, in the absence of mitigating controls, continued to engage in activities that resulted in uncontrolled risk taking and the accumulation of high-risk assets. These activities resulted in a rapid deterioration in the financial condition at many of these institutions. Accordingly, it was not uncommon for the institutions to have satisfactory composite CAMELS[6] ratings at one examination and be on the verge of insolvency at the next examination.

Use of Enforcement Tools and Prompt Corrective Action

The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and FDICIA provided additional regulatory tools to address the problems experienced in the banking and thrift industries, including tools to deal with recalcitrant bank management. For example, FIRREA expanded and increased the dollar limits on civil money penalties. FDICIA expanded the authority of regulatory agencies by enacting PCA, requiring annual regulatory examinations, developing and implementing safety and soundness standards, and applying capital standards to restrict the use of brokered deposits.[7]

For the 7 MLRs, we found that OCC or OTS did not always use these tools in a timely and effective manner. Instead, examiners attempted to first persuade management to cease unsafe and unsound practices through less formal measures. When stricter actions were eventually imposed, the institutions were too

[6] Financial institution regulators use the Uniform Financial Institutions Rating System to evaluate an institution's performance. CAMELS is an acronym for the performance rating components: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. The Sensitivity component was added effective January 1997. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst rated banks.

[7] Brokered deposits are funds, which a bank obtains, either directly or indirectly, by or through a broker, for deposit into a deposit account. Brokered deposits include funds in which a single depositor holds the entire beneficial interest and funds in which the deposit broker sells participations to one or more investors. Under 12 CFR § 337.6, only "well capitalized" banks may accept brokered deposits without FDIC approval.

weakened from deteriorating asset quality, deficient capital, nonexistent earnings, and other factors to affect a recovery.

Section 38 of the FDI Act, *Prompt Corrective Action*, established regulatory capital minimums to assist in the regulation of financial institutions. PCA was intended to resolve problem institutions by providing more timely intervention by regulators to achieve the least possible long-term loss to the deposit insurance funds. Section 38 stratifies institutions into 5 capital categories ranging from the highest category referred to as "well capitalized" to the lowest category known as "critically undercapitalized." There are 3 other intermediate categories between these 2 extremes ("adequately capitalized," "undercapitalized," and "significantly undercapitalized"). The PCA categories are looked upon as rungs on a ladder. With this in mind, the way PCA is intended to work is that as an institution ventures down the "PCA capital ladder" from the top rung of "well capitalized" to a lower category, Section 38 provides for the application of more operating restrictions on the institution, and the federal banking regulators are required to take increasingly severe actions to attempt to halt further deterioration of the institution. These actions range from restricting certain activities, such as asset growth or dividend payments, to closing institutions that remain in a "critically undercapitalized" state.

PCA was used at 5 of the failed institutions.[8] However, PCA was unsuccessful in rehabilitating these institutions, as discussed below:

- At Mechanics National Bank, OCC initiated PCA the year prior to its failure. In this regard, OCC reclassified the institution's capital category from "adequately capitalized" to "undercapitalized" based on its unsafe and unsound condition. By doing this, OCC was able to dismiss two key individuals and effect the resignation of another individual who was responsible for the deteriorating condition of the bank. However, the bank's condition continued to deteriorate and once it became "critically undercapitalized," the bank was closed by OCC within 90 days as provided by PCA.

[8] County Bank and Mission Viejo National Bank failed prior to the effective date of PCA.

- The overstatement of Keystone's assets due to fraud precluded an accurate determination of its actual capital ratios in time for PCA to take effect. Once Keystone's capital was adjusted downward for the unsubstantiated loans, its PCA category fell from "adequately capitalized" to "critically undercapitalized" and the bank was closed.

- Although OTS used PCA in response to Superior Bank's problems, its usefulness was impacted by OTS' delayed supervisory response in detecting deficiencies at the thrift. It also appeared that OTS exercised regulatory forbearance by delaying the recognition of Superior Bank's true capital position in early 2001.

- OCC used PCA to reclassify Hamilton Bank's capital category from "adequately capitalized" to "undercapitalized," which restricted certain of its activities, after OCC concluded the institution had engaged in unsafe and unsound practices. However, due to the institution's weakened condition, it failed less than a year after OCC instituted PCA.

- Because of its operational deficiencies NextBank suffered an immediate drop in its capital category from "well capitalized" to "significantly undercapitalized" in October 2001. This immediately subjected NextBank to PCA restrictions, and OCC implemented additional restrictions. By December 2001, NextBank was unable to address its capital deficiency and the institution closed in February 2002.

In addition to PCA, regulators can effect changes in problem institutions through the use of informal and formal enforcement actions. Informal actions are (1) less severe than formal actions, (2) not legally enforceable, (3) not public information, and (4) generally entered into by consent. Examples of informal actions are Board Resolutions, Commitment Letters, and Memoranda of Understanding. Conversely, formal actions are severe remedies designed to address significant problems, violations, and non-compliance with prior enforcement actions. They are issued either by consent or following an administrative hearing and are generally public information. Examples of formal enforcement actions

include Formal Agreements, Cease and Desist (C&D) Orders, and Temporary C&D Orders.[9]

All 7 institutions were under some type of informal action, formal action, or both, prior to failure. Analysis of our MLRs pertaining to the recommendation, implementation, and follow-up of enforcement actions noted that: (1) the actions, whether formal or informal, were generally not stringent enough to address the institutions' deficiencies, (2) bank management was unresponsive to the provisions contained in the corrective measures, (3) progressively more forceful action was not always taken when management did not address and comply with the enforcement actions, (4) verification of compliance with the provisions of the various actions was not always performed, and (5) many of the actions were implemented too late to effect correction.

MLR Recommendations to Improve Supervisory Policies and Practices

We made a number of recommendations, detailed in Appendix 3, to address supervisory weaknesses noted in our MLRs. In each case, OCC and OTS management concurred with the recommendations, and instituted policies and procedures, expanded examination guidance, and took other corrective action that generally met the intent of our recommendations. For example, although both OCC and OTS use a risk-based approach to examine financial institutions, OCC expanded its risk-based approach to include a 9-point risk assessment process to facilitate the best use for examination resources. There is also a management review section in OCC's Examiner View (EV) system[10] that incorporates varying levels of supervisory review depending on the risks associated with the management factor. The regulators also actively monitor institutions that engage in high-risk activities. For example, OCC performs quarterly supervisory reviews on its community and mid-sized banks to determine if the institutions' ratings or risk profile

[9] Temporary C&D Orders are not public information.

[10] EV is OCC's automated examination system that contains modules addressing specific topics and varying levels of supervisory review. The level of supervisory review depends on problems noted at previous examinations and any additional potential areas at the institution that could affect the management component rating.

have changed. OCC revises EV as needed. Furthermore, both OCC and OTS update examination guidelines and issue memorandums and directives to examiners concerning various regulatory issues as they arise.

Additionally, following any national bank failure, OCC conducts a "lessons learned review." OCC initiated these reviews after the Keystone failure to determine if its supervisory efforts were adequate or if extra measures should have been instituted. OTS also conducted a "lessons learned review" after the failure of Superior Bank. Furthermore, the Federal Financial Institutions Examination Council (FFIEC)[11] publishes Financial Institution Letters to keep the financial industry appraised of agreements among the regulatory agencies regarding requirements or examination treatments for new or unusual items, or potential changes in, or the initiation of, outstanding or proposed regulations.

Office of Financial Institutions, OCC, and OTS Comments

We provided a draft of this Compendium Report to the Assistant Secretary for Financial Institutions, OCC, and OTS. The Office of Financial Institutions did not offer any comments on the draft. OCC staff provided several technical comments, which were incorporated in our final report as appropriate. OTS provided a written response, which is included in Appendix 5. In its response, OTS suggested that certain references on page 13 regarding the use of PCA at Superior Bank be deleted. The first reference relates to the appearance that OTS exercised regulatory forbearance by delaying the recognition of the thrift's capital position in early 2001. In this regard, OTS noted that it immediately placed Superior into receivership when it became clear that credible and repeated representations by Superior's ownership interests to infuse capital were not going to be honored. As discussed in more depth in our MLR report, and as indicated in the response, OTS provided Superior additional time to obtain capital even after it was

[11] FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the examination of banks by federal regulators (OCC, OTS, FDIC, the Board of Governors of the Federal Reserve System, and the National Credit Union Administration) established under Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978.

apparent the thrift was near insolvency. Accordingly, we did not make the suggested change to this report. The second reference relates to OTS failing to enforce PCA restrictions on senior executive bonuses. We revised our report and deleted the reference. OTS made several technical comments in its response which we addressed as appropriate.

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If you have any questions about this report, please contact me at (202) 927-5400. Major contributors to the report are listed in Appendix 6.

Marla A. Freedman
Assistant Inspector General for Audit

The objectives of an MLR are mandated by law. Section 38(k) of the FDI Act, 12 USC § 1831o(k), as amended by FDICIA, provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the Inspector General for the appropriate federal banking agency shall prepare a report to the agency, which shall:

- Ascertain why the institution's problems resulted in a material loss to the insurance fund;
- Review the agency's supervision of the institution, including the requirements of PCA; and
- Make recommendations for preventing any such loss in the future.

We initiate an MLR once our office receives written notification from the FDIC OIG that a material loss has been recorded on FDIC's books (i.e., loss is greater of $25 million or 2 percent of the institution's total assets). Our report is required to be completed within 6 months of the notification of a material loss. By law, we provide a copy of our MLR report to (1) the Comptroller General of the United States, (2) the FDIC, and (3) any Member of Congress upon request.

In performing an MLR, we:

- Interview OCC or OTS examiners, analysts, attorneys, and other personnel to obtain their perspectives on the institution's condition and the scope of the examinations performed at the institution.
- Interview personnel of FDIC's Division of Resolutions and Receiverships (DRR) and Division of Finance personnel who were involved in the receivership process conducted before and after the institution's closure and appointment of receiver. We also review the records of the failed institution in the possession of the FDIC DRR.

- Review OTS and OCC's supervisory actions to gain an understanding of (1) if or when deficiencies leading to the institution's failure were identified, (2) the approach used by the regulators to assess the extent of the deficiencies and the institution's condition, and (3) the regulatory actions instituted to compel management to address identified deficiencies.

- Review examination workpapers, files, and examination reports to determine the nature, scope, and conclusions regarding the regulatory review of the institution. A chronology of significant events is then developed.

- Assess the adequacy of regulatory actions taken based on internal guidance and legislative mandates.

- Inquire of appropriate law enforcement agencies about the existence and nature of any criminal investigations being conducted into the activities of the failed institution. These inquiries are made throughout the duration of the MLR.

If the institution was owned by a holding company, we also review relevant records of the Board of Governors of the Federal Reserve Board (FRB), and interview FRB staff. If the institution is owned by a thrift holding company, we also review relevant OTS supervisory records for the holding company. Our reviews of FDIC and FRB records and interviews with agency personnel are coordinated through the OIGs of these agencies.

Before we issue our report on an MLR, we provide a draft to OCC or OTS management for official comment. We also circulate the draft to FDIC and, as appropriate, to the FRB and law enforcement agencies, and consider any comments they may have when finalizing the MLR report.

We conduct the MLR in accordance with the generally accepted government auditing standards.

The 1980s and early 1990s ushered in numerous regulatory changes for the banking and thrift industries, the most notable transformation in regulation among these entities since the Great Depression. There were five major laws enacted between 1980 and 1991 that significantly affected the financial industry, and they are listed below:

- Depository Institutions Deregulation and Monetary Control Act of 1980;
- Garn-St Germain Depository Act of 1982;
- Competitive Equality Banking Act of 1987;
- Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and
- Federal Deposit Insurance Corporation Improvement Act of 1991.

By 1980, problems in the thrift industry were beginning to surface. In an attempt to remedy the troubles, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), which contained provisions that were intended to reduce and/or eliminate the problems. DIDMCA was also an attempt to deregulate a heavily regulated industry and create a level playing field for all financial institutions by removing several of the barriers that existed between banks and thrifts.[12]

When it became apparent that DIDMCA was not resolving the problems in the thrifts, the Garn-St Germain Depository Act of 1982 (Garn-St Germain Act) was enacted in an attempt to rescue the thrift industry. Broad areas affected by Garn-St Germain Act included the following:

[12] Areas affected by DIDMCA included establishing uniform reserve requirements, availing Federal Reserve services to all depository institutions, removing interest rate ceilings on maximum allowable deposit rates, authorizing the issuance of checking and negotiable order of withdrawal (NOW) accounts or their equivalents for all institutions, and increasing the deposit insurance level to $100,000. This is not an all-inclusive list; additional powers were also granted by DIDMCA. However, these noted areas contributed to significant changes in the industry.

1) Sources of funds were expanded and included the creation of money market deposit accounts, the ability of federal, state, and local governments to acquire NOW accounts, and the abolishment of any residual interest rate differentials on deposit accounts between banks and thrifts.
2) Thrifts were granted additional powers.[13]
3) Rules on lending and borrowing by national banks were revised.
4) Statutory restrictions on real estate lending by national banks were removed.
5) FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were empowered to provide assistance to troubled institutions.

Despite the expansion of powers granted through the enactment of DIDMCA and the Garn-St Germain Act, by 1987 the thrift industry was in crisis. The Competitive Equality Banking Act (CEBA) was passed in 1987 with the primary purpose of assisting the FSLIC[14] and eliminating the problems in the ailing thrift industry. Some of CEBA's major provisions included providing funds to recapitalize the FSLIC fund, creating a forbearance program for qualifying well-managed thrifts, and providing for stricter appraisal, accounting, reserve, and capital standards for the industry. Other provisions in CEBA were focused on efforts to encourage the acquisition of failing or failed institutions, whose numbers were increasing and reaching epidemic proportions - a total of 204 institutions failed during 1986 alone.

Attempts at regulatory intervention, in an effort to abate the thrift crisis, were not succeeding. Therefore, in 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which significantly restructured the regulation of the thrift industry. The statute abolished the FSLIC and established the

[13] Thrifts were permitted to invest a maximum of 5 percent of their assets in commercial loans and a maximum of 30 percent of their assets in consumer loans. The Act enabled them to also invest in local and State government revenue bonds.

[14] Prior to the establishment of the OTS and SAIF, the FHLBB was the primary federal regulatory agency and FSLIC was the insurer for the savings and loan industry.

SAIF, which is maintained by FDIC.[15] FIRREA also established the FSLIC Resolution Fund and the Resolution Trust Corporation to handle insolvent institutions that were formerly insured by FSLIC. The FHLBB, the regulator of the thrifts, was abolished and OTS was created as a Treasury bureau to regulate this industry. Stricter accounting, capital, and lending standards were also established for the industry.

In addition to the provisions directed at the thrifts, there were provisions of FIRREA that were applicable to commercial banks. The enforcement authority of primary federal regulators was greatly enhanced. Deposit insurance protection could be revoked more quickly and insurance coverage could be suspended on institutions with no tangible capital. C&D[16] authority was expanded to address specific activities. Temporary C&Ds could be issued for various actions including restrictions on the institution's growth. If a regulator determined that certain activities posed risks that could result in significant damage to the institution or if the institution's books and records were too incomplete to enable regulators to assess the true condition of the bank, a temporary C&D could also be levied. Civil money penalties that regulators could impose upon institutions were greatly increased. Additionally, banks that did not meet certain capital adequacy standards were prohibited from accepting brokered deposits without prior approval from the FDIC. Each federal financial regulatory agency was required to establish real estate appraisal standards. An Appraisal Subcommittee under the FFIEC was created under FIRREA to establish the standards.

As Congress continued to address the thrift crisis, the banking crisis continued to escalate and the number of bank failures began to erode the BIF. By 1990, the BIF required replenishment, and congressional efforts were concentrated on stabilizing the banking industry. The Federal Deposit Insurance Corporation Improvement

[15] FIRREA also established the BIF, which is also maintained by the FDIC. The BIF covers banks, and the SAIF covers thrifts.

[16] A C&D is a formal enforcement action that regulators can recommend for institutions or affiliated parties to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with the provisions in the C&D.

Act (FDICIA) was passed in 1991 and resulted in significant regulatory changes. To address the deficient insurance fund, the law increased FDIC's borrowing authority from the Treasury to cover insurance losses[17] with repayment to be derived from deposit insurance assessments. FDICIA also enabled FDIC to borrow on a short-term basis for working capital needs with repayment from asset sales from failed institutions. The recapitalization of the BIF was to occur within 15 years and the recapitalization of the SAIF within a "reasonable" time. Regulatory reforms were also included in FDICIA. One of the most prominent features was PCA. PCA required regulators to develop a laddering of five capital categories ranging from "well capitalized" to "critically undercapitalized."[18] The purpose of this laddering was so that as an institution's capital level dropped from one category to a lower category, regulators were empowered to enforce greater restrictions on its activities. Annual examinations[19] were also required. Although FDICIA contained numerous mandates that affected the financial industry, the most relevant provisions included requirements that:

1) Institutions with assets exceeding $150 million provide annual audited financial statements to their primary federal regulator.
2) Federal regulators develop safety and soundness standards relating to operations and management; asset quality, earnings, and stock valuation; and employee compensation.
3) Federal regulators revise risk-based capital standards to include interest rate risk.
4) Institutions adopt uniform standards for real estate lending.
5) Federal regulators apply capital standards to restrict the use of brokered deposits by financial institutions.

Additionally, FDICIA enacted provisions for deposit insurance reform, which required the implementation of risk-based premiums

[17] The limit was increased from $5 billion to $30 billion.

[18] The intervening capital categories were "adequately capitalized", "undercapitalized", and "significantly undercapitalized."

[19] The annual cycle was subsequently expanded to an 18-month interval for healthy banks with assets of less than $100 million.

by 1994. FDICIA also requires FDIC to use the "least cost" alternative in failed bank resolutions.[20]

[20] Least cost resolution is required unless there is a determination that this approach would result in a systemic risk of serious adverse effects on economic conditions or financial stability. Such a determination can only be made by the Secretary of the Treasury upon recommendation (by a vote of at least two-thirds of the members) of the FDIC Board of Directors and the Board of Governors of the Federal Reserve. In this event, the FDIC can take other action and or provide assistance to avoid or mitigate such adverse effects.

The following table summarizes (1) the causes of failure for the seven failed institutions reviewed by Treasury OIG, (2) the supervisory weaknesses noted with these institutions, and (3) our recommendations directed to OCC or OTS management to prevent future losses.

Table 4: OIG MLR Recommendations to OCC and OTS Management

Institution Name, Failure Date, and Principal Causes of Failure	Supervisory Weaknesses	OIG Recommendations
County Bank, FSB March 27, 1991 Decisions and practices by the Board of Directors and senior management resulted in: (1) speculative growth strategy; and (2) poor lending policies and procedures	FHLBB should have been more proactive by identifying County Bank's poor lending policies and practices in 1984 versus 1986. Also, FHLBB should have conducted more in-depth loan sampling during full-scope examinations between 1984 and 1989 to identify the extent of the asset quality problems.	We reflected in the report that legislative actions (FIRREA and FDICIA) addressed deficient areas by instituting measures such as (1) limitations on brokered deposits and (2) improved capital standards that require risk- based capital standards to consider concentrations of credit risk. We recommended that OTS: (1) determine if there was any merit in pursuing prohibition orders against any of the parties involved in the institution's failure and if so, a plan be developed to pursue the action before the statute of limitations expired; (2) determine if the likelihood of overlooking levying prohibition orders for thrift officials after thrift closures is a systemic OTS-wide problem and if so, a plan of action to address the problem be developed; and (3) continue to develop working arrangements to improve coordination and information sharing with other regulatory agencies, such as the FDIC or Resolution Trust Corporation.
Mission Viejo National Bank February 28, 1992 Poor management by the Board of Directors resulted in (1) deficient underwriting and loan administration and (2) reliance on volatile funding.	OCC failed to attribute the bank's problems to the institution's management. This was due to OCC's examination approach that devoted efforts to previously identified problems and potential risks. By the time OCC identified and reported the inadequate board supervision, the bank had too many loans that it could not sell and was unable to attract depositors to meet its daily liquidity needs.	There were no formal recommendations in the report. However, the report contained suggestions that OCC (1) require examiners to conduct management appraisals when problems remain uncorrected and (2) issue enforcement actions based on industry-wide standards as outlined in the Standards on Safety and Soundness as promulgated under FDICIA.

Table 4: OIG MLR Recommendations to OCC and OTS Management

Institution Name, Failure Date, and Principal Causes of Failure	Supervisory Weaknesses	OIG Recommendations
Mechanics National Bank April 1, 1994 Decisions and practices by the Board of Directors and senior management resulted in: (1) uncontrolled, rapid growth; (2) lack of expertise, systems, policies and procedures; (3) loans centered in speculative construction and development activities; (4) poor underwriting and loan administration; and (5) an adversarial relationship with regulators.	OCC's examination efforts could have been more proactive. OCC did not fully identify or address the managerial weaknesses or unsafe lending practices until a base of problem loans was established. If the management and lending problems were identified earlier, OCC may have initiated enforcement actions earlier.	The report did not contain any formal recommendations. The report did state that various changes including legislative actions, FIRREA and FDICIA, and changes in examination policies and procedures would address regulatory shortcomings by instituting measures such as: (1) enhancing enforcement actions including increased civil monetary penalties; (2) requiring annual full scope examinations; (3) enacting of PCA requirements restricting asset growth; (4) enacting of stricter controls over real estate lending; (5) incorporating Safety and Soundness Standards which requires regulators to prescribe guidelines relating to loan standards, growth, internal controls and auditing, and compensation; and (6) revising risk-based capital standards by incorporating the effect of concentrations of credit risk. Additionally, an Interagency Policy Statement was issued requiring banks to maintain an ALLL that considers both on and off balance sheet risks.
The First National Bank of Keystone (Keystone) September 1, 1999 Unsafe and unsound banking practice of including nonexistent loans on institution's balance sheet led to its insolvency. The overstated asset values were attributed to alleged fraudulent activities. The inadequate accounting systems and controls as well as uncooperative management masked the alleged fraud.	Despite finding significant problems, OCC generally did not perform more extensive examination procedures that may have revealed the true condition of the bank. OCC focused on the credit risk associated with the subprime mortgage loan securitizations rather the inaccurate financial records. The timeliness and types of enforcement actions may have been contributing factors.	We recommended that OCC: (1) issue guidance requiring risk assessment of bank's financial accounting, reporting, and controls to determine overall risk; (2) develop examination guidelines to determine when reliance upon external auditors' reports is not acceptable; (3) establish testing procedures for instances when the external audit reports are not acceptable; (4) enhance existing review procedures for enforcement actions that establish clear guidance on areas concerning what constitutes full compliance of a provision before an action is terminated, extended, or replaced, and the maximum time allotted to achieve full compliance with enforcement action provisions; (5) reassess current practices that permit use of concurrent informal actions for repeat violations; (6) reassess use of PCA reclassification as a vehicle to curb growth without adequate controls in place; (7) perform an assessment as to whether Keystone's failure necessitates a different supervisory response to mitigate ultimate risk exposure to the BIF. With respect to this last recommendation, the assessment should focus on high-risk growth, while addressing known unsafe and unsound practices; adequacy of existing regulations for brokered deposits; and certain interest rate restrictions.

Table 4: OIG MLR Recommendations to OCC and OTS Management

Institution Name, Failure Date, and Principal Causes of Failure	Supervisory Weaknesses	OIG Recommendations
Superior Bank, FSB July 27, 2001 Insolvency was due to extensive asset write-downs to correct improper accounting and valuation practices. OTS records trace these causes to thrift practices from possibly as early as 1993. The MLR details the problems that the OTS regulators experienced with management.	In the early years, OTS' supervision appeared incongruous with the institution's increasing risk profile since 1993. It was not until 2000 that OTS expanded examination coverage of residual assets and began meaningful enforcement action. OTS examinations lacked supervisory skepticism and assumed that the ownership interests would not allow Superior Bank to fail and would always provide any needed capital. OTS assumed that thrift management was experienced in and had implemented sufficient controls to safely manage the complexities and high-risks of asset securitizations. OTS also unduly relied on the external auditors to attest to Superior Bank's residual asset valuation.	We recommended that OTS: (1) ensure examination coverage of third party servicers by expanding guidance to include assessing management adequacy and controls to monitor and manage risks associated with third party servicers, evaluate risk factors and conditions to determine examination coverage, determine expected documentation for an assessment of nature and extent of third party relationships; (2) ensure adequate examination coverage is afforded to geographically dispersed operating units; (3) ensure adherence to OTS policies, require quality assurance reviews covering examinations when expanded assessments of external auditor's workpapers would be warranted; (4) reassess guidance to ensure adequate examination coverage of proper application of new accounting pronouncements and standards; (5) establish minimum testing procedures to ensure sufficient coverage of thrifts' valuation policies and procedures; (6) ensure that quality assurance reviews cover adequacy of examiner follow-up on previously reported problems; (7) assess whether appropriate enforcement sanctions should be pursued with respect to senior executive bonuses that were paid in possible violation of PCA restrictions; (8) assess the adequacy of existing supervisory controls to ensure thrifts' compliance with PCA restrictions; and (9) discuss with the FFIEC the need to assess if revisions to PCA are warranted with respect to brokered deposit restrictions.
Hamilton Bank, N.A. January 11, 2002 Failure attributed to rapid growth coupled with unsafe and unsound banking practices including aggressive growth, weak underwriting practices, and inadequate risk management systems and controls. The board was ineffective and management was non-responsive.	OCC's on-site examinations and enforcement actions could have been more forceful between 1992 and 1997. OCC did not fully identify or address management's weakness or unsafe lending practices until the institution established a base of problem loans. The OCC did not follow up on identified accounting deficiencies until 10 months later. OCC also did not follow-up to determine compliance with a Safety and Soundness Notice.	We recommended that OCC: (1) ensure the recommendations in from its "lessons learned" review of the Hamilton Bank failure are implemented as planned; (2) reassess the "lessons learned" review process to ensure coverage of all pertinent areas and provide support for recommendations and conclusions, (3) develop or revise policies to include examiner review procedures for institutions experiencing significant capital infusions, (4) reassess examination guidance regarding actions to be taken when examiners encounter unusual accounting transactions that warrant further investigation, and (5) establish controls to ensure timely examiner follow-up on bank compliance with enforcement actions.

Table 4: OIG MLR Recommendations to OCC and OTS Management

Institution Name, Failure Date, and Principal Causes of Failure	Supervisory Weaknesses	OIG Recommendations
NextBank, N.A. February 7, 2002 Failure is attributed to improperly managed rapid growth. NextBank's exorbitant growth was exacerbated by expansion in subprime lending activities	The first OCC examination was supposed to be a full-scope examination. However, the actual examination only included the lack of documented controls, the risk management systems, and whether or not the bank adhered to its business plan. Little, if any, portfolio analysis was completed, the actual impact of the absence of controls and management systems was not assessed, and the bank's true condition as a result of its rapid growth into subprime lending was not determined. OCC lacked examiners who were experienced in this area and did not provide adequate time to conduct the examination. The next examination revealed the deteriorating financial condition and quantified the understated losses associated with deficient accounting practices.	We recommended that OCC: (1) establish a process to allocate specialized examiners to institutions with a high or increasing risk profile. The process should be centralized to permit specialized requests and assigning resources and the pool of specialized examiners should be expanded based on emerging trends and industry developments; (2) reassess OCC's audit handbook for clarity and determining if procedures need to be expanded to incorporate reviewing external auditor's workpapers to determine compliance with generally accepted accounting principles; (3) reassess OCC guidance relating to a third party servicer, (4) assess the actual amount of brokered deposits for the fourth quarter 2001 to determine if further sanctions are needed, (5) seek clarification regarding OCC's authority to condition a change-in-control application, and (6) reassess the adequacy of OCC's guidance on how examiners evaluate the effects and risks presented by the parent entity to the bank.

Source: OIG Summary of MLRs from 1993 through 2002.

Following is a list of Treasury OIG MLR Reports issued from 1993 through 2002 that were the basis of this Compendium Report:

- *Pilot Audit of a Failed National Bank Under the Federal Deposit Insurance Corporation Improvement Act of 1991* [Mission Viejo National Bank], OIG-93-131, September 24, 1993.

- *Pilot Material Loss Review Under FDICIA: County Bank, A Federal Savings Bank, Santa Barbara, California*, OIG-94-059, March 22, 1994.

- *Material Loss Review Under FDIA: Mechanics National Bank, Paramount, California*, OIG-95-134, September 29, 1995.

- *Material Loss Review of the First National Bank of Keystone*, OIG-00-067, March 10, 2000. (See Report at http://www.ustreas.gov/offices/inspector-general/audit-reports/2000/oig00067.pdf)

- *Material Loss Review of Superior Bank, FSB*, OIG-02-040, February 6, 2002. (See Report at http://www.ustreas.gov/offices/inspector-general/audit-reports/2002/oig02040.pdf)

- *Material Loss Review of NextBank, NA*, OIG-03-024, November 26, 2002. (See Report at http://www.ustreas.gov/offices/inspector-general/audit-reports/2003/oig03024.pdf)

- *Material Loss Review of Hamilton Bank, NA*, OIG-03-032, December 17, 2002. (See Report at http://www.ustreas.gov/offices/inspector-general/audit-reports/2003/oig03032.pdf)

Office of Thrift Supervision
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May 25, 2004

Marla A. Freedman
Assistant Inspector General for Audit
Department of the Treasury
740 15th Street, NW, Suite 600
Washington, D.C. 20220

Dear Ms. Freedman:

Thank you for the opportunity to comment on the draft compendium report entitled "Summary of Treasury OIG's Material Loss Reviews of Failed National Banks and Thrift Institutions Between 1993 and 2002." Director Gilleran asked that I reply on behalf of the Agency. In the main, we have focused our review on the discussion of failed thrift institutions and offer no comment on the discussion of failed national banks.

We have a few comments regarding the discussion on the failed thrifts. We offer the following suggested changes to clarify the draft.

Page 6, footnote 1 to Table 2. Delete "Changes in accounting pronouncements" and substitute "Improper application of accounting principles". This change properly presents the situation and it aligns footnote 1 with the text in the middle of the first full paragraph on page 8.

Page 13, first bullet point. We recommend deleting the following two sentences: "It also appeared that OTS exercised regulatory forbearance by delaying the recognition of Superior Bank's true capital position in early 2001. OTS may also have failed to enforce one of the PCA restrictions over senior executives' bonuses." [1] Regarding the first sentence, the ownership interests of Superior made credible and repeated representations to OTS executive management that they would implement the capital plan and promptly infuse the necessary capital into the institution. When it became clear that this representation was not going to be honored, OTS immediately placed Superior into receivership. Regarding the second sentence concerning alleged bonuses, it appears that the payments at issue were deferred compensation payments, not bonuses. Despite extensive reviews by other federal offices, the payments in question have never been proven to be bonuses.

Page 18 of Appendix 1. In addition to the sentence regarding the Federal Reserve Board's holding company authorities, a parallel sentence regarding OTS's authority over thrift holding

[1] If the sentence regarding senior executives' bonuses is deleted, Recommendation 7 in Table 4 of Appendix 3 should also be deleted.

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companies should be added: "If the institution is owned by a thrift holding company, we also review relevant records of the OTS and interview OTS staff."

Please contact me or Randy Thomas (202-906-7945) if you would like further discussion of these issues.

Sincerely,

Scott M. Albinson

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