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# THRIFT FAILURES

## Costly Failures Resulted From Regulatory Violations and Unsafe Practices





United States  
General Accounting Office  
Washington, D.C. 20548

Comptroller General  
of the United States

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To the President of the Senate and the  
Speaker of the House of Representatives

This report presents the results of our review of regulatory and examination documents related to 26 thrifts which failed between January 1, 1985, and September 30, 1987. These 26 failed thrifts represented over 50 percent of the Federal Savings and Loan Insurance Corporation's estimated losses for institutions that failed during the 21-month period ended September 30, 1987. Serious internal control weaknesses contributed significantly to virtually all of these thrift failures. The Financial Institutions Reform, Recovery and Enforcement Act of 1989, H.R. 1278, which was approved by the House Committee on Banking, Finance and Urban Affairs on May 2, 1989, includes the reporting requirements we are recommending. We strongly urge that the Congress support these provisions, which we believe will help to ensure that the thrift industry crisis is not repeated.

We are sending copies of this report to the Chairmen of the Senate Committee on Banking, Housing and Urban Affairs; the House Committee on Banking, Finance and Urban Affairs; the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations; the House Committee on Energy and Commerce; and other interested parties. We will send copies to others upon request.

This report was prepared under the direction of Frederick D. Wolf, Assistant Comptroller General for Accounting and Financial Management. Major contributors to this report are listed in appendix IV.

A handwritten signature in cursive script that reads 'Charles A. Bowsher'.

Charles A. Bowsher  
Comptroller General  
of the United States

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# Executive Summary

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## Purpose

The thrift industry faces a crisis, and its insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), is insolvent. In 1988, more than 220 institutions were closed or merged, and more than 300 other institutions remained insolvent. Currently, GAO and others estimate that the cost of dealing with the industry's problems will be in excess of \$100 billion. On February 6, 1989, the administration presented to the Congress a comprehensive set of proposals for dealing with the crisis. GAO initiated this review to provide perspective on factors that characterized those thrift failures that have caused some of the larger losses to FSLIC.

The objectives of GAO's review were to (1) identify common characteristics of a sample of failed thrifts which were most costly to FSLIC, especially to determine whether violations of federal laws or regulations, related unsafe practices, and fraud and insider abuse were present, (2) compare and contrast those data with the characteristics of selected solvent thrifts, and (3) identify the impact of deregulation, the regional or local economic factors, and the federal regulator's supervision and enforcement efforts for both types of thrifts.

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## Background

Between January 1, 1985, and September 30, 1987, FSLIC merged, liquidated, began assisting, or anticipated assisting 284 thrifts. GAO reviewed a judgmental sample of 26 of these thrifts which represented over 50 percent of FSLIC's estimated losses at that time. GAO identified characteristics of these failed thrifts by analyzing examination reports, Federal Home Loan Bank System documents, records of civil suits, criminal referral forms, and other materials. GAO also interviewed thrift industry executives.

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## Results in Brief

Examination reports and related Bank Board data showed that regulators noted numerous and sometimes blatant violations of laws and regulations at the 26 failed thrifts in GAO's sample. Indications of fraud or insider abuse existed at all these failed thrifts. In contrast, the solvent thrifts generally complied with laws and regulations. When violations did occur, they were generally less extensive and severe than those at the failed institutions.

Changes in federal and state laws and downturns in some sectors of the economy were beyond management's control and affected all thrifts. The condition of some thrifts which eventually failed, weakened by their improper and/or unsafe practices coupled with higher-risk investments, was exacerbated by the adverse effects of the regional or local

economy. Thrifts that operated prudently generally survived the same adverse economic conditions.

Examination reports revealed critical problems at the 26 failed thrifts over extended periods of time. Management at these thrifts was often unresponsive to the concerns of regulators and violated written agreements or enforcement actions. In contrast, the solvent thrifts generally took corrective actions when regulators cited them for violations or deficiencies.

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## Principal Findings

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### Higher-Risk Investments and Regulatory Violations

Virtually all the failed thrifts changed from traditional home mortgage lending to higher-risk activities permitted under federal and more liberal state deregulation. Violations of laws and regulations made these business activities even riskier. Violations noted at the 26 failed thrifts included the following:

- 17 did not obtain accurate appraisals for real estate investment projects,
  - 23 exceeded the legal limit of funds that could be lent to one borrower,
  - 21 conducted business with prohibited persons or entities affiliated with the thrift, and
  - 24 did not adequately assess a borrower's ability to repay a loan.
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### Indications of Fraud and Insider Abuse

Indications of "fraud and insider abuse," as defined by the Bank Board, were evident at all the failed thrifts. A majority of the allegations of criminal misconduct at both the failed and solvent thrifts involved officers or directors. In contrast to the failed thrifts, where criminal misconduct was reported by Bank System personnel, allegations of criminal misconduct at the solvent thrifts were reported by thrift personnel—an indication of good internal controls.

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### External Influences Common to All Thrifts

Events outside the control of thrift management, including changes in the law and the economy, affected all thrifts. Poor regional economic conditions exacerbated the problems of the 26 failed thrifts, which engaged extensively in higher-risk activities, often in concert with violations of regulations and related unsafe practices. Bank Board data on 26 solvent thrifts exposed to the same regional economic conditions showed



that they generally complied with regulations, followed prudent business practices, and maintained diversified portfolios. This suggests that these practices enabled them to survive the economic downturns.

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### Problems Identified by Examinations Often Persisted

Federal examinations of failed thrifts documented over extended periods, as long as 5 years or more, numerous safety and soundness problems. Moreover, the ratings examiners assigned to these thrifts categorized them as requiring “urgent and decisive corrective measures” and noted that they required “more than normal supervision.”<sup>1</sup> In commenting on this long-standing pattern of regulatory violations and unsafe practices, Bank Board officials stated that the size and expertise of their regulatory staff have increased in the last 3 years. The Bank Board has developed new training programs and established a new office to oversee district bank regulatory efforts and ensure consistency nationwide. However, these actions occurred too late to head off the massive losses in the troubled segment of the thrift industry. In the future, if these actions are accompanied by prompt, aggressive enforcement, including closings, they would help provide a basis for better regulation. Finally, these actions do not address a basic structural flaw in the Bank System, namely that the Bank Board and district banks have multiple and conflicting roles as promoters, regulators, and bankers of thrift activities.

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### Recommendations

GAO is recommending that the Congress pass legislation which would (1) provide certain regulatory and examination responsibilities to the insurer and (2) require, as a condition for deposit insurance, thrift management to provide the federal regulator with management and auditor reports on internal controls and on compliance with laws and regulations. This should aid thrift management and the federal regulator in the prompt detection and correction of internal control weaknesses as well as reduce thrifts’ vulnerability to fraud, insider abuse, and environmental factors. (See chapter 10.)

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### Agency Comments

In commenting on a draft of this report, the Bank Board stated that attention should be focused on continuing the improvements in the examination and supervision processes that it has already undertaken rather than on legislative requirements for audit and management reports, as GAO has proposed. However, GAO believes these reports are

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<sup>1</sup>The effectiveness of the regulatory actions is currently being addressed in an ongoing GAO review

necessary if those processes are to ensure that thrifts have adequate systems of internal controls.

The Bank Board also stated that its multiple roles are incorporated into the statutory mission of the Federal Home Loan Bank System. GAO continues to believe that this current statutory structure possesses inherent conflicts which may hinder the Bank System from successfully fulfilling all these roles.

The Bank Board stated its belief that supervisory actions had halted a majority of the regulatory violations and unsafe or unsound practices at the 26 failed thrifts in GAO's sample. The Bank Board attributed the failure of these institutions to economic conditions and deficient management practices prior to supervisory actions. However, regulatory documents and other evidence GAO obtained from the Bank Board showed that violations and unsafe or unsound practices at these failed thrifts had often persisted for years. GAO noted that both the solvent and failed thrifts in the sample were affected by economic downturns in some regions. These conditions were not cited by examiners as the sole causes of failures. Rather, they exposed the existing weak management and poor internal controls of the failed thrifts, increasing their losses and driving some of them into insolvency. In contrast, thrifts that were operated in a prudent manner have generally survived the regional economic problems.

See the "Agency Comments and Our Evaluation" sections of chapters 9 and 10 and appendix III for a complete discussion of the Bank Board's comments.

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**Abbreviations**

ADC	acquisition, development, and construction
AICPA	American Institute of Certified Public Accountants
DOJ	Department of Justice
FASB	Financial Accounting Standards Board
FBI	Federal Bureau of Investigation
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	generally accepted accounting principles
OCC	Office of the Comptroller of the Currency
OE	Office of Enforcement
OMB	Office of Management and Budget
OPM	Office of Personnel Management
ORA	Office of Regulatory Activities
PSA	principal supervisory agent
SEC	Securities and Exchange Commission

# Introduction

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As of December 31, 1988, the Federal Savings and Loan Insurance Corporation (FSLIC) insured 2,949 thrift institutions, of which 2,585 (88 percent) were solvent with capital of \$59.4 billion, and 364 (12 percent) were insolvent with negative capital of \$13.2 billion, as measured by generally accepted accounting principles (GAAP). During 1988, FSLIC acted to resolve over 220 severely troubled institutions, at an estimated present value cost of approximately \$37 billion.

Traditionally, the thrifts' primary mission has been to ensure the availability of funds for home financing. Thrifts obtain their charters and legal authority to operate from either the state in which they reside (state-chartered thrifts) or the Federal Home Loan Bank Board (federally chartered thrifts). Thrifts chartered by either the federal or state governments are eligible for FSLIC insurance, which protects depositors' funds up to \$100,000.

The thrifts' charters and insurance status govern the laws and regulations under which they operate. State-chartered thrifts must comply with laws and regulations of the state from which they obtained their charters. These laws and regulations may vary from state to state. Federally chartered thrifts must comply with applicable federal laws and regulations adopted by the Bank Board for federal thrifts. In addition, all insured thrifts, regardless of charter, must comply with federal laws and the rules and regulations applicable to FSLIC-insured institutions.

Thrift examinations are the state and federal regulators' primary tool for ensuring that thrifts are operating in a safe and sound manner and are in compliance with applicable laws and regulations. State-chartered thrifts which have FSLIC insurance are subject to examination by both state and federal regulators.

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## The Federal Home Loan Bank System

In addition to FSLIC, the Federal Home Loan Bank (FHLB) System has several other components, including the Federal Home Loan Bank Board, the 12 regional Federal Home Loan Banks (or district banks), and the individual savings institutions that make up the thrift industry.

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## The Federal Home Loan Bank Board

The Federal Home Loan Bank Board was established by the Federal Home Loan Bank Act of 1932 (12 U.S.C. 1421 *et. seq.*) as an independent agency in the executive branch. Comprised of a chairman and two members appointed by the President and confirmed by the Senate, the Bank Board is responsible for regulating and supervising all federally

chartered thrift institutions and, in conjunction with state agencies, the state-chartered thrifts insured by FSLIC. It has delegated to the district banks the day-to-day responsibilities for examining and supervising thrifts. The Bank Board oversees the operations of the 12 district banks, FSLIC, and other entities related to home mortgages. It is also responsible for promoting the housing industry.

The Federal Home Loan Bank Board is authorized under the Home Owners' Loan Act of 1933 (12 U.S.C. 1461 *et. seq.*) and title IV of the National Housing Act of 1934 (12 U.S.C. 1724 *et. seq.*) to issue regulations and to enforce laws and regulations to carry out its duties. The regulations the Bank Board issues pursuant to these statutory authorities are contained in chapter V, title 12 of the Code of Federal Regulations.

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## The District Banks

The district banks two major functions are (1) providing thrift institutions with the funds to finance home ownership and (2) examining and supervising their member institutions. To provide the industry with funds to make loans and meet deposit withdrawal demands, the district banks make advances to member thrifts at interest rates at a slight premium over Treasury rates for comparable institutions. They also provide services such as check clearing, safekeeping of securities, demand and time deposit accounts, technical assistance, economic analysis, and access to the federal funds market.

The 12 district banks link the Federal Home Loan Bank Board with the member thrifts. In 1985, the Bank Board delegated its responsibility to examine and supervise member thrifts to the district banks. The examiners report to supervisory agents at the district banks who monitor the condition of the thrifts. The agents are responsible for providing day-to-day oversight and for instituting corrective measures at thrifts. The district bank presidents usually serve as the "principal supervisory agents" (PSAs). Since this regulatory role is so important, the presidents must be approved by the Bank Board, even though they are appointed by each district bank's board of directors. At the national level, the FHLB System's Office of Regulatory Activities (ORA) oversees and monitors these examination and supervision functions.

The supervisory agents have discretionary authority to require a thrift to take corrective action when examination reports reveal either unsafe practices or violations of law or regulations. Supervisory agents initiate



corrective actions through either informal meetings with the institution's management or documented actions, such as supervisory letters or written supervisory agreements. If the thrift's problems are not resolved, or the PSA believes that they are significant, the district banks alert ORA, which begins to monitor the thrift's status. The PSA can request that the Bank Board initiate a formal enforcement action, such as (1) a cease and desist order, (2) an order to prohibit or remove officers or directors, or (3) a termination of FSLIC insurance. If the PSA and ORA determine that the problems cannot be resolved without assistance from FSLIC, they can transfer the case to FSLIC for resolution. FSLIC becomes responsible for resolving a case once its personnel agree to accept the transfer.

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## Appointment of FSLIC as a Receiver for a Thrift

FSLIC may become a receiver or conservator of a federally chartered thrift when any of the following conditions is present:

- insolvency;
- substantial dissipation of assets or earnings due to any violation of law, rules, or regulations or any unsafe or unsound practice or practices;
- an unsafe or unsound condition to transact business;
- willful violation of a cease and desist order which has become final; or
- concealment of thrift books, papers, records, or assets or refusal to submit any such materials for inspection to any examiner or lawful agent of the Bank Board.

For a state-chartered thrift, there are three ways FSLIC can be appointed as receiver. First, a state court or other public official authorized to make appointments under state law may name FSLIC as a conservator, receiver, or other legal custodian. Under such an appointment, FSLIC may proceed in its appointed capacity without the approval of the state official having jurisdiction over the institution. Second, the Bank Board may appoint FSLIC as receiver or conservator when it determines that there is insolvency; dissipation of assets or earnings due to any violation of law, rules, or regulations, or any unsafe or unsound practice; or an unsafe or unsound condition to transact business. In order to appoint FSLIC as receiver, the Bank Board must obtain written approval from the proper state regulators that conditions specified by the Bank Board exist. If 90 days have passed without such concurrence, the Bank Board may then appoint FSLIC as receiver without state approval. Third, the Bank Board has exclusive power to appoint FSLIC as receiver if it determines that (1) state regulators have closed the thrift or have appointed a conservator or receiver who has been in that capacity for at least 15 consecutive

days, (2) the state closure or appointment was preceded by one of the five conditions which must be met for FSLIC to take over a federally chartered thrift, and (3) account holders are unable to make any withdrawals from their accounts with the thrift.

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## Objectives, Scope, and Methodology

The objectives of this review were to

- review data for a sample of the most costly thrift failures in order to identify common characteristics, such as violations of federal law, regulations, or related unsafe practices, and fraud and insider abuse;
- compare and contrast these data with the characteristics of selected solvent thrifts; and
- identify the impact of deregulation, regional or local economic factors, and the federal regulator's supervision and enforcement efforts for both types of thrifts.

Between January 1, 1985, and September 30, 1987, the Bank Board, through FSLIC, began assisting or anticipated assisting 284 insolvent institutions. These thrifts, referred to in this report as "failed" thrifts, include (1) FSLIC-assisted acquisitions, mergers, and liquidations, (2) thrifts at which FSLIC took over management, replacing the board of directors and management, and (3) thrifts which remained open but for which FSLIC anticipated a probable loss. From this sample, we judgmentally selected the 26 thrifts representing the largest actual or estimated losses to FSLIC as of September 30, 1987. These 26 thrifts represented over 57 percent of FSLIC's estimated \$20 billion loss associated with those institutions.<sup>1</sup> Appendix I shows the geographic distribution of the 284 insolvent thrifts, including the 26 insolvent thrifts in our sample.

We also identified a group of solvent thrifts which were similar in asset size, had positive net worth as of September 30, 1987, and were located in the same geographic areas as the 26 failed thrifts. We compiled a list of such thrifts and asked district bank regulators to identify well-managed, solvent thrifts, from which we selected a judgmental sample of 26.

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<sup>1</sup>This amount is only a portion of FSLIC's total losses for all failed thrifts. We chose the January 1, 1985, to September 30, 1987, time frame because of the record number of thrift failures and extraordinary cost of many of these failures. FSLIC has further increased its estimate of losses on these thrifts since September 30, 1987.

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In view of the ongoing criminal and civil investigations at some of the failed thrifts, as well as our long-standing policies of not disclosing the identities of "open" institutions, we have not identified the names of the 52 thrifts in our samples.<sup>2</sup>

The characteristics we noted and will discuss in this report consist of violations of various laws and regulations, unsafe and unsound practices, and other attributes identified by the Bank Board. We reviewed records prepared by the Bank Board staff, including examination reports, other documents and reports considered by the Bank Board or district bank before taking action against a thrift, civil complaints filed by FSLIC, referrals of alleged criminal activity, and other relevant documents. We interviewed federal and state regulatory staff, attorneys, managers hired by FSLIC to operate insolvent thrifts, and others. In addition, we interviewed the chief executives and the chairmen of the boards of directors of several solvent and failed thrifts. The results of this review are not intended to be predictive and do not necessarily reflect the characteristics which may be present at other failed thrifts.

Our fieldwork was conducted at the Federal Home Loan Bank Board in Washington, D.C., the Dallas and San Francisco district banks, and selected thrifts in Texas and California. We conducted our work between September 1987 and March 1989 in accordance with generally accepted government auditing standards. We obtained official agency comments from the Federal Home Loan Bank Board.

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## Thrift Examinations Identify Weaknesses at Failed Institutions in Our Sample

The weaknesses discussed throughout this report were compiled primarily from data in federal thrift examination reports and related documentation. Thrift examiners generally prepare examination reports on an exception basis, documenting what they believe to be a thrift's weaknesses rather than its strengths. During the examination process, examiners' criteria consist of laws, regulations, or related policy guidance focusing on the safety and soundness of thrift operations.

The laws and regulations for federally insured thrifts are numerous and specific, governing such areas as appraisals, loan applications, and conflicts of interest. While specific laws and regulations may not prohibit certain actions, regulators or examiners may nevertheless deem them to

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<sup>2</sup>31 U.S.C. 714 (c) precludes us from disclosing the identity of a specific open bank. While this act applies only to the federal commercial bank regulatory agencies, we have, as a matter of policy, extended the provisions of the act to all financial institution regulators.

be unsafe or unsound.<sup>3</sup> According to the Bank Board, unsafe practices are “contrary to generally accepted standards of prudent operation, the possible consequence of which, if continued, is abnormal risk or loss or damage to the institution, the shareholders, or the Federal Savings and Loan Insurance Corporation.”<sup>4</sup> In addition, thrift examiners may also include comments on other aspects of a thrift’s operations (such as its board of directors or management) or environment (such as local economic conditions). Table 1.1 shows weaknesses examiners cited and actions taken at the failed thrifts in our sample.

**Table 1.1: Characteristics of 26 Failed Thrifts in Our Sample**

	Number of thrifts	Percent
<b>Weaknesses cited</b>		
Inaccurate recordkeeping or inadequate controls	26	100
Change from traditional to higher-risk activity	26	100
Inadequate credit analysis	24	92
Inadequate appraisals	23	88
Excessive loans to one borrower	23	88
Growth with jumbo deposits	21	81
Transactions with affiliates	21	81
Conflicts of interest	20	77
Acquisition, development, and construction lending	19	73
Passive board of directors or dominant individual	19	73
Excessive compensation	17	65
Inadequate project analysis	17	65
Faulty loan disbursements	17	65
Change in control	16	62
<b>Actions taken</b>		
Supervisory agreement signed with district bank	22	85
Enforcement action taken by Bank Board	9	35
Criminal referrals	19	73
Civil suits filed by Bank Board	16	62

<sup>3</sup>For example, making loans to acquire land and subsequently developing an office-apartment complex on the land is not prohibited by law or regulation. If, however, a thrift has an inordinately high percentage of its loan portfolio invested in such endeavors within the same geographic area, an examiner might conclude that such a practice is unsafe because of the narrow concentration of risk.

<sup>4</sup>This definition was provided in a hearing before the House Committee on Banking and Currency in September 1966. The Deputy Director, Office of Enforcement, stated this definition is still used by the Bank Board and within the industry.

On the basis of documentation we reviewed, these characteristics represented sources of difficulty for the 26 failed thrifts in our sample. However, regulators did not cite any one of these characteristics as the sole contributing factor to a thrift's failure, but each of these characteristics related to some aspect of thrift operations directly within the control of the board of directors and management. Moreover, most of these characteristics also represent weaknesses in the thrifts' systems of internal control. An effective system of internal control as well as other factors, such as adequacy of capital, and external factors, such as regional or local economic conditions, play an important role in determining the ultimate viability of a thrift.

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## Organization of the Report

Chapters 2 through 5 discuss internal characteristics which examiners and regulators identified at the 26 failed thrifts in our sample. These characteristics were within the control of thrift management and reflect decisions made and actions taken by management, including business decisions and strategies, underwriting and loan administration practices, recordkeeping, and audits. Chapter 6 discusses investigative and legal actions related to alleged violations of laws and regulations, and chapter 7 compares conditions identified by examiners at the 26 solvent thrifts in our sample with those present at the 26 failed thrifts. Chapter 8 describes the effect of regional or local economic conditions on both the failed and solvent thrifts we reviewed. Chapter 9 discusses the role of regulators in taking supervisory and enforcement actions against failed thrifts, as well as thrift management's response to regulators and recent Bank Board initiatives to improve supervision and enforcement activities. Chapter 10 outlines additional measures which we believe are necessary to strengthen thrift management and to improve the supervisory and regulatory processes and presents our recommendations to the Congress. Appendix I contains information on the geographic distribution of thrift failures, and appendix II describes internal controls. Appendix III contains the Federal Home Loan Bank Board's comments on a draft of this report. A list of major contributors to this report is presented in appendix IV.

# Officers and Directors Breached Their Duties, Including Those Relating to Internal Controls

Regulators have often cited management-related weaknesses as leading factors in thrift failures. Moreover, for virtually all the failed thrifts included in our review, serious internal control deficiencies existed in various aspects of the thrifts' operations prior to their failure. Each of the weaknesses related to some aspect of thrift operations that was directly within the control of the board of directors or thrift management.

The broad objectives of internal controls are to safeguard assets; to ensure accuracy and reliability of data; to foster compliance with policies, laws, and regulations; and to promote management efficiency.<sup>1</sup> Maintaining an effective internal control structure to achieve such objectives is one of management's most basic responsibilities. Accordingly, we believe that when management fails to implement adequate internal controls or when it does not correct identified internal weaknesses,<sup>2</sup> management risks breaching its fiduciary duty to operate a thrift in a safe and sound manner. Management must be held accountable for establishing and maintaining effective internal controls.

The business decisions made and strategies pursued at the failed thrifts were often facilitated by passive boards of directors or by boards which were typically dominated by one or two individuals. All of the 26 failed thrifts made nontraditional, higher-risk investments and in doing so, according to examiners, violated laws and regulations and engaged in unsafe practices related to conflicts of interest, excessive loans to one borrower, and transactions with affiliates. Such actions were facilitated by the absence or circumvention of sound internal controls. Examiners also cited these thrifts for paying excessive salaries and making inappropriate expenditures. All of these characteristics are internal to the thrifts' operations and, thus, were within the control of thrift management. The Bank Board cited in its definition of fraud and insider abuse<sup>3</sup> many of the activities engaged in by the 26 failed thrifts in our sample.

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<sup>1</sup>See appendix II for a description of the internal control structure as contained in the American Institute of Certified Public Accountants' (AICPA) Statement on Auditing Standards Number 55, "Consideration of the Internal Control Structure in a Financial Statement Audit."

<sup>2</sup>Many of the problems in thrift operations described in chapters 2 through 5 constitute internal control weaknesses. Such weaknesses generally remained uncorrected despite regulators' efforts, primarily through the examination process and related supervisory actions (see chapter 9), to encourage thrift management to remedy identified internal control weaknesses.

<sup>3</sup>See the Bank Board's definition of fraud and insider abuse later in this chapter.

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## Passive Boards of Directors

Members of a thrift's board of directors have a duty to ensure that their thrift operates prudently and in a safe and sound manner so that depositors' money is adequately protected. By assigning directors many specific responsibilities, federal regulations imply that the board of directors must take an active role in operating the thrift. According to Bank Board documents, at 19 of the 26 failed thrifts, the boards took a passive rather than active oversight role or allowed one or a few individuals to dominate the thrifts' activities. For example, one member of a new executive team at a failed, but still open thrift, told us that directors of the thrift's board said they did not question business decisions of the former chairman of the board because he owned the thrift—they thought he could do as he pleased.

At one failed thrift, the president of the thrift initiated a construction lending program in 1980 whereby the thrift provided 100 percent of the financing in return for interest and a profit participation. The board of directors did not give serious review or consideration to the amount of capital involved or to the necessary staffing, recordkeeping, and monitoring requirements prior to adopting the new lending program. Moreover, without board oversight and control, the president and other senior management simply operated the program as they wished. Despite the fact that since 1982, examination reports pointed out problems with the new lending program, the problems were not corrected. In 1983, over \$500 million (approximately 16 percent of the thrift's assets) had been committed to the program. The thrift's board of directors dismissed the president in 1984 but still made little progress in correcting the previously cited deficiencies. Bank Board documents noted that, in the aggregate, "substantial losses" were incurred as a result of the lending program and additional losses were expected.

In 1983, the chairman of the board at another thrift made an offer to acquire a company before obtaining approval of the other members of the board of directors. Board approval was subsequently obtained via a telephone conference call, at which time the chairman portrayed the company as a good investment. Minutes of that meeting show that the pros and cons of the acquisition were not discussed. A motion approving the acquisition was unanimous. In effect, the board rubber-stamped the acquisition, which examiners later described as "an awful investment with dire impacts on the association's fiscal condition." Examiners classified the thrift's investment in and loans to the company as substandard in both 1983 and 1984. By 1985, examiners found that fully 70 percent of the thrift's losses were attributable to the acquired company.

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## Transactions Were Not Always Made in the Thrifts' Best Interests

According to the Bank Board, a thrift's board of directors and officers have a duty not to compromise the thrift's best interest in favor of their own or others' personal interest. However, almost all of the 26 failed thrifts made transactions that were not in the thrift's best interest. Rather, the transactions often personally benefited directors, officers, and other related parties. To protect a thrift's interest, several regulations limit or prohibit certain kinds of transactions. Regulations govern transactions with affiliates, conflicts of interest, and the amount of loans made to one borrower.

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## Transactions With Affiliates

Examiners found that 21 of 26 failed thrifts violated the regulation governing transactions with affiliates or engaged in related unsafe practices. "Affiliates" generally result from business relationships in which, due to common ownership, directors, or influence, people or business entities are closely tied to a thrift. For example, directors, officers, and their immediate families would be considered affiliated persons, as would individuals who control a thrift either directly or indirectly—for example, a stockholder who controls the appointment of a majority of the board of directors. An affiliate could also be a corporation which a thrift owns or in which it controls a majority of stock.

The president of a failed thrift included in our sample formed a separate corporation to receive loan referral fees for identifying borrowers for the thrift. The transactions between the thrift and the corporation constituted affiliated transactions which were prohibited by Bank Board regulation. In March 1984, the Bank Board informed the thrift that its president was an affiliated person who could not properly accept loan fees. However, even after this admonition, the president received almost \$1 million in fees. Moreover, Bank Board officials estimated losses to be a minimum of \$5.1 million on some of the loans to borrowers identified by the president's affiliated corporation.

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## Conflicts of Interest

Examiners found that 20 of 26 failed thrifts violated a regulation governing conflicts of interest or engaged in related unsafe practices. The Bank Board regulation addresses the need to prevent and eliminate practices and conditions that represent conflicts between the interests of a thrift and the personal financial interests of directors, officers, and other affiliated persons. According to the Bank Board, it is impossible to define every practice or condition which falls within the broad concept of conflict of interest. Nevertheless, the Bank Board has issued regulations that prohibit or limit certain activities deemed conflicts of interest.



In April 1984, a thrift's chairman attested to the Bank Board in writing that he had no interest in, and would receive no direct or indirect benefit from a proposed transaction which required prior Bank Board approval. The transaction regulators approved was for the thrift to buy a 50-percent interest in a real estate development firm for \$2 million. Instead, the thrift bought the 50-percent interest for \$1 million and paid a \$1 million finder's fee to another firm—a mortgage company. The mortgage company was 100-percent owned by the thrift chairman, who had previously signed an affidavit saying neither he nor his entities held any ownership interest, legal or beneficial, that would directly or indirectly benefit from the transaction.

Conflict of interest violations at the failed thrifts were not confined to officers and directors. At one thrift, the law firm that acted as the thrift's general counsel engaged in activities constituting conflicts of interest. At the same time the law firm represented the thrift, it referred borrowers to the thrift, represented both parties in the resulting transactions, received fees from both parties, allowed loans to close under terms materially different from those approved by the thrift, and failed to obtain documentation required for the loan commitments issued by the thrift.

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## Loans to Borrowers Exceeded the Legal Limit

Twenty-three of the 26 failed thrifts in our sample violated a federal regulation which limits amounts a thrift can lend to one borrower. For example, the regulation states that outstanding loans to one borrower should not exceed, in the aggregate, the lesser of 10 percent of a thrift's withdrawable accounts or an amount equal to the thrift's regulatory capital. Another regulation limits the amount of commercial loans to one borrower to 15 percent of the thrift's unimpaired capital and surplus. These regulations are designed to avoid situations in which a thrift's financial condition is dependent on the financial viability of any single borrower.

Examiners and the Bank Board informed one thrift on numerous occasions that loans to some of the thrift's borrowers exceeded the legal lending limit. The thrift gave repeated assurances that it would correct the violations but, in fact, did just the opposite, lending additional funds to those same borrowers whose loans already exceeded the limits. One of these borrowers who received \$88 million in loans stopped making payments; the thrift expected to lose at least \$23 million on transactions with this borrower.

Examiners warned another thrift that a series of loans made to one borrower from June 1980 through August 1981, totaling approximately \$30 million, exceeded the legal limit. During the next year, rather than decreasing the loan amounts, the thrift lent the borrower an additional \$10 million. Subsequently, the borrower filed for bankruptcy, and the thrift expected to lose at least \$10 million from these transactions. At this same thrift, another series of loans made to one borrower from 1979 to 1981 and totaling approximately \$54 million exceeded the legal lending limit. Nevertheless, in a following 6-month period, the thrift loaned an additional \$11 million to the borrower. The borrower defaulted on loan payments, and the expected loss is at least \$20 million.

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## Compensation and Other Expenses Were Excessive

Examiners cited 17 of the 26 failed thrifts for payment of excessive compensation to officers, directors, or employees. A federal regulation states that compensation to thrift personnel should not exceed a level that is reasonable and commensurate with their duties and responsibilities. Compensation includes salaries as well as bonuses, dividend payments, and perquisites for executives. On several occasions, examiners' efforts to restrain or reverse such expenditures were ignored or circumvented by thrift management. Several instances of excesses cited by examiners follow.

The chairman of the board of directors at one thrift resigned in January 1985 and then immediately entered into a "services agreement" with the thrift to perform the functions of his former position. The agreement called for a base pay of \$326,000 and a bonus if the thrift earned a profit. The agreement stipulated no bonus would be paid until after December 31, 1985. In July 1985, the Bank Board requested that the thrift reconsider the reasonableness of the compensation package. In August 1985, in addition to his salary, the thrift paid the former chairman \$500,000 in "special employee compensation." The Bank Board determined this payment was improper because the thrift lost almost \$23 million in 1985, and no bonus payment at all was to be made before December 31, 1985. In response, the thrift set up a committee to review the compensation and requested that the former chairman reimburse \$320,000 to the thrift. The former chairman declined to make any reimbursement; records we reviewed did not indicate if the thrift pursued the matter further.

Also, according to the Bank Board, the assets of another thrift were used to finance perquisites which were neither reasonably necessary nor business related, as shown in the following examples.

- The owner of 90 percent of the thrift's stock had the thrift buy an out-of-town beach house for \$2 million. He used the house as his personal residence for a year and a half but did not pay rent or other compensation to the thrift. Furthermore, the thrift spent over \$500,000 for personal expenses while he occupied the house.
- The thrift purchased or leased five airplanes (including two jets) and employed six pilots. The planes were used for personal, nonbusiness travel at a cost of \$5.5 million in just over 3 years.

The Bank Board found that another failed thrift made exorbitant and unjustified expenditures for purported business trips to Europe and the Far East by officers who purchased expensive suits, automobiles, and other items during the trips. On at least one occasion, such travel expenses were also paid for officers' families. The same thrift was cited for spending \$132,000 on a Christmas party, allowing the use of the thrift's plane for a fishing trip, and paying for over \$100,000 in personal expenses incurred by directors and officers. In addition, it spent over \$90,000 to decorate the president's office and bought a \$35,000 chess set.

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## Fraud and Insider Abuse

In a March 1988 report to the Congress, the Bank Board cited fraud and insider abuse as the most pernicious of all factors leading to the insolvency of thrift institutions. It broadly defined fraud and insider abuse in this manner:<sup>4</sup>

"...individuals in a position of trust in the institution or closely affiliated with it have, in general terms, breached their fiduciary duties; traded on inside information; usurped opportunities or profits; engaged in self-dealing; or otherwise used the institution for personal advantage. Specific examples of insider abuse include loans to insiders in excess of that allowed by regulation; high-risk speculative ventures; payment of exorbitant dividends at times when the institution is at or near insolvency; payment from institution funds for personal vacations, automobiles, clothing, and art; payment of unwarranted commissions and fees to companies owned by a shareholder; payment of 'consulting fees' to insiders or their companies; use of insiders' companies for association business; and putting friends and relatives on the payroll of the institutions."

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<sup>4</sup>In Federal Home Loan Bank Board Resolution 88-133, the Bank Board adopted a staff report describing the actions the Bank Board has taken or plans to take to prevent thrift insolvencies. The resolution also directs the staff to transmit the report, required by the Competitive Equality Banking Act of 1987, to the Congress. While we recognize there may be no universally agreed upon definition of the term "fraud and insider abuse," we used the term as the Bank Board defined it in that report to the Congress.

On the basis of the Bank Board's definition, we found that examiners and other Bank Board officials documented activities at each of the 26 failed thrifts in our study which appear to constitute fraud and insider abuse.<sup>5</sup> In addition to the prohibited transactions with affiliates, conflicts of interest, and excessive compensation and expenditures described in this chapter, some of the other violations of federal regulations and related unsafe practices described elsewhere in this report would also seem to fall within the Bank Board's definition of "fraud and insider abuse."

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## Conclusions

The Bank Board had cited the majority of the failed thrifts we reviewed for violations of laws and regulations prohibiting conflicts of interest and transactions with affiliates. In 1988, the Bank Board defined these and other characteristics as "fraud and insider abuse." The presence of fraud and insider abuse indicates management's neglect of its fiduciary responsibility to ensure the safe and sound operation of the insured institution.

These characteristics, combined with passive boards of directors at many of the 26 failed thrifts, contributed to a pattern of risky business transactions often made to benefit insiders, related parties, or others to the detriment of the thrifts' financial health. In many cases, even as the health of the thrifts deteriorated, management compensated itself and made expenditures which federal regulators said were excessive, violated sound business practices and, at times, a federal regulation on compensation. Such practices indicate a lack or circumvention of effective internal controls, creating environments in which the thrifts were vulnerable to abuse from thrift insiders and others.

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<sup>5</sup>A recent congressional committee report on fraud, abuse, and misconduct in federally insured financial institutions found that "over three-quarters of all S&L insolvencies appear to be linked in varying degrees to such misconduct [serious abuse by senior insiders or outsiders]." See Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Efforts Are Inadequate (House Government Operations Committee, House Report 100-1088, October 13, 1988, page 10).

# Business Decisions and Strategies

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In the early 1980s, liberalization of federal and state laws governing thrift activities permitted officers and directors of thrifts to develop new strategies both for attracting deposits to their institutions and for making use of deposited funds to generate income for the thrifts. Examiners documented that most of the failed thrifts in our sample chose to engage in activities which resulted in large inflows of deposits and potentially higher than traditional profits. However, such activities often entail greater risk, especially when combined with violations of laws and regulations, and examiners cited them as weakening the financial condition of a majority of the failed thrifts included in our review.

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## Changes in the Law

In the early 1980s, both federal and state laws applicable to thrifts were revised. These revisions led to changes in thrift business activities. In particular, two federal laws significantly affected thrifts. First, the Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980. Among other things, this act began phasing out restrictions on interest rates paid by all depository institutions (banks and savings and loans). This change meant that individual thrift institutions would face greater competition in attracting deposits.

The second law, the Garn-St Germain Depository Institutions Act of 1982, eliminated the statutory differential between interest rates payable by thrifts and commercial banks and also accelerated the phase out of interest rate restrictions begun by the 1980 act. Broader investment powers for federally chartered, FSLIC-insured thrifts were also authorized under the 1982 act. For example, the act authorized thrifts to

- make commercial, corporate, business, or agricultural loans, which after January 1, 1984, could constitute in the aggregate up to 10 percent of their assets;
- increase investments in loans secured by nonresidential real estate from 20 percent to 40 percent of their assets;
- invest in the time and savings deposits of other thrifts;
- invest up to 100 percent of their assets in local and state government obligations; and
- increase investments in consumer loans from 20 to 30 percent of their assets.

Although this law was not directly applicable to the investment powers of state-chartered, FSLIC-insured thrifts, several Bank Board officials believe such thrifts were indirectly affected by its passage. Prior to the Garn-St Germain Act, various states, including Texas and California,

had already given their state-chartered thrift institutions similar but broader authority to expand the types and extent of their investment activities.<sup>1</sup> (Twenty of the 26 failed thrifts in our sample were state-chartered.) For example, state-chartered thrifts in Texas could invest unlimited amounts in loans secured by nonresidential real estate, while federally chartered thrifts were limited to investing 40 percent of their assets in such loans. State-chartered thrifts in Texas could also invest unlimited amounts in commercial non-real estate loans, while the limit for federally chartered thrifts was 5 percent of their assets prior to January 1, 1984, and 10 percent thereafter. According to Bank Board officials, after passage of the Garn-St Germain Act, there was a proliferation of "me too" legislation among other states which expanded the investment activities of state-chartered thrifts where such authority did not previously exist.

## Volatile Deposits Solicited

Twenty-one of 26 failed thrifts solicited jumbo certificates of deposits (which have a minimum \$100,000 deposit) as a means of obtaining cash to make loans. Some of these jumbo deposits came directly from individual depositors, while in other cases, thrifts received deposits from a deposit broker—a person engaged in the business of soliciting funds from third parties. After soliciting such funds, the deposit broker would have a large sum of money to deposit in thrifts which paid a high interest rate. Consequently, thrifts had easy access to virtually unlimited amounts of deposits.<sup>2</sup>

Core deposits are considered to be those checking, savings, and time deposits which, in the aggregate, are not volatile and which have traditionally served as a thrift's basic deposit support. In contrast, large deposits, such as jumbo certificates, are particularly interest-rate sensitive and are considered volatile because they are controlled by relatively few individuals who can quickly move them from one thrift to another

<sup>1</sup>Of the 26 failed thrifts in our review, 10 were state-chartered in Texas and 8 were state-chartered in California.

<sup>2</sup>In 1984, the Bank Board issued a regulation which would, in essence, have virtually eliminated brokered deposit activity at thrifts by limiting to \$100,000 the deposit insurance for all funds placed in a single institution by the same deposit broker. The United States District Court for the District of Columbia set aside the regulation as invalid on the grounds that the statutes creating federal deposit insurance intended to grant to each depositor (the beneficial owner of the account) federal deposit insurance up to the statutory ceiling regardless of the means by which that depositor placed his funds in an insured institution. See *FAIC Securities, Inc. vs. U.S.*, 595 F. Supp. 73 (D.D.C. 1984). The Court of Appeals affirmed this decision. See 768 F.2d 352 (D.C. Cir. 1985). In 1985, the Bank Board adopted regulations which limited the amount of brokered deposits in institutions with low net worth. There has been no legal challenge to this regulation.

which pays higher interest. As a result, these deposits carry additional liquidity-related risks for a thrift, and, according to the Bank Board, a large volume of these deposits is not prudent. Nevertheless, some thrifts had staff who solicited such large, short-term (some were only overnight) deposits from professional fund managers nationwide, and even worldwide, as in the case of one failed thrift which sold jumbo certificates in European markets. Such operations are referred to as “money desks,” while the deposits, because of their volatility, are known as “hot money.”

Regulators documented the following instances of a thrift’s reliance on such volatile funding sources:

- At one failed thrift, jumbo deposits represented 96 percent of total deposits.
- Within 5 years, jumbo certificates went from 30 percent to 80 percent of total deposits at another failed thrift.
- In 1 year, brokered deposits grew from 14 to 86 percent of all deposits at another failed thrift.
- One failed thrift took in almost \$170 million of brokered deposits during a 6-month period—an average of over \$1 million per day.

A thrift which relies on such deposits is effectively forced to offer higher interest rates or face withdrawal of these funds. Paying high interest rates increases a thrift’s cost of funds, in turn exerting pressure on the thrift to make high-yielding, potentially risky investments in order to cover its cost of funds.

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## Thrift Management Pursued Business Decisions and Strategies Which Entailed Greater Risk

All 26 failed thrifts we reviewed began to pursue business strategies which involved nontraditional activities such as “direct investment” rather than funding traditional residential mortgages. While direct investment activities have the potential for producing greater income, they can be riskier than traditional mortgage lending because the thrifts’ profits essentially depend on the project being completed and achieving profitability.<sup>3</sup> While the Bank Board does not consider direct investment activities to be unsafe per se, they do consider them to pose potentially higher risks. Poor management of or an overreliance on such activities, combined with lax underwriting procedures (see chapter 4), ultimately proved to be a source of difficulty contributing to the failure of the 26

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<sup>3</sup>In 1985, the Bank Board issued a regulation to limit direct investment activity. See chapter 9 for a further discussion of this regulatory action.

thrifts we reviewed. The types of direct investment activities these thrifts started, continued, or expanded included

- providing funds to developers to acquire land and construct buildings with little or no developer equity;
- investing in real estate, including ownership in anything from raw land to a residential development to an established income-producing property;
- investing in equity securities, such as corporate shares of stock and investments in joint ventures; and
- investing in service corporations and operating subsidiaries which engaged in lines of business not related to the thrift industry.<sup>4</sup>

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## Acquisition, Development, and Construction Lending

Nineteen of the 26 failed thrifts provided funds to a developer to acquire land and construct some facility through acquisition, development, and construction (ADC) transactions. A typical ADC transaction was characterized by a potentially higher rate of return compared to traditional loans. Normally, thrifts provided most or all of the funds to developers to acquire land and build some type of office, condominium, apartment complex, or other facility, and, in doing so, the thrifts assumed most of the risk. To compensate for the risk, the thrifts charged a higher-than-market rate of interest and/or, in many instances, received a guaranteed part of any profits in the property. Generally, the failed thrifts released developers from any personal liability to repay the funds. If the developer defaulted, the thrift had only the property for recourse.

The Bank Board views ADC projects as generally speculative since the outcome depends heavily on future events. Therefore, overreliance on such activities can be detrimental to a thrift. Moreover, prudence would dictate that a thrift perform a study and analysis to determine marketability before funding a project. Such a study would determine whether there is a need for the proposed project, whether the project will be salable or rentable, and how long it will take to complete and market the project. Almost two thirds of the failed thrifts performed either no or inadequate marketability studies.

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<sup>4</sup>Through its proposed risk-based capital guidelines, the Bank Board has designated certain activities as having more risk. Under the proposed rule, those activities found at the failed thrifts and enumerated above would be in the highest-risk category. Thus, the proposed rule would require a thrift engaging in such activities to maintain three to six times the capital required for traditional mortgage lending activities. However, according to the Bank Board, with proper diversification and sound management, the nontraditional activities can be appropriate and desirable assets for a thrift, notwithstanding the greater risk they entail.



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Concentration of ADC Lending in Texas

Eleven of the 19 failed thrifts which funded ADC transactions were located in the Dallas district, and a substantial amount of their ADC lending was for projects in Texas, primarily in Dallas and Houston. The remaining 8 thrifts were located outside of the Dallas district, although several of these also funded ADC transactions for projects in Texas.

A thrift should structure its loan portfolio to mitigate the adverse effects of changes in economic conditions or situations where management has misjudged a market for particular investments. However, for the failed thrifts in our sample, ADC lending was concentrated in Texas and was done for projects which, when completed, were not in high demand. Property values in Texas decreased due to poor economic conditions and, according to one Texas economist, also due to thrift-financed overbuilding which exceeded reasonable levels of demand.<sup>5</sup> For example, examiners concluded that ADC projects financed by just one of the failed thrifts in our review contributed to the saturation of the rental markets in three major Texas cities—Dallas, San Antonio, and Houston. Because the markets were saturated, rent and occupancy rates were driven so low that virtually every rental complex financed by the thrift suffered a depression of value. Furthermore, the loans were poorly underwritten and many became delinquent, which forced the thrift to restructure loans at below-market interest rates and to extend terms to avoid foreclosure.

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Unsafe Nonlending Activities

Eleven of the 26 failed thrifts engaged in nonlending activities that examiners judged to be done in an unsafe manner, which contributed to the poor financial condition of these failed thrifts. Such activities included acquiring subsidiary businesses without adequate appraisals and unsafe investment transactions.

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Inadequate Appraisal of Businesses Thrifts Acquired

Bank Board guidance on factors a thrift should consider when acquiring a business specifies that

- thrifts should obtain an independent appraisal to substantiate the value of the business entity,
- the purchase price should be based on operating results for the current year and the 3 years prior to acquisition, and

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<sup>5</sup>The Estimated Economic Impact of Excessive Construction Financing in the Savings and Loan Industry on the Economies of Texas and the Dallas-Ft. Worth Area. M. Ray Perryman Consultants, Inc., Dallas, Texas, November 1987.

- the board of directors should review all documentation relative to the acquisition before approving the price and value of the purchase.

The failure of one thrift in our sample was attributable to losses from a business acquired without following this guidance. At another thrift, the condition of an acquired business significantly contributed to the thrift's demise.

One thrift purchased an out-of-state corporation which acquired, sold, and managed both undeveloped and developed real estate. Because the corporation was in another state, prudent judgment would dictate especially close adherence to Bank Board guidance to obtain maximum assurance of the entity's soundness. However, the board of directors did not review all documentation relative to the acquisition, nor did the thrift obtain a written appraisal of the corporation's assets or perform a complete financial analysis of its operations. According to the examination report, such an analysis would have disclosed that the corporation had slow sales, high cancellation rates, and other problems. More specifically, district bank supervisors said the thrift's decision to acquire the corporation was "fundamentally flawed and the product of unsafe practices" and that it was a major cause of the thrift's financial difficulties. After acquiring the corporation, the thrift sustained a \$15.2 million net loss in 1985—more than 70 percent of which was directly attributable to the acquired corporation.

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### Investment Transactions Pursued in Unsafe Manner

One thrift engaged in financial instrument transactions (such as agreeing to purchase securities on a specified date at a specified price) to reduce its interest rate risk exposure. In July 1984, the Bank Board specifically advised this thrift that these transactions violated federal regulations. Among other deficiencies, the thrift failed to maintain adequate documentation to record its strategies or purposes for the transactions, and the board of directors failed to ensure that applicable internal control procedures were established. Even after repeated warnings, the thrift continued its actions and, in May and June 1985, it lost over \$4.6 million on such transactions. The Bank Board also stated that the transactions were done in a "reckless, unsafe, unsound manner and in disregard of applicable Bank Board regulations."

Between March and December 1984, another thrift's investment in high-yield corporate securities ("junk bonds") grew to almost \$310 million, or 11 percent of its assets. According to the Bank Board, the investment in the junk bonds "constituted an unsafe and unsound practice" because

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the thrift failed to establish policies and procedures to select and purchase the investments, nor did the thrift review the financial condition of the companies that issued the bonds. The thrift lost over \$10 million on the investments.

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## Conclusions

The majority of the failed thrifts in our sample solicited volatile jumbo deposits, rather than relying on more stable core deposits to provide funds to finance lending activities. To cover the high interest costs of such deposits and to achieve profits, some thrifts pursued business strategies which entailed greater risk, such as direct investment activities. The risks associated with these activities were increased because the thrifts often had lax underwriting standards, engaged in unsafe practices, or violated federal regulations related to these activities.

The failed thrifts also incurred losses on other types of nonlending activities, such as acquisition of business subsidiaries or financial instrument investment transactions. While such activities are not prohibited per se by law or regulation, the fact that thrift management conducted them in violation of applicable regulations or in an unsafe manner raises concerns with management's ability to operate a thrift in a safe and sound manner.

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# Unsafe Underwriting and Lending Practices

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Traditionally, lending has been at the core of a thrift's activities, providing the greatest single source of earnings and accounting for the largest category of assets. The objectives of the lending process are to (1) grant loans on a sound and collectible basis, (2) invest the thrift's funds profitably, and (3) serve the legitimate needs of the community in which the thrift is located. A sound lending process requires general policies and procedures for maintaining the loan portfolio, as well as specific policies addressing credit analysis, loan documentation, credit administration, and establishment of adequate loan loss allowances.

Implementing adequate, prudent lending policies and procedures helps management and loan personnel maintain proper credit standards, avoid unnecessary risks, and properly evaluate new business opportunities. Such policies and procedures for granting and administering credit, however, should not necessarily be uniform or static. Rather, they should be sufficiently flexible to allow for fast reaction and early adaptation to changing conditions in the thrift's loan portfolio and service area. Moreover, management should periodically review the loan underwriting criteria, loan application requirements, and approval authority to determine the need for changes.

The Bank Board has provided federal regulations and other guidance that thrift management should follow in establishing sound lending policies and procedures. Bank Board documents for the 26 failed thrifts showed that their underwriting of loans and subsequent loan disbursements often did not conform to such regulations and guidance. Specifically, examiners reported that the failed thrifts did not always obtain proper appraisals for properties used as collateral, did not check borrowers' ability to repay loans, and lost control over loan disbursements.

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## Underwriting Deficiencies

Gathering loan documentation, complete and accurate data to use as a basis for credit decisions, is a fundamental aspect of granting credit and underwriting loans. Lending errors frequently result from management's failure to obtain and properly evaluate credit information. Current financial statements, such as the income statement and cash flow statement, and other pertinent financial data should be obtained and evaluated. Credit files should also obtain other essential information, such as the reason for the loan request, the intended plan or sources of repayment, progress reports, inspections and appraisals, and memorandums containing outside information and records of loan conferences. Sound credit management is difficult, if not impossible, if management fails to update and analyze credit data.

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## Thrifts Often Did Not Meet Requirements for Analyzing Borrowers' Ability to Repay Loans

To provide an increased margin of security for a thrift, one of the most basic steps in underwriting loans is to analyze a potential borrower's financial ability to repay. Relying solely on factors other than the borrower's ability to repay, such as character or collateral, to support credit decisions may lead to a buildup of problem loans and may increase a thrift's exposure to loss.

Federal regulations and Bank Board guidance require thrifts to obtain and analyze appropriate financial data on borrowers to determine creditworthiness. However, 24 of the 26 failed thrifts violated the regulation or engaged in related unsafe practices. When a loan application is made, federal regulation requires thrifts to obtain from the borrower a current, signed financial statement disclosing his or her financial ability to repay the loan, or a written credit report prepared by or on behalf of the thrift. Bank Board guidance indicates that borrowers applying for a loan to purchase, construct, or develop commercial properties should provide recently audited (or otherwise verified) financial statements and tax returns. The guidance further provides that such lending decisions should include a rigorous analysis of the borrower's ability to complete the project for which the loan is being made.

The failed thrifts in our sample usually did not sufficiently analyze the borrowers' financial ability to repay. Examiners often found that financial statements were not obtained, were not current, were not complete, or were not audited or otherwise verified by the thrift. Some financial statements showed insufficient ability to repay a loan or income far below what examiners deemed reasonable for multimillion dollar loans, yet the loans were made.

One thrift approved and disbursed loans totaling approximately \$40 million to one borrower to finance construction of residential and commercial developments. The thrift failed to perform adequate checks of the borrower's creditworthiness before making the loans. The borrower filed a petition for bankruptcy and the thrift lost at least \$10 million.

At another thrift, after borrowers defaulted on loans, the thrift granted new loans to repay the unpaid balances and delinquent interest on the defaulted loans. This history of problems notwithstanding, the thrift did not obtain financial statements from the borrowers or guarantors. The borrowers subsequently defaulted on the new loans as well. On another occasion, the same thrift made a \$3 million unsecured loan to a borrower, but his financial statements did not indicate any potential source

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of repayment. Moreover, the borrower's most current tax return showed gross income of just under \$50,000.

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## Poor Appraisal Practices

Appraisals are vital for both sound loan underwriting and also for investment decisions involving real property. Examiners noted violations of the regulations requiring appraisals for loans secured by real estate in 23 of the 26 failed thrifts. In addition, examiners noted that Bank Board appraisal guidance requiring feasibility studies for real estate investment projects, such as a commercial or industrial development, were not followed in 17 of the 26 thrifts in our sample.

According to Bank Board guidance, to help ensure that a thrift is protected through the life of a loan, an appraisal should provide sufficient qualitative information about the property or other security, including its use, its prospects for success, and other pertinent facts influencing its value. Bank Board regulations require thrifts to obtain a written appraisal report for a loan secured by real estate. The appraisal should be prepared specifically for the thrift by an appraiser, in accordance with policies established by the thrift's board of directors, and should be completed and signed by the appraiser prior to approval of the loan application. Among other requirements, the report should disclose the market value of the collateral and contain sufficient information to substantiate that value.

Bank Board guidance on the regulation further provided that if a proposed loan were for a real estate investment project, the written appraisal report should address the project's economic feasibility, that is, whether there is a need for such a development, whether it will be marketable as planned, and whether the anticipated income will be adequate, not only to cover expenses but also to provide the developer with the profit incentive to complete the project.

Examiners found the thrifts accepted appraisal reports that were not adequately or accurately substantiated as required. Other times, examiners noted that thrifts did not obtain an appraisal at all or obtained one only after a loan was already made. Examiners often noted that thrifts accepted appraisals requested by borrowers rather than by the thrift itself. Under such circumstances, the appraisal was prepared according to the borrower's instructions, not the thrift's, and in some cases the appraiser had not been previously approved by the thrift directors, as required by regulation. Bank Board officials told us, and examination reports confirmed, that appraisals often reflected only the "best case"

scenario for the property or project assessed. Sometimes, unfavorable information would be overlooked or high occupancy rates at top-dollar rents would be assumed.

To illustrate, when one thrift made a loan of over \$54 million to a borrower who bought an office complex, it relied on a borrower-ordered appraisal. Examiners found that the appraisal did not accurately assess the property's value because, among other reasons, it did not consider

- that more than half of the rentable space in the complex was already obligated by leases and options to lease at rates that were 50 percent below the current market prices, and
- that occupancy levels were low in nearby comparable properties as a result of newly built office buildings.

Examiners also noted instances in which thrifts did not obtain feasibility studies for development projects. For example, a thrift in California lent \$40 million to one borrower, principally to build condominiums and a shopping center, but no feasibility studies were done. Examiners stated that adequate feasibility studies would have shown that the area was already overbuilt with condominiums and shopping facilities before the loans were made. This thrift expects to lose over \$10 million on this project.

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## Other Underwriting Deficiencies

Numerous other underwriting practices in which thrifts engaged, although not always a violation of regulations, were considered unsafe by examiners. These include the following conditions:

- Borrowers had little or no equity in property or projects.
- Thrifts lent an amount that equaled or exceeded the purchase price or the appraised value of collateral.
- Loan approval terms were not followed.
- Borrowers were released from any personal liability to repay a loan.

Examiners noted many violations of the regulations related to applications, notes, deeds, and liens. We believe unsafe practices related to violation of or deviation from loan terms that had been established by thrift management at loan approval are especially significant. Federal regulations require that loan records show when and by whom loans are approved and any terms and conditions of such approval. Examiners noted that half of the 26 failed thrifts violated these regulations or engaged in related unsafe practices, such as significantly deviating from

the original terms without subsequent approval from authorizing thrift officials.

For example, in December 1982, a thrift's loan committee approved a \$5 million loan for a borrower to acquire and develop a ski resort. The approval also required

- the thrift to seek other lenders to finance the construction phase,
- the thrift to receive 25 percent of the total profits generated by the project,
- a 2-year maturity term, and
- an interest rate of prime plus 2.5 percent.

However, the loan did not conform to those terms; it was for 5 years and had a ceiling of 16 percent. Although \$2 million of the \$5 million loan proceeds was to be used for land acquisition, the borrower used \$1.8 million for other purposes and only \$200,000 to purchase the land. Further, the borrower did not invest any funds in the project. The thrift expected to incur a loss in excess of \$3.5 million on this loan.

In similar loans, examiners noted that borrowers not only had no funds of their own invested in the projects that the thrifts were funding, but these borrowers also personally received a portion of the funds when the loans were made. Thrift industry personnel refer to such arrangements as "drag loans" because the borrower "drags away" part of the proceeds.

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## Loan Disbursement Practices Were Unsafe and Violated Regulations

A federal regulation requires thrifts to maintain documentation showing the date, amount, purpose, and recipient of every disbursement made for a loan. Furthermore, the regulation requires that the identity of any recipient who is an agent for the borrower be documented. Examiners found that 14 of the 26 thrifts in our sample violated this regulation or engaged in related unsafe practices. Another federal regulation specifically requires thrifts to document that for each disbursement requested on development or construction loans, the work has actually been completed. Examiners found that half of the thrifts in our sample violated this regulation or engaged in related unsafe practices. Thus, 17 of the 26 failed thrifts exhibited faulty loan practices by violating one or both of these regulations.

Given the number and size of development loans which the failed thrifts in our sample made, the second regulation described above is especially



significant. If a thrift did not verify that development or construction work on a project was properly completed before disbursing loan funds, the thrift could be left with incomplete or poorly built projects that served as the collateral for funds it disbursed.

To illustrate, examiners found that one thrift's controls over disbursements for a loan to develop a condominium project were "poor or nonexistent." Specifically, \$7.6 million of a \$10.5 million loan was disbursed before the developer had even started any significant construction. Another thrift lent over \$6 million to construct a shopping center. The developer was to complete all site work and make improvements within 12 months of the loan's closing. However, after 15 months, only 3.5 percent (valued at \$31,000) of the site work had been completed, even though the thrift had disbursed over \$800,000, or 13 percent of the loan.

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## Other Unsafe Lending Practices

Although thrifts' primary mission has traditionally been to lend funds for home financing, they also engage in commercial and consumer lending. The failed thrifts in our review did so, and examiners noted instances in which such loans were made in an unsafe manner and in which thrift management lacked the expertise needed to evaluate these activities. Moreover, once such loans were granted, thrift management often failed to perform such actions as evaluating a borrower's financial condition on an ongoing basis, securing interests in collateral positions,<sup>1</sup> and implementing adequate collection procedures. Failing to maintain and evaluate current, detailed financial information once a loan is granted prevents accurate, ongoing risk assessment, which in turn can delay recognition of a problem and lead to actions that would be recognized as imprudent if the true financial condition of the loan portfolio were known. In addition, failing to secure an interest in collateral positions or to implement adequate follow-up and collection procedures, such as failing to enforce repayment terms, allowing borrowers to dictate or ignore repayment terms, or frequently renewing loans without requiring a significant loan repayment, can result in otherwise avoidable losses.

At one failed thrift, a borrower arranged loans to finance both his auto auction and auto dealership activities. The thrift lacked experience with these types of lending activities and, in some respects, relied on the borrower to establish and control the lending program. In making loans for

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<sup>1</sup>Securing an interest in collateral positions results in obtaining a legal right to pledged property in the event of loan default.

the auto auction activities, the thrift provided cash advances to the borrower which were secured by bank drafts (similar to checks) which the borrower received from purchasers at the auto auctions. The thrift remitted the bank drafts to the purchasers' banks for collection and then used the collections from them to reduce the borrower's loan balance. However, many of these drafts were never honored by the banks on which they were drawn. The thrift's computer system was unable to process the large number of these dishonored drafts, so it developed manual records for this purpose. The borrower was periodically given access to these manual records. After one of his reviews, pages of the manual records were discovered missing, and the account balance could no longer be reconciled to the thrift's detailed records.

The same thrift did not adequately collateralize its lending for auto dealership activities with the same borrower. The thrift essentially financed an inventory of autos for the borrower under a "floor plan" arrangement. When it provided funding for the inventory, the thrift would obtain from the borrower a list of cars which served as security for the loan. When a car was sold by the borrower, the portion of the loan attributable to that car had to be paid, or another auto had to be provided as security. When the borrower made payments on the loan, he did so by instructing thrift personnel to write and often sign checks drawn on his checking account at the thrift. When the borrower provided another auto as security on the loan to replace one sold, he did so by providing the replacement vehicle's identification number, often over the phone. The thrift did not obtain titles to the vehicles when securing the inventory loan, as good business practice would dictate. When the thrift tried to reconcile its loan records, vehicle numbers, and actual vehicles, it found that the identification numbers the borrower provided could not be matched to specific cars. The thrift's losses from the auto dealership and auto auction lending activities were expected to total almost \$4 million.

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## Unsafe Loan Purchases

Examiners documented problems at 9 of the 26 failed thrifts that purchased or participated in loans originated by other thrifts. Loan participations should be subjected to the same critical review and documentation requirements as those loans originated by the purchasing thrift. Federal regulations require thrifts making such purchases to obtain adequate documentation, including loan applications, notes, deeds of trust, and appraisals from the thrift which originated the loan. Additionally, the purchasing thrift should evaluate the selling thrift's loan underwriting standards to determine whether they parallel its own.

In fact, several of the failed thrifts in our sample bought participations from other failed thrifts in the sample which also did a poor job underwriting loans.

For nine failed thrifts, examiners noted that the thrifts violated federal regulations or engaged in related unsafe practices when they bought loan participations. For example, one failed thrift did not obtain basic underwriting documentation, such as appraisal reports and evaluations of borrowers' ability to repay loans, when it purchased loans from another failed thrift in the sample. Consequently, examiners could not assess the value of the security or the collectibility of the loans bought by the failed thrift. By June 1987, 90 percent of the \$313 million in loan participations bought by the thrift were either delinquent or in default.

At another failed thrift which bought many loan participations, examiners found violations of regulations and related unsafe practices, including deficiencies in determining creditworthiness. During an examination completed in April 1985, examiners found records for 11 loan participations totaling \$74 million that had no documentation to substantiate that the borrowers' unaudited financial statements had been verified. Due to the extent of the deficiencies, the examiners reviewed 20 additional loan participations totaling \$102 million. They found the following deficiencies, among others:

- 18 loan files did not contain credit reports,
- 15 loan files did not have financial statements, and
- 5 loan files contained financial statements that were unaudited, unverified, and/or unsigned.

The thrift promised examiners it would take corrective action. Subsequently, examiners reviewed 33 additional loan participations totaling \$147 million. The deficiencies were just as extensive as those which had been previously noted. This thrift was insolvent as of September 1986. Along with conflicts of interest and other regulatory violations, district bank officials stated that its "reckless and imprudent underwriting" caused its failure.

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## Conclusions

The failed thrifts in our sample often did not comply with regulations and guidance designed to help ensure that their interests would be protected throughout the life of the loans they made. While this noncompliance with regulations and guidance would have been detrimental to thrifts engaged in a traditional lending program, it was particularly

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harmful to the failed thrifts because they all engaged in various forms of the higher-risk, nontraditional lending described in previous chapters or, in some cases, granted credit in areas in which they lacked sufficient expertise. In addition, some thrifts purchased or participated in loans originated by other thrifts without performing sufficient reviews of the originating thrifts' underwriting standards. The violations and deficiencies related to underwriting and loan disbursements further increased their risks and their exposure to losses.

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# Deficiencies in Financial Information and Records Were Common at Failed Thrifts

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One of the basic elements of a system of internal controls is maintaining books and records in a manner designed to provide reasonable assurance that financial information is accurate and reliable. In this regard, federal regulations require thrifts to establish and maintain accounting and other records to provide accurate and complete information about their business. Documents we reviewed showed that all 26 failed thrifts were cited by examiners for deficiencies in accounting or other records, which can be considered indications of poor or nonexistent internal controls. Moreover, the lack of effective internal controls related to accounting records facilitates a thrift's violating regulations or engaging in unsafe practices.

In a June 1984 memorandum, the Bank Board stated,

"It is highly improbable that a thrift institution which is unable to maintain accurate and complete books can operate efficiently and/or profitably. Nor can it be expected that records in a state of disarray will allow for safe or prudent transactions."

Furthermore, other Bank Board documents reflected the view that violating regulations is probably indicative of severely deficient operating standards and a deteriorating financial condition.

Maintaining accurate and complete records is critically important to thrift management, stockholders, and depositors, each of whom may make judgments based upon the information provided by those records. Management must have accurate records to effectively analyze past performance and help establish and measure its attainment of long-term and short-term goals; stockholders need accurate reports from which to make investment decisions; and depositors, particularly those with deposits exceeding the insured limits, need accurate financial information to assess a thrift's viability.

Accurate and complete financial information is also vital to regulators in order to properly monitor the activities of insured thrifts. This need for accurate financial information is underscored by the fact that regulators generally did not close the thrifts in our sample until they were actually reporting insolvency. Given this condition, inaccurate books and records can impede needed regulatory action.<sup>1</sup>

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<sup>1</sup>The Bank Board made several legislative proposals to the Congress which it believes would expand its ability to take enforcement actions against institutions that do not maintain adequate books and records. (See chapter 9.)

To help ensure the development and reporting of accurate and reliable financial information, FSLIC regulations require all insured thrifts to be audited annually and to submit the audit reports to the district banks. However, we found that the potential benefits of annual audits may have been reduced because reports were not always submitted to the district banks on time. Additionally, other GAO work has noted that some audits did not meet professional standards.

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## Types of Problems Found

Examiners cited the following frequent problems with books and records of the failed thrifts: (1) unreconciled supporting detail, (2) misclassification of ADC transactions, and (3) understatement of loan and real estate valuation reserves. In several cases, regulators indicated that the books and records were in such disarray that the true financial condition of the thrift could not be determined.

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## Unreconciled Supporting Detail

Financial information reported in the financial statements and provided to regulators and others should be based upon detailed supporting records that agree with (or reconcile to) that financial information.<sup>2</sup> For example, the balance reported as loans receivable should be supported by a listing of every loan held by the thrift. Without this detail, which would include identifying by whom the money is owed, it would be difficult to collect the loans. A thrift may have several detail listings for the same loan portfolio which it would use for different purposes, such as collection and regulatory disclosure requirements, but each of these listings should reconcile to the total loan balance. At half of the 26 thrifts in our review, regulators indicated that the accounting systems produced unsupported or unreconciled balances, an indication of poor internal controls at the thrifts.

At one thrift, reports on loan activity were generated by two different computer systems as well as a manual system. These reports, which contained information about the same loans in different formats, did not agree with one another and had not been reconciled. Moreover, examiners described the records used to prepare the quarterly reports for the Bank Board, as "from no more than approximately correct to completely inaccurate" and reported the thrift's quarterly information was filled

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<sup>2</sup>All insured thrifts file quarterly reports with the Bank Board disclosing their financial condition, asset and liability composition, and other financial information. Regulators analyze the results of these reports, which often serve as an early signal that a thrift is in trouble. Through their periodic examinations of thrifts, regulators attempt to ensure that the information provided is accurate.

“with a multitude of unexplained figures apparently stored” in the controller’s memory. As a result, examiners could not determine the true financial condition of the thrift.

Consultants who reviewed the financial condition of another thrift found the quality of its financial information extremely poor. They reported that it “is unreliable to the point of representing an ‘unsafe and unsound’ condition, irrespective of the other regulatory requirements that have failed. People supply independently generated figures at the department level which are ‘plugged’ into company financials.”

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## Misclassified ADC Transactions

The accounting treatment of acquisition, development, and construction (ADC) transactions depends on whether the thrift classifies them as loans or investments. The two types of classifications result in different financial pictures. Thus, a thrift could possibly forestall regulatory action by using whichever classification resulted in the most favorable portrayal of its financial condition. Of the 19 failed thrifts participating in ADC transactions, examiners cited 11 for misclassification of such transactions. However, as discussed below, the lack of Bank Board guidance on the accounting for such transactions may have hampered examiners in some cases.

Generally, thrifts only became heavily involved in ADC transactions after the enactment of the 1982 law which removed some of the restrictions on investment activities. Although the accounting profession issued guidance in 1983 and again in 1984 on how to account for these transactions, it was not until 1986 that additional guidance was issued eliminating several loopholes which existed under the earlier guidance. In addition, the Bank Board did not provide any accounting guidance on ADC transactions until 1985.<sup>3</sup>

One district bank official expressed the view that guidance on ADC transactions was very “gray” prior to 1985. The official told us he sought guidance in this area from Bank Board officials but was told that the Bank Board was not going to act on this issue. He subsequently stopped questioning the accounting treatment of these transactions.

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<sup>3</sup>The Bank Board’s 1985 regulation parallels the accounting profession’s 1983 and 1984 guidance and was not updated to incorporate the 1986 changes. In an effort to comply with the provisions of the Competitive Equality Banking Act of 1987, the Bank Board withdrew this regulation effective November 10, 1988, adopting generally accepted accounting principles as provided by the 1986 guidance.

Bank Board officials admitted that there was a very real lack of accounting guidance regarding ADC transactions. They stated that they had repeatedly asked the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) for accounting guidance on these transactions. Bank Board officials indicated that, to adhere to generally accepted accounting principles, they attempted to follow the AICPA and FASB guidance, although the guidance was admittedly lacking.

#### Effect of Accounting Treatment

Under the 1986 accounting guidance, if an ADC transaction has a preponderance of characteristics generally associated with a loan, it should be accounted for as a loan. In contrast, if the transaction displays risks generally associated with a real estate venture, such as payment being dependent upon selling the project, investment accounting should be used.

Under loan accounting, the thrift would record fees and interest income during the term of the loan, thereby increasing net worth by the portion of income recorded each year. Under investment accounting, fee and interest income are generally deferred until the project is sold, resulting in no increase in net worth until that time.

The fee and interest income recorded from ADC transactions involved significant sums at several of the failed thrifts. At one failed thrift, the level of fee and interest income recorded from ADC transactions represented over 70 percent of the thrift's total operations. As a result, misclassifying such transactions as loans can materially misstate the operations and financial condition of the thrift, reflecting a more favorable financial picture than actually exists.

To illustrate, at one failed thrift, an audit adjustment was made which eliminated previously recorded income from ADC transactions which had been improperly classified as loans. This adjustment alone resulted in a reduction in net worth of over \$14.5 million, or from approximately 3 percent to 1 percent of deposit liabilities. This audit adjustment, along with others, rendered the institution insolvent.

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#### Loss Reserves Inadequate

Examiners cited 18 of the failed thrifts for failure to establish adequate loss allowances on loans and real estate. Accounting conventions require a reserve or allowance for loan losses to be established at a level adequate to absorb reasonably expected losses from uncollectible loans in a



thrift's loan portfolio. Loss reserves should be established on real estate when it becomes probable that the value of the real estate on the thrift's books cannot be recovered through a sale of the real estate project. Such an allowance provides information on the true condition of the loan and real estate portfolios and the results of operations (since loss reserves are charged against income) for decision-making and financial reporting purposes.

Examiners commonly cited these thrifts for not recording loss reserves on loans that were restructured while in default or on loans and investments that were made based upon inadequate appraisal and/or underwriting standards. At one failed thrift, examiners reported,

"It is a common lending policy to pyramid problem and/or maturing loans with unsecured loans to provide interest to carry the real estate loans. Land acquisition loans are refinanced at maturity for debt restructuring at higher amounts just for the sole purpose of providing interest carry with no development ever proposed."

Because these loans were then portrayed as "performing," the thrift did not record loss provisions. At another failed thrift, property appraisals or reappraisals ordered by examiners indicated unrecorded losses of \$39 million, resulting in the institution's insolvency and contributing to the Bank Board's decision to close the thrift.

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## Transactions Recorded in a Deceptive Manner

Thrifts are required to maintain specified levels of regulatory capital; if regulatory capital falls below these levels, the Bank Board can initiate administrative or enforcement actions.<sup>4</sup> Some of the failed thrifts recorded transactions that examiners concluded were designed to present a better financial picture than actually existed, thereby forestalling supervisory action.

In what examiners described as an attempt to restore net worth to meet its regulatory minimum requirement, one failed thrift recorded nearly \$21 million of income on several transactions on the last few days of December 1985. Subsequent review of these transactions by examiners revealed that (1) inadequate documentation was developed to support several of the transactions, (2) the amount of cash received on the transactions was inadequate to result in income recognition, (3) appropriate collectibility analysis was not performed on notes received in connection with several of these transactions, and (4) in at least one case, the thrift

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<sup>4</sup>See chapter 9 for a discussion of administrative and enforcement actions.

appeared to fund the downpayment it received on one transaction with the proceeds of another loan obtained with questionable collateral. The thrift's net worth would have been approximately negative \$12 million without these improper transactions, rather than the positive \$9 million its records showed.

Examiners also documented some thrifts' use of faulty appraisals, which permitted thrifts to artificially inflate their reported net worth, thus creating the appearance of a better financial condition than was actually the case. To accomplish this, some thrifts, primarily in Texas, engaged in elaborately complex transactions with several other entities in which they each bought and/or sold properties to each other at unrealistically high prices. The result was overstated asset values and the reporting of profits. Such deceptive arrangements became known in the industry as "daisy chains" or "network deals" made with "trading partners."

Under other arrangements, thrifts financed the purchase of their own stock to show an improvement in reported net worth, which at times was done for the purpose of meeting regulatory requirements. Often, the parties to such arrangements included more than one of the failed thrifts in our sample. An example of how such arrangements operated is described in a FSLIC civil suit.

FSLIC alleged that, in October 1984, a thrift knowingly paid an inflated price for interests in real estate partnerships with the understanding that the seller would use the excess proceeds from the sale to purchase the thrift's stock. The thrift invested \$6 million to build a multiuse community of office and industrial buildings, a golf course, and residential units. According to FSLIC's suit, the thrift did not obtain an independent appraisal but instead justified the purchase based upon an appraisal prepared for the partnerships.

The civil suit further alleged that this appraisal did not assess the value of the land in its then essentially undeveloped condition but rather assumed the site was fully developed as planned. Such an approach is not consistent with sound judgment, Bank Board policy, or general appraisal standards. According to FSLIC, a few months before its investment, the thrift itself had estimated the value of the property in its then "as is" condition at between \$2 and \$3 million, but nevertheless invested \$6 million in the project. Subsequent reappraisals confirmed that the thrift paid at least \$3 million more than the fair value for its investment. Nonetheless, the thrift's board of directors approved the investment.

The board members were aware that the transaction was being done to increase the thrift's net worth. Two months after the thrift's investment, its net worth increased by \$3 million due to the purchase of that amount of stock by the person who controlled the partnerships. Regulators term such an arrangement a "dirt for stock" transaction because it masks the fact that the thrift funded the purchase of its own stock, in violation of regulations.

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## Potential Benefits of Independent Audits Not Always Realized

Independent audits are a primary means of helping to ensure that adequate internal controls are in place and operating in a manner that provides accurate and reliable financial data, books, and records. While the Bank Board requires thrifts to submit annual audited financial statements to the district banks, delays in reporting, failure of thrifts to file audit reports, and some audits that did not meet professional standards may have diminished the effectiveness of this regulatory control.

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## Bank Board Requirements

The Bank Board is currently revising and updating its auditing and reporting guidance.<sup>5</sup> During the period of our review, the Bank Board required that an independent auditor's report on the financial statements and an auditor's report on any material weaknesses in internal controls, be filed within 90 days after the thrift's fiscal year-end. If an opinion other than an "unqualified opinion" (which in general terms means that the statements fairly reflect the thrift's financial condition) is received when appropriate action by the thrift could have removed any qualification, the Bank Board will generally reject the report (that is, the thrift will not have fulfilled its audit requirement). For example, an auditor's report that was "qualified" because the thrift would not record what the auditor believed were adequate loss reserves would be rejected because the qualification could have been removed if the thrift had recorded those reserves. In other words, the Bank Board expects thrifts to take corrective actions and to submit acceptable audited financial statements. Bank Board policy revisions are not expected to substantially alter these primary reporting requirements.

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## Timeliness of Filings

Of the 26 failed thrifts in our sample, information on audit reports was readily available on 9 from the San Francisco district and 7 from the

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<sup>5</sup>The Bank Board's PA-7 Bulletins provide the Bank Board's current guidance to independent auditors and thrifts on meeting the annual audit requirement. These bulletins include detailed examples of acceptable and unacceptable audit reports, internal control review procedures, procedures for requesting an extension of time to meet the audit requirement, and other matters.

Dallas district. The 9 San Francisco district thrifts should have filed a total of 27 audit reports in the 3 years prior to failure. Twenty-one of those 27 reports were filed late and, in 3 instances, no reports were filed at all. Information obtained for the 7 Dallas district thrifts reflected similar delays. Of the 21 reports expected to be filed in the last 3 years prior to failure, 13 reports were filed late or not filed. When reports were filed late in both districts, delays ranged from a few days to as long as 14 months.<sup>6</sup>

The Bank Board's district accountants attributed many of the delays to the auditors' inability to determine the underlying collateral value of loans and the value of real estate projects. Auditors, in attempting to meet the "no qualification" reporting requirements established by the Bank Board, tried to obtain additional documentation, such as appraisals, to verify those balances. For example, at one thrift, auditors requested over 150 appraisals to determine the value of its assets.

In addition, auditors' disagreements with thrift management over accounting matters resulted in delays. At one thrift where auditors and management disagreed over the adequacy of the loss provision, regulators attempted to resolve the issue by offering to meet with the auditors. Thrift management, however, threatened to sue the auditors if they met with the regulator. Although the auditors appeared cooperative, in view of the threatened litigation, they declined to meet with the regulators. The regulators finally issued a subpoena to obtain the auditors' working papers which discussed their disagreement with the thrift's management.

Delays in submitting audit reports did not always result in removal of audit qualifications. Even with the delays, thrift managements' inability to obtain adequate documentation to support the financial statements or other factors led auditors in the San Francisco and Dallas districts to qualify their reports in over 50 percent of the audit reports filed late by the failed thrifts.<sup>7</sup>

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<sup>6</sup>A request for extension of the time required to file an audit report can be granted at the discretion of district bank officials. Records of such requests and grants were not readily obtainable for the failed thrifts. In a 1985 memorandum to supervisory agents, the Bank Board Chairman at that time emphasized the need for the timely submission of audited financial statements and advised district bank officials that, contrary to practice in some districts, such requests for extensions should be granted in very limited circumstances.

<sup>7</sup>In an exception to the general rule requiring the thrift to submit an unqualified audit opinion, the Bank Board allows thrifts to report using regulatory accounting principles. Such reporting may result in an adverse audit opinion. This "acceptable" departure from an unqualified opinion has been excluded from the percentage of late reports filed with qualified opinions.

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Because auditors' reports were often late, regulators could not be confident that the financial information filed by thrifts was accurate. Nonetheless, the audit requirement was not entirely without benefit. One district bank's chief accountant told us that not receiving either an audit report or a request to extend the due date of the audit was often a first indication of problems at the thrift. Another chief accountant said that such circumstances tended to confirm regulators' suspicions of problems and, in some cases, may have prompted earlier-than-planned supervisory actions.

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## Changing Auditors

In addition to delays caused by asset valuation issues, changing auditors also caused delays and, according to regulators, became a tactic some thrifts used in attempting to report better financial results. For example, a failed thrift, which changed auditors for its December 31, 1984, audit, terminated the new auditor in March 1985 before the auditor issued an opinion on the financial statements. The thrift then proceeded to rehire the former auditor. The terminated auditor had disagreed with the thrift's practice of classifying certain items as income, most notably profit on simultaneous or near-simultaneous real estate purchases and resales ("land flips"), for which the thrift financed the resale. Apparently believing the former auditor would condone the practice, the thrift cited the accounting disagreement and delays in the audit as the reason for terminating the new auditor. However, after being rehired by the thrift, the first auditor resigned upon finding accounting irregularities. Regulators credit this auditor's firm with "blowing the whistle" on the institution by pointing out many accounting irregularities relating to land flips and similar transactions.

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## Audit Failures

In some cases, the auditors' failure to follow professional standards reduced the potential benefit of an audit. One former Bank Board official told us that there were many cases where the "tough, good" auditors who were following professional standards were fired, while those auditors who liberally interpreted the standards acquired clients and expanded their practices. He stated that the audit requirement could have been more effective if regulators had been more attentive to which auditors were hired and fired during the period from 1982 to 1984 and the reasons therefor.

The scope of this report did not include a review of the audit quality at the failed thrifts. However, our recent report on audit quality at failed institutions in the Dallas district found significant deficiencies in the

audits and the reports of material internal control weaknesses of selected failed thrifts.<sup>8</sup> Seven of the failed thrifts we covered in this review were included in that sample. Auditors of three of those were found to have been deficient in applying auditing and/or reporting standards.

FSLIC is currently investigating audit quality at some of the failed thrifts to determine whether civil litigation against the auditing firm is warranted. At one failed thrift (not included in the audit quality report), new thrift management officials told us they recovered a substantial sum from former auditors after the succeeding auditors required the thrift to restate its prior year's financial statements. Those restated financial statements showed that the thrift was severely insolvent when the previous auditors had opined that the thrift had substantial net worth.

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## Conclusions

Accurate books and records provide the foundation for appropriate management, investor, and regulatory decisions. Ineffective internal control systems at the failed thrifts resulted in deficiencies in accounting or other records at each of the failed thrifts.

Accounting for ADC transactions as loans rather than as investments may have contributed to masking the true financial condition of many of these failed thrifts. Unrecorded loss reserves for loans and real estate also masked the true condition of these failed thrifts.

While independent audits were at times credited with providing regulators valuable assistance, delays in obtaining timely audits and audit failures may have lessened or negated the benefit that could have been obtained had they been timely and well-conducted.

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<sup>8</sup>CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems (GAO/AFMD-89-45, February 2, 1989).

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# Investigations and Legal Activities Related to Failed Thrifts

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Investigative or legal actions related to alleged violations of criminal and/or civil statutes have been initiated against 25 of the 26 failed thrifts in our sample or persons associated with them. The actions included referrals of suspected criminal activities to the Department of Justice (DOJ), actual indictments for criminal violations, and civil suits filed by FSLIC against officers, directors, and other individuals to recover insurance fund losses and to deter others from operating thrifts in an unsafe manner. Criminal referrals were made on 19 of the failed thrifts. The majority of the persons involved in the alleged criminal activity were officers and directors. The most frequent allegation was making false entries in thrift books and records. FSLIC also filed 25 civil suits involving 16 of the failed thrifts and has initiated or has recently completed investigations related to 8 other failed thrifts to determine if civil suits should be filed.

The criminal referrals and civil suits further indicate the lack of or weaknesses in internal controls within the failed thrifts—a situation readily exploited by insiders. The suits filed by FSLIC against officers and directors and the criminal referrals made by Bank Board officials clearly support the Bank Board's belief that such exploitation occurred.

We were unable to analyze criminal referrals in depth because the Bank Board's confidentiality policies regarding alleged criminal activity limited the information it would provide to us. However, we summarized available data on the types of violations alleged, persons involved, and estimated losses.

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## Suspected Criminal Activity at Failed Thrifts

The Bank Board's Office of Enforcement (OE) provided us with (1) all referrals of alleged criminal activity which involved insiders and (2) any referral which district bank officials believed contributed to the demise of the thrifts. The 85 criminal referrals which met these criteria related to 19 of the 26 failed thrifts in our sample and, in the majority of cases, were made by FHLB System personnel.<sup>1</sup>

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<sup>1</sup>Other criminal referrals may have been filed directly with the Federal Bureau of Investigation (FBI) or a U.S. Attorney. In addition, Bank Board officials told us referrals may have been warranted, but would not have been filed, by Bank Board personnel when investigations by the FBI or U.S. Attorneys were ongoing. Thus, the 85 referrals we received from the Bank Board represent the minimum number filed.

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## Types of Alleged Criminal Activity

The 85 referrals contained allegations of 179 violations of criminal law. When provided in the referral, the criminal statutes most often cited concerned false entries, conspiracy, theft, embezzlement, willful misapplication of funds, and fraud. Other types of alleged violations included falsifying information on loan applications, and accepting kickbacks and bribes.

Allegations of making false entries under 18 U.S.C. 1006 have been made against individuals for preparing reports or statements with material omissions or misstatements with intent to injure or defraud an insured institution or to deceive a Bank Board examiner. The law also applies to any benefits received by an officer, agent, or employee of the institution from a transaction with intent to defraud. Forty-two violations of this law were alleged (23 percent of the 179 alleged criminal violations).

Under 18 U.S.C. 371, a "conspiracy" exists where two or more persons plan to commit a federal offense or to defraud an agency of the United States, and at least one of the persons acts to implement the conspiracy. In regard to federally insured thrifts, FSLIC is the government agency allegedly being defrauded because it insures the thrifts' deposits. The referrals contained 32 allegations (18 percent of the suspected violations) of individuals conspiring to defraud a thrift and, thus, FSLIC. Of these violations, 27 pertained to thrifts in Texas.

Allegations of theft, embezzlement, or the willful misapplication of an insured institution's funds (18 U.S.C. 657) by an officer, director, agent, or employee were made in 29 (16 percent) of the referrals.

Violations of three fraud statutes were alleged in 21 instances (12 percent of the violations). A bank fraud statute (18 U.S.C. 1344) governs schemes to defraud a federally insured institution or to take money, funds, credit, assets, security, or other property from the institution by false or fraudulent pretenses or representations. The other two fraud statutes (18 U.S.C. 1341 and 1343) apply to the use of mail or wire, radio, or television to defraud.

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## Persons Allegedly Involved in Criminal Activities

The 85 criminal referrals related to failed thrifts contained allegations of criminal violations against 182 persons. Some of the persons cited were involved with other federally insured institutions and/or related business enterprises. For example, in 13 referrals the suspect was affiliated with another federally insured institution. In other referrals, the



suspects were affiliated with a business enterprise related to the thrift industry, such as a real estate or finance company, at the same time that they were affiliated with a thrift. The majority of these allegations (113 instances or 62 percent), however, involved current or former officers (65 instances or 36 percent), directors (33 instances or 18 percent), or shareholders (15 instances or 8 percent). The remaining 69 individuals (38 percent) cited in the referrals included employees, customers, borrowers, agents, brokers, and others.

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## Amounts of Losses

In 34 of the 85 criminal referrals, the person making the referral stated that the alleged offense had a material impact on the institution's financial soundness. Although estimates of losses are subjective, such estimates were provided for 30 of these referrals. The amounts ranged from \$75,000 to \$313 million and totaled over \$510 million for the 12 thrifts involved.

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## Criminal Indictments and Convictions

The Department of Justice has established local working groups which pool the resources of the FBI, DOJ, and state and federal regulators, the agencies involved in the investigation and prosecution processes, in an effort to deal with crimes committed at financial institutions in the most efficient manner. The Dallas Bank Fraud Task Force, one such working group, was established in October 1987 to investigate and prosecute fraud connected with the extraordinary number of thrift failures in Texas. Criminal indictments have been brought against 47 individuals involved with 13 of the 26 failed thrifts, and federal officials expect additional indictments related to Texas thrifts.<sup>2</sup>

The relationships between the persons indicted and the thrifts and the statutes violated generally parallel those we saw in the criminal referrals. Many of those indicted were insiders—owners, presidents, and chairmen. Others were real estate developers, former owners and executives, lawyers, borrowers, and appraisers. The most common charges were conspiracy, misapplication of funds, fraud, and false statements.

As of March 1989, the Bank System had received information regarding criminal indictments, convictions, or acquittals associated with 13 of the 19 failed thrifts in our sample which had criminal referrals. According

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<sup>2</sup>The criminal referrals discussed previously may or may not have resulted in one of these actions. While information (such as the names of the persons and thrifts involved) on indictments and convictions is public, such information on the criminal referrals is not; thus, it was not possible for us to determine the relationship between them.

to this information, 27 persons had been convicted, 18 individuals were under indictment, and 2 people had been tried and acquitted. At least 15 of the 27 convicted pleaded guilty. In 19 of the 27 cases, the persons convicted were officers, directors, stockholders, or borrowers. Others included real estate brokers, an attorney, and a consultant. The Bank Board had sentencing information for 18 of the 27 convictions. Those convicted were sentenced to prison in 14 of the 18 cases. However, the prison sentences were generally for 6 months or less or were suspended with probation. These sentences are similar to those noted in a House Government Operations Committee report on criminal misconduct and insider abuse in the nation's financial institutions.<sup>3</sup> The report states that, on the average, prison sentences for convicted insiders are often suspended with probation; most convicted insiders who actually do go to prison spend less than 2 years there. For example, one former director of a failed thrift who pleaded guilty to receiving kickbacks was sentenced to 5 years in prison with all but 6 months suspended, given 5 years probation, and ordered to pay \$100,000 restitution and to fulfill 500 hours of public service.

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## Civil Suits

Bank Board policy states that civil suits are to be pursued when the Board believes that the thrift's failure was caused by management's violations of law and unsafe practices. In this regard, the Bank Board's written policy explicitly states that suits are not filed where thrift failure or problems are due to business judgment errors. Instead, the policy specifies that FSLIC, at the direction of the Bank Board should pursue "claims against individuals whose breach of fiduciary duty cause the collapse of an insured institution."

Private attorneys retained by FSLIC investigate activities of failed thrifts and prepare drafts of civil complaints when circumstances warrant such action. As of March 30, 1989, FSLIC had filed 25 suits involving 16 of the 26 failed thrifts in our sample. Attorneys were still investigating activities at 5 institutions. Investigations at 3 others had been completed and decisions were pending regarding litigation. The remaining 2 of the 26 failed thrifts were open, and FSLIC had filed no complaints.

The 25 civil suits included 10 related to failed thrifts in the San Francisco district, 9 in the Dallas district, and 6 in other districts. The suits included alleged violations of law and other unsafe practices related to

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<sup>3</sup>Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions (House Report 98-1137, October 4, 1984).

the same types of thrift activities discussed in the preceding chapters, including

- changes from traditional to higher-risk lending,
- expansion of trading operations,
- transactions with affiliates,
- mismanagement,
- inflated appraisals, and
- ADC loans.

Filing civil suits serves two purposes. First, it deters individuals from violating laws and regulations and conducting other unsafe practices. Second, it recovers losses FSLIC suffers when thrifts fail. The amount of recovery sought in the 25 suits was \$2.8 billion; FSLIC estimated its total losses on the 16 failed thrifts involved in these suits to be \$7.6 billion.

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## Conclusions

The allegations of criminal activity and the filing of civil suits suggest a management style characterized by violations of law, regulations, and unsafe practices which regulators cited and which we described earlier in this report. Moreover, the criminal allegations and civil suits, together with Bank Board policy governing these matters, suggest that the Bank Board believes that the willful violations of law and unsafe practices contributed to the failure of the majority of the 26 failed thrifts we reviewed.

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# Characteristics of Solvent Thrifts

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To compare the characteristics of the 26 failed thrifts in our sample with those of other thrifts, we reviewed a judgmental sample of 26 solvent thrifts. The 26 were similar in asset size to the original sample. They had positive net worth as of September 30, 1987, and were located in the same geographic areas as the 26 failed thrifts. However, the solvent thrifts differed significantly from the failed thrifts. In general, they refrained from extensively engaging in riskier business practices; complied with laws, regulations, and related Bank Board guidance; had better internal controls; and were responsive to concerns raised by regulators.

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## Pattern of Compliance

Examiners cited the 26 solvent thrifts for violations or unsafe practices much less than the 26 failed thrifts. Furthermore, the nature and extent of the violations or practices noted were generally less severe than those at the failed thrifts. For example, the loans-to-one-borrower regulation prohibits a thrift from lending large amounts of money to one borrower and specifies detailed recordkeeping provisions for such loans. Examiners record deficiencies in either of these two areas as violations. The violations or unsafe practices noted at the solvent thrifts were mostly related to recordkeeping deficiencies or other technical errors, rather than to the lending limit, the substance of the regulation.<sup>1</sup> Thus, the solvent thrifts' violations or unsafe practices differed significantly from those examiners noted for the failed thrifts, as described in previous chapters. Moreover, subsequent examination reports for the solvent thrifts generally revealed that violations had ceased and unsafe practices had been halted whereas violations and unsafe practices continued for long periods of time at the failed thrifts.

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## Thrift Management

Characteristics related to management included any change in the control (ownership) of the thrift and any comments examiners made regarding the board of directors or other management.

Solvent thrifts experienced changes of control (in general, a purchase of a thrift) much less frequently than the failed thrifts in our sample. Sixteen of the 26 failed thrifts experienced a change in control; typically, new management then led the thrift into nontraditional, higher-risk activities, such as those described in chapter 3. Examiners noted

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<sup>1</sup>The Bank Board's 1988 guidance to examiners and supervisors recognizes these differences in the nature and extent of violations. It emphasizes the prudence of activities rather than technical compliance with regulations.

changes of control at only three of the solvent thrifts and only cited one instance in which the change was detrimental to the thrift.

Examiners cited the presence of a dominant individual or a passive board of directors at 8 of the 26 solvent thrifts, compared to 19 of the 26 failed thrifts. In all but one instance, examiners perceived the dominant person to have had either no negative effect or a positive effect on the solvent thrift. For example, examiners reported that one dominant thrift president controlled costs effectively, thus helping the thrift to maintain a strong financial position. Moreover, the vast majority of the solvent thrifts had active boards of directors.

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## Business Decisions and Strategies

Unlike the failed thrifts in our sample, the solvent thrifts did not rely on jumbo or brokered deposits to finance their activities. Moreover, the majority of the solvent thrifts maintained diversified asset portfolios rather than concentrating on specific areas of lending activity, as was frequently the case with the failed thrifts in our sample.

Generally, the solvent thrifts solicited less volatile deposits, such as certificates of deposits under \$100,000 and money market accounts. Other solvent thrifts maintained branch networks which usually enabled them to attract more customers and thus establish a larger and more stable deposit base. While 21 of the 26 failed thrifts used jumbo deposits extensively, examiners noted similar practices at only 5 of the 26 solvent thrifts. In addition, only 5 of the solvent thrifts accepted brokered deposits, and they did so on a limited basis—only one of these thrifts had over 30 percent of its total deposits in brokered funds, and the other four thrifts had less than 10 percent.

The majority of the solvent thrifts maintained diversified asset portfolios with a wide variety of lending and investment activities, unlike the failed thrifts, which tended to concentrate their portfolios in riskier activities such as ADC lending. In addition to maintaining a portfolio of first mortgages on single-family homes, the solvent thrifts generally limited their lending activities in

- apartment projects;
- automobile and other commercial loans;
- home improvement loans;
- acquisition, development, and construction loans;
- other construction loans; and
- loans originated by other thrifts (loan participations).

The chairman of one board said his thrift was still solvent because it continued to do what it knew best—single-family lending. Eighty-four percent of its assets were primarily for single-family loans, and only 2 percent were in real estate investment. Several other solvent thrifts maintained diversified loan portfolios and were also involved in financial instrument transactions (such as investment and hedging activities) to reduce their interest-rate risk exposure. One solvent thrift had investments in the secondary loans market and short-term loans, such as mobile home, home improvement, education, and consumer loans. However, it also had traditional, long-term home mortgages and a hedging program to reduce the interest-rate risk.

A few of the solvent thrifts even withdrew from the lending market and relied on their investment trading portfolios for income. For example, one had 60 percent of its assets in cash and securities and only 25 percent in mortgage loans. The extent of these activities would be considered nontraditional for a thrift although the examiners did not criticize the thrift's operations, considering it fundamentally sound and stable. The president at another solvent thrift noted that, because of the area's stagnant economy and soft real estate market, securities trading, an area in which his thrift had expertise, was preferable to investing in large commercial projects in which his thrift had no expertise.

Twelve of the 26 solvent thrifts engaged in higher-risk lending. All but one, however, limited such lending. For example, one thrift reduced construction and ADC lending from 30 percent to 17 percent of its loan portfolio, while another limited commercial mortgage lending to 15 percent of its loans. Executives at one solvent thrift told us they had ventured into some ADC lending on a limited basis but soon halted that activity due to losses. This lending contrasts sharply with some of the failed thrifts whose portfolios included up to 82 percent of loans for higher-risk ADC lending.

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## Loan Underwriting and Administration

At the solvent thrifts, some of the same violations of regulations and unsafe practices found at the failed thrifts were also present but usually were less extensive and severe. The most common loan underwriting and administration weaknesses were the failure of appraisals to comply with regulations, inadequate analysis of a borrower's ability to repay a loan, and incomplete loan applications.

Examiners cited poor loan appraisal practices at 24 of the 26 solvent thrifts. Some appraisals were not done or did not substantiate the value

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of a property. Other problems included appraisals that were not in narrative form or did not include purchase prices of the properties in the appraisal reports. Problems with appraisals were also extensive at the failed thrifts in our sample (examiners noted them at 23 of those thrifts), but we found them to be far more extensive and severe than those examiners noted at the solvent thrifts. (See chapter 4.)

According to regulators, 13 of the solvent thrifts did not always properly analyze a borrower's financial ability to repay a loan, while 24 of the failed thrifts had deficiencies in this area. One solvent thrift was criticized because it placed greater reliance on the value of the collateral and management's knowledge of borrowers rather than on financial information about the borrower. However, the thrift did not experience major losses as a result of this practice, and examiners subsequently noted that the solvent thrift significantly improved its underwriting policies.

Although incomplete loan applications were noted at 12 of the solvent thrifts, the examiners' comments tended to relate to matters of technical compliance, such as an application's not being signed or dated. In other cases, owner occupancy statements were not completed. However, we found that the violations occurred infrequently and generally appeared to result from oversight rather than standard operating procedures. The deficiencies examiners noted in loan applications at 13 failed thrifts were generally more severe.

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## Prohibited Transactions

The solvent thrifts were involved far less frequently than the failed thrifts in prohibited transactions with affiliated persons, excessive loans to one borrower, or conflicts of interest. In addition, when examiners did cite violations of these regulations or related unsafe practices, they were not as severe as those at the failed thrifts.

The solvent thrifts' transactions with affiliated persons were not as complex as those at the failed thrifts. As a result, the violations and unsafe practices involved relatively modest amounts and could usually be quickly resolved; thus, large losses to the thrifts did not occur. For example, one thrift violated regulations by lending a director \$108,840 when it could lend only \$100,000. A violation at another solvent thrift was due to the purchase, without prior Bank Board approval, of about \$4,200 worth of computer equipment from a firm owned by a director of the thrift. Another solvent thrift was cited for numerous transactions-with-affiliate violations because it provided below-cost home mortgages

to employees as a company benefit. However, underwriting deficiencies were not noted for these mortgages, and the amounts involved were modest. Violations such as these were significantly less severe than transaction-with-affiliate violations found at the failed thrifts, as discussed in chapter 2.

Eleven of the 26 solvent thrifts violated the loans-to-one-borrower regulation, compared to 23 of the 26 failed thrifts. This regulation prohibits a thrift from lending large amounts of money to one borrower<sup>2</sup> and includes detailed recordkeeping provisions to track individual loans to each borrower. Again, the violations at the solvent thrifts differed from those of the failed thrifts in that most were related to recordkeeping requirements, rather than to exceeding the legal lending amount. However, it is important to note that, without proper recordkeeping, the potential exists to exceed the legal lending amount.

Examiners noted potential conflict of interest conditions at only 3 of the solvent thrifts, compared to 20 of the failed thrifts. In one case, examiners said the chief executive officer of one solvent thrift may have placed himself in a conflict of interest position by accepting a gift. The thrift's board of directors sold the thrift's airplane, valued at over \$95,000, to the executive for \$45,000. The board considered the difference between the book value and the sale price to be a gift to the officer for his 47 years of service. District bank supervisors brought this matter to the board of directors' attention; the board then requested and received \$50,000 from the officer as additional payment for the airplane.

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## Other Characteristics

Three other areas in which the solvent thrifts differed significantly from the failed thrifts were records and controls, compensation and expenditures, and responsiveness to regulators.

Examiners cited 9 of the 26 solvent thrifts as having some recordkeeping and internal control deficiencies; all of the failed thrifts were cited for problems in this area. Only 3 solvent thrifts were cited by examiners for excessive compensation, but 17 of the failed thrifts had violations and related unsafe practices. No solvent thrift was cited for making excessive expenditures, while examiners cited five failed thrifts for doing so. The solvent thrifts generally responded positively to their regulators' comments and concerns. After examiners noted violations and

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<sup>2</sup>The amounts are determined by a formula; thus, they differ for each thrift.



unsafe practices, subsequent examinations often showed improvements—a pattern not seen in our sample of failed thrifts.

## Criminal Referrals on Solvent Thrifts

Few criminal referrals were made on the solvent thrifts, and the amounts of estimated losses were small compared to those of the failed thrifts. For the solvent thrifts, we obtained all criminal referrals involving insiders and referrals which, in the opinion of district bank officials, (1) exposed serious weaknesses in the solvent thrifts' internal operations or (2) posed a threat to their financial condition. We were provided 14 criminal referrals for 7 of the 26 solvent thrifts. The types of violations alleged were generally the same as those related to the failed thrifts and most often related to statutes regarding theft, embezzlement, the willful misapplication of funds, false entries, and false statements. Allegations were made most often against directors or officers (53 percent)—almost exactly the same proportion as for the failed thrifts (54 percent). Only 3 of the 14 referrals were reported to have a material impact on the solvent thrifts involved. The estimated losses for two of those three referrals were \$143,000 and \$10.9 million.

It is significant to note that personnel of the solvent thrifts—officers, internal auditors, or directors of security—made virtually all the criminal referrals (12 of the 14) filed with the Bank Board.<sup>3</sup> We believe this is a good indication that internal controls were in place and working. Moreover, this generally enabled misconduct to be recognized before it had a material impact on the thrift. In contrast, a majority of the referrals filed with the Bank Board on the failed thrifts were made by examiners or other Bank Board System personnel and the amounts of estimated losses were higher.

## Conclusions

The solvent thrifts generally complied with laws, regulations, and engaged in safe business practices. While examiners did note some violations and unsafe practices, they were less severe and occurred less often than those noted at the failed thrifts. Examination reports revealed that the solvent thrifts pursued a variety of business strategies including, to a limited extent, some higher-risk lending activities. In addition, solvent thrifts usually had active boards of directors, which, along with management, fulfilled their fiduciary obligations by approving transactions

<sup>3</sup>In one referral, information on who reported the alleged violation was not provided; in the other, a district bank agent made the referral but the alleged criminal activity had been discovered by the thrift's internal auditor.

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that usually benefited the thrift rather than others. There were fewer instances noted in examination reports related to deficiencies in books and records and internal controls, nor did the examination reports generally reveal excessive amounts of money being spent on compensation or other expenses. Solvent thrifts were generally responsive to Bank Board concerns and corrected problems which examiners identified.

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# Strong Internal Controls and Sound Management Practices Serve as Buffers Against Adverse Economic Conditions

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Although adverse economic conditions made it more difficult for thrifts to operate profitably, regulators rarely identified economic conditions as the sole factor contributing to a thrift's failure. While all thrifts operating in a given area were subject to the same environmental factors (which were beyond the direct control of management), some thrifts remained viable entities while others failed. In the documents that we reviewed for both failed and solvent thrifts, examiners and other Bank Board officials often commented that economic conditions were poor in the geographic areas in which the thrifts had loans or investments. Such conditions were noted for 12 of the 26 failed thrifts and 14 of the 26 solvent thrifts.

In this report, economic factors are defined as economic conditions which affect a thrift's performance but are external to the thrift and, thus, beyond management's direct control. Economic factors include both national economic conditions (such as interest rates) and regional economic conditions (such as the performance of a key industry, for example, energy or agriculture).

Our analysis of failed and solvent thrifts indicated that severe internal control deficiencies, violations of laws and regulations, and related unsafe practices existed at the 26 failed thrifts in our sample but were present to a much lesser extent at the 26 solvent thrifts we reviewed. Because the combined effect of internal control deficiencies, violations of laws and regulations, and related unsafe practices weaken a thrift, a thrift may become more vulnerable to the impact of economic conditions. Conversely, good internal controls, adherence to laws and regulations, and safe and sound business practices can serve as buffers to help thrifts survive adverse economic conditions. Therefore, we believe that internal control weaknesses, as well as violations of laws and regulations and related unsafe practices, play a very significant role in determining a thrift's viability.

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## Adverse Regional Economic Conditions

The downturns in the oil and gas sectors of the economy and the related impact on real estate were significant regional economic factors affecting the thrift industry. The dramatic increase in energy prices fueled tremendous growth and rapid inflation of real estate values in the Southwest. The rapid decline in energy prices in the mid-1980s contributed to the equally dramatic decline in those real estate values. "Overbuilding" in some areas of Texas has also been cited as contributing to declines in real estate values.

Examiners cited regional economic problems as affecting 12 failed thrifts in our sample. Nine of the thrifts were in the Southwest and the three remaining ones were located in Florida, Oregon, and California. The Florida thrift lent in areas of Texas and Florida which examiners stated were characterized by overbuilding of commercial projects. The Oregon thrift invested in condominium and residential real estate in Oregon where the markets were soft and also had loans in Texas. The California thrift had a subsidiary that dealt in property throughout the country. Examiners noted that uncertainty due to federal tax reform proposals and also a weakening real estate market in several geographic areas contributed to losses of the subsidiary, which then weakened the financial condition of the thrift. Each of these thrifts, however, was also cited for extensive violations of regulations and related unsafe practices, which resulted in significant losses contributing to their failures.

Examiners also mentioned poor regional economic conditions in reports on 14 of the solvent thrifts we reviewed: 6 in the Dallas district, 3 in the San Francisco district, and 5 in four other districts. Examiners' comments regarding regional economic conditions were generally similar to those which examiners made relative to the failed thrifts. They noted declines in real estate values in Texas, as well as soft real estate markets and weak local economies elsewhere. However, regulators cited fewer management-related deficiencies at the solvent thrifts.

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## Regional Economic Conditions Exacerbate Thrifts' Problems

Federal and state regulators, as well as industry officials, believe the influence of economic factors on the failed thrifts exacerbated the effects of their violations of laws and regulations and their unsafe practices, consequently making them more vulnerable to poor regional economies. For example, three executives who worked with several thrifts after they had failed maintained that the loans and investments those thrifts made were so speculative that they would not have been profitable even if national and regional economic conditions had remained stable. Some of the loans and investments were predicated on assumptions of continued high rates of economic growth and rapid increases in real estate values. One thrift executive stated that "without continuous inflation there were built-in losses" on the loans made. Another executive said that "the success of deals financed and made otherwise were predicated on inflation—totally dependent on the continuing increase of property values."

In regard to failed thrifts in Texas, federal regulators stated during congressional testimony that "the decline of the regional economy merely

exacerbated losses. . . . [O]n average the 'Texas 40' [40 weak thrifts in Texas] were insolvent on a tangible capital basis by the end of 1984—well before the steep 1986 drop in oil prices.”

A Texas gubernatorial task force on the status of the state's thrift industry also acknowledged the impact of the downturn in its regional economy. The study noted that the poor economy “has brought down not only the mismanaged and fraudulently managed thrifts, but has caused stress in the more conservative and prudently managed institutions.” These findings are consistent with our belief that, while both solvent and failed thrifts in our sample were affected by regional economic downturns in some geographic areas, the effects at failed thrifts were exacerbated by factors under the direct control of management—weak internal controls, violations of laws and regulations, and other unsafe practices.

Federal officials and thrift executives in California also said that segments of the regional economy which declined may have been only a minor factor affecting the failed thrifts in that state. The California Savings and Loan Commissioner was more emphatic about the economy's limited effect in testimony before the Congress in June 1987. When asked if economic conditions had caused the thrift problems in California, the Commissioner responded:

“We [in California] do have areas that are overbuilt; California is the largest farm State in the Union, and California is an energy State, too. People say farming and energy cause all our problems. In States across the country, and California, in financial institutions, there were crooks, greedy, and stupid people in there. You can't blame it on economics, you have got to blame it on the directors, officers, and owners.”<sup>1</sup>

Statements by bank regulators support this general view in regard to the banking industry, which has also had record failures in recent years. A recent study by the Office of the Comptroller of the Currency found the following:

“Economic decline contributed to the difficulties of many of the failed and problem banks...Rarely, however, were economic factors the sole cause of a bank's decline.”

[Text omitted.]

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<sup>1</sup>Fraud and Abuse by Insiders, Borrowers, and Appraisers in the California Thrift Industry, testimony before a Subcommittee of the Committee on Government Operations, House of Representatives, June 13, 1987.

**Chapter 8**  
**Strong Internal Controls and Sound**  
**Management Practices Serve as Buffers**  
**Against Adverse Economic Conditions**

“While a banker’s job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times.”<sup>2</sup>

Officials of the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation concurred in this opinion. In addition, our recent review of bank failures noted that a weak economy tends to expose internal problems which may not be evident when a bank is operating in a strong economy.<sup>3</sup> Therefore, banks with internal control weaknesses were also more vulnerable to adverse economic conditions. Conversely, good internal controls tended to serve as a buffer to protect banks from those conditions.

**Figure 8.1: Matrix of Combined Effects of Economy, Management, and Internal Controls**

		MANAGEMENT AND INTERNAL CONTROLS	
		STRONG	WEAK
ECONOMY	STRONG	Healthy Institution	Potential Problem Institution
	WEAK	Potential Sound Institution	Potential Failed Institution

We believe that good internal controls, which facilitate adherence to laws and regulations and sound practices, and good management serve

<sup>2</sup>Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks, Office of the Comptroller of the Currency, Washington, D.C., June 1988.

<sup>3</sup>Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO: AFMD-89-25, May 31, 1989).

as buffers to help protect thrifts against poor national and regional economic conditions. Figure 8.1 illustrates this point by showing the combined effects of economy and management. In a strong economy, a financial institution with strong management and strong internal controls will most likely be healthy, and even an institution with weak management and weak internal controls may be able to continue to operate, although it may encounter some problems. By contrast, in a weak economy, an institution with strong management and strong internal controls will probably be able to remain sound, but an institution with weak management and weak internal controls is more likely to fail.

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## Conclusions

National and regional economic factors cannot be controlled by thrift management and are often difficult to predict. Although adverse regional economic conditions may have contributed to problems of the failed thrifts in our sample in certain geographic areas, regulators indicated that economic factors alone did not cause any of these thrifts to fail.

While a thrift's management cannot control economic factors, it can determine the thrift's business decisions and the nature of its operations. In addition, strong internal controls help thrift management to adhere to laws and regulations and to operate the thrift in a safe and sound manner.<sup>4</sup> We noted that the 26 failed thrifts we reviewed were characterized by violations of regulations and unsafe practices, while the solvent thrifts demonstrated better compliance and more prudent practices. Given similar economic factors, we found that thrifts with fewer serious internal control weaknesses—the solvent thrifts we analyzed—were better able to survive adverse regional economic conditions. Therefore, we believe that the combined effect of internal control weaknesses, violations of laws and regulations, and related unsafe practices make a thrift substantially more vulnerable to economic factors. Conversely, good internal controls, adherence to laws and regulations, and safe and sound management practices tend to serve as buffers to protect thrifts from adverse economic conditions.

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<sup>4</sup>As discussed in chapter 2, establishing and maintaining an effective system of internal control is one of management's most basic responsibilities.

# Actions Related to Long-Standing Problems Identified by the Examination and Supervision Process

The Bank Board documents we reviewed regarding the 26 failed thrifts in our sample provided information on examination and supervision activities. According to the Bank Board's criteria, the ratings examiners assigned to the 26 failed thrifts indicated that "urgent and decisive corrective measures and a definite plan for corrective action" were needed. However, for 20 of the 26 failed thrifts in our sample, at least 12 months passed between examinations, including 5 instances where examinations did not take place for at least 24 months. This raises questions about the Bank Board's oversight, since, on the basis of their examination ratings, the thrifts required "more than normal supervision."

Federal supervisory agents at the district banks have discretion in determining actions to take when an examination discloses violations of regulations and unsafe practices. Such actions range from oral discussions with thrift management, to supervisory letters discussing weaknesses, to written agreements in which management agrees to take corrective action. Some of these supervisory efforts were evident at all 26 failed thrifts. Supervisors can also request that the Bank Board take formal enforcement actions, such as cease and desist orders and removal of management, to correct problems. The Bank Board records show that relatively few such actions were taken: 14 enforcement actions against only 9 of the 26 failed thrifts. We also found that the supervisory and enforcement actions of the Bank Board were sometimes thwarted or circumvented by unresponsive thrift management.

In interviews with Bank Board officials, we asked them to comment on what we saw as a pattern of regulatory violations and unsafe practices documented in examination reports, which often persisted for years. Bank Board officials cited several reasons for what appeared to be untimely actions and provided information on specific steps that the Bank System has taken to improve supervision and regulation as a result of the unprecedented number of thrift failures. Another GAO review is evaluating the effectiveness of the Bank Board's supervision and enforcement activities, and we issued a report discussing the preliminary results of this work in April 1989.<sup>1</sup>

<sup>1</sup> "Failed Thrifts: Bank Board Use of Enforcement Actions" (GAO/IGD-89-68BR, April 13, 1989).



## Examination Ratings Indicated Long- Standing Problems

The thrift examination is the regulators' primary means of fulfilling their oversight responsibilities. Regulators summarize overall examination results with a five-point rating scale covering critical aspects of thrift operations and conditions. In assigning the overall rating, the examiner considers these and other factors:

- adequacy of the capital base, net worth and reserves, future growth plans, quality of loans, investments and other assets;
- ability to manage liquidity and funding;
- quality of internal controls;
- operating procedures and all lending, investment and operating policies;
- compliance with relevant laws and regulations; and
- the involvement of the directors, officers, and employees.

The examination can emphasize one or a combination of these factors.

Regulators assign the thrifts an overall or composite rating of 1 to 5, with a 1 representing a strong institution and a 5 representing an institution with a high probability of failure. The composite rating is a subjective evaluation of the overall condition and soundness of the institution, rather than an arithmetic average of individual components. Regulators generally consider thrifts with a composite 3, 4, or 5 rating to warrant special supervisory attention. Table 9.1 summarizes each of the five composite ratings.

**Table 9.1: Composite Ratings for Thrifts**

<b>Composite rating</b>	<b>Description</b>
1	A rating of 1 indicates strong thrift performance that is significantly higher than average and gives no cause for supervisory concern.
2	A rating of 2 reflects satisfactory thrift performance that is average or above and requires limited supervisory action.
3	A rating of 3 represents performance that is marginal and, as such, is considered below average; gives cause for supervisory concern; and requires more than normal supervision.
4	A rating of 4 refers to significantly below average thrift performance which, if left unchecked, might evolve into weaknesses or conditions that could threaten the thrift's viability. Thrifts in this category have severe financial weaknesses or a combination of other conditions that are unsatisfactory. Such thrifts require <u>urgent</u> and <u>decisive</u> corrective measures and a definite plan for corrective action.
5	A rating of 5 indicates unsatisfactory thrift performance that is critically deficient and in need of immediate remedial attention. Such performance by itself or in combination with other weaknesses impairs the thrift's viability. This category is reserved for thrifts with an extremely high immediate or near-term probability of failure.

Source: Federal Home Loan Bank Board, Manual of Examination Objectives and Procedures.

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**Table 9.2: Examination Ratings and Regulatory Efforts From January 1980 Until Date Closed**

Sample number	1980	1981	1982	1983	1984	1985	1986	1987
1	3	3	4,5	W,5,5	W,5,5,L,L,L,5	5	L,C	
2	3	3	3		4	W,4	5	
3		3	5,5	5	4,W,W	3,5,C		
4	3	3	4,3		4,4	5,W		C
5		2	3		3	2,W	W	C
6		2	3		5,W,5	W,4,C		
7	1		5,3			W	W,5	5
8	3	3	4	W	5,5,5,L,5	5,C		
9	5	5	5	5	5	L	C	
10		1	3		5,4,L,4	4	C	
11		1		1	W,5,W		L,5	C
12		2	3	4	2,W	W	5,W	C
13	1		3				W,5	5
14	2		4,5	5,L,L	W,5		5	C
15	1	3		4		W,W	L,5	
16		1	4	3		5,W	W,W,5	5
17	4	2		4		4,W	5,W,5,C	
18		4	4,4	4		4,L	L,5	
19	2	3	4	4		W,W,C		
20	3		4,4	4	4,W,4,W	C		
21		2	1		W,4	4	C	
22	2		4	4	5,W	C		
23		2	3	3	4	W,C		
24	2		3			4,W	C	
25		2		3	3	C		
26		3	3	4	4,W	L,C		

**Legend**

W = Written agreement on corrective action obtained by district supervisory agent

L = Legal enforcement action by the Bank Board

C = Year closed, i.e., receivership or conservatorship, if applicable. Some institutions were still open. See discussion of "failed" institutions in chapter 1.

**Notes**

1. Examinations of less than 50 hours are excluded.

2. The examination ratings and regulatory efforts are listed in chronological order.

The length of time that many of the 26 failed thrifts had below-average ratings indicated that long-standing problems existed at these institutions. Table 9.2 shows the examination ratings for the 26 failed thrifts.

over an 8-year period. Overall, 63 percent of the failed thrifts had composite ratings of 4 or 5 signifying "serious financial weaknesses or a combination of other conditions that are unsatisfactory" or indicating "an extremely high immediate or near-term probability of failure." However, in general, these thrifts remained open and operating. Although the 26 failed thrifts occasionally received examination ratings of 1 or 2, indicating satisfactory performance, over 80 percent of those ratings were received in 1980 and 1981.

From 1980 to 1987, the interval between examinations for the 26 failed thrifts ranged from 5 to 26 months.<sup>2</sup> Nine of the 26 thrifts were examined within 1 year after receiving an unsatisfactory (composite 3) or worse rating, 10 were examined within 13 to 18 months, and over 18 months elapsed before the remaining 7 thrifts were examined. The number of examinations for each thrift ranged from 3 to 10 with an average of 5 examinations during the 8-year period.

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## Supervisory Efforts to Correct Problems Identified in Examinations

The supervisory agent has fairly broad discretion to determine whether and what type of action will be taken to correct problems noted at a thrift. The action may be tailored to each case—the Bank Board sets no specific requirements. Instead, Bank Board directives state that actions should be taken according to the severity of the violations or unsafe practices, and the responsiveness and willingness of thrift management to take corrective action should also be considered.

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## Administrative Actions

Actions taken through the district bank supervisory agent, which do not require Bank Board approval, are referred to in this report as "administrative actions." In taking such actions, a supervisory agent might, for example, meet with thrift management and verbally reach agreement about corrective action management will take. In other instances, the agent might ask management to sign a written administrative agreement stipulating corrective action.

In an April 1984 memorandum, the Bank Board chairman, citing unspecified "problems that have occurred," stressed to all supervisory agents

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<sup>2</sup>Prior to September 1986, Bank Board examination criteria gave supervisory agents broad discretionary authority over the timing of examinations. However, in September 1986, noting the poor condition of the thrift industry and the speed with which changes can occur in a thrift's condition, the Bank Board established uniform standards for the maximum time between examinations. The required frequency varies from 3 to 24 months depending upon a thrift's circumstances. For example, if examiners judge a thrift's performance as unsatisfactory (a rating of 3, 4, or 5) another examination should start no later than 12 months from the previous examination.

the need to obtain written administrative agreements from thrift management to correct substantial problems revealed by examinations. For 22 of the 26 failed thrifts, supervisory agents obtained 36 such written administrative agreements over a period of 8 years.

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## Enforcement Actions

If the administrative actions are not effective or the principal supervisory agent (PSA) of the district bank (who is usually the president of the bank) considers the violations of law or unsafe practices significant, the PSA can request that the Bank Board take stronger actions provided to it by law (formal enforcement actions). In an August 1985 memorandum, the Bank Board chairman directed all PSAs to “make vigorous use of the formal enforcement tools available” by requesting such actions be taken by the Bank Board. Formal enforcement actions include (1) an order to cease and desist specified practices, (2) removal and prohibition of management, and (3) notice to terminate FSLIC insurance.

The Bank Board can issue a cease and desist order when any violation of regulations occur, unsafe practices are conducted, or a written administrative agreement is not honored. It also can be used instead of administrative actions when the supervisory agent and the Bank Board believe that the thrift’s problems are serious enough to warrant such immediate action.

The law provides for the Bank Board to obtain a court injunction to enforce cease and desist orders that thrifts violate. If thrift management fails to obey the injunction, it would be subject to a contempt of court citation and court-ordered penalties, such as a monetary penalty imposed on the institution or its individual officers. In addition, willful violations of a cease and desist order can serve as grounds for closing a thrift. Violations of cease and desist orders were cited in closing three of the seven thrifts which were subject to such orders.

The Bank Board also has authority to issue temporary cease and desist orders during administrative proceedings to determine whether a permanent cease and desist order should be issued to stop a violation of law, rule, or regulation, or an unsafe practice by a thrift. If the Bank Board determines that the violation or unsafe practice is likely to have a substantial adverse effect on the thrift’s financial condition before the cease and desist order can be issued, the Bank Board can issue a temporary order requiring the thrift to stop the violation or unsafe practice. (See 12 U.S.C. 1464 (d)(3)(A) and 1730 (f)(1).)

We noted, however, that the Bank Board did not consistently take advantage of this authority in all instances. For example, Bank Board officials stated that the authority to issue a temporary cease and desist order based on a finding of inadequate books and records had not been tested.<sup>3</sup> The Office of Regulatory Activities stated that "the Board is still seeking legislation to enable the pursuit of temporary cease and desist orders for serious [recordkeeping] deficiencies." We are not convinced, however, that the Bank Board's broad statutory authority for temporary cease and desist orders is not applicable to thrifts which do not maintain adequate books and records.

The Bank Board also has enforcement authority to remove or suspend officers and directors if they violate laws, regulations, or a cease and desist order, or if they breach their fiduciary duty in such a way that it will or has caused the thrift to suffer losses or other damage. In addition, the Bank Board can serve notice to terminate FSLIC insurance, effectively closing the thrift, if it is operating in an unsafe manner, or has violated laws, regulations, or any written agreement.

Between 1980 and 1987, prior to formal conservatorship or receivership actions, the Bank Board took the following enforcement actions against 9 of the 26 failed thrifts:

- one thrift had a temporary cease and desist order and, 3 months later, a permanent cease and desist order;
- four thrifts had permanent cease and desist orders;
- two thrifts had removal and prohibition actions;
- one thrift had a permanent cease and desist order along with a removal and prohibition action; and
- one thrift had removal and prohibition actions against two officers and a former officer and a prohibition action against a borrower who also owned an insured institution in Texas.

At the time these thrifts failed, compliance with the enforcement actions was unsatisfactory or only partially satisfactory. Our review indicated that thrift management was often unresponsive to supervisory concerns. Thrift management did not always take action to correct problems examiners identified, nor did it implement promised corrective

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<sup>3</sup>As stated in chapter 5, despite a Bank Board regulation for thrifts to establish and maintain accurate and complete records (12 CFR 563.17-1), recordkeeping deficiencies existed at all 26 thrifts we reviewed.

actions or abide by written agreements. In some cases, thrift management simply would not execute a written agreement. Moreover, some thrifts ignored or circumvented Bank Board enforcement actions.

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## Circumvention of Supervisory Actions

Even when regulators obtained written administrative agreements requiring thrift management or owners to take specific corrective actions, these regulatory efforts were often thwarted when thrifts violated the agreements. Of the 22 thrifts which had signed administrative agreements, subsequent examinations revealed that 11 violated the agreements. However, the documented violation of agreements can provide support for stronger Bank Board enforcement actions. The Bank Board took subsequent formal enforcement actions against 4 of the 11 thrifts that violated their supervisory agreements.

At times, managements' responses effectively circumvented supervisory agreements. For example, examiners noted one thrift that continually violated the regulation limiting loans to one borrower. Although a subsequent examination of the thrift's records showed it no longer exceeded the amount it could legally loan to one borrower, it continued the concentration of loans to that borrower by indirectly making loans to him through a third party.

In another case, a supervisory agent informed a thrift's management that a bonus of over \$800,000 (one third of the thrift's earnings) paid to an officer/director already receiving a \$100,000 salary was excessive and a waste of assets. A subsequent examination revealed that, in addition to the \$800,000 bonus, management paid the officer/director \$350,000 to relinquish his right to future bonuses and increased his salary from \$100,000 to \$250,000.

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## Other Ongoing GAO Work Noted Similar Problems

As previously stated, we are assessing the Bank Board's use of enforcement actions in another review. That study encompasses a review of the supervisory histories of 424 thrifts, including a detailed review of 47 thrifts from three Federal Home Loan Bank districts.<sup>4</sup> However, in Troubled Thrifts: Bank Board Use of Enforcement Actions (GAO GGD-89-68BR), we reported the preliminary results of our work on enforcement efforts at the 47 near-failing thrifts. Our preliminary work indicated that (1) some of the 47 near-failing thrifts had not been subject to

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<sup>4</sup>That review includes three Bank Board districts: Dallas, San Francisco, and Chicago. Twenty of the 26 failed thrifts in our sample were located in those districts.

any formal enforcement actions, (2) enforcement actions that were taken were often not effective, and (3) implementation of the enforcement actions often took an undue amount of time. The preliminary results of that report appear consistent with our observations regarding the enforcement actions which the Bank Board took against the failed thrifts in our sample.

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## Bank Board Comments on Supervisory and Enforcement Action

As part of our review of the failed thrifts, we requested that Bank Board officials provide written comments on what we saw in examination reports at the 26 failed thrifts as a pattern of regulatory violations and unsafe practices which often persisted for years. Bank Board officials cited several reasons for what appeared to be untimely actions and provided information on specific steps that the Bank System has taken as a result of the unprecedented number of thrift failures to improve supervision and regulation.

With regard to the timeliness and frequency of enforcement actions taken by the Bank Board, several officials cited the onerous burdens of proof and the necessarily long "due process" required by the law, as well as "regulatory breakdowns" due to the fact that the Bank Board was unaccustomed to handling such a volume of problem thrifts. Before the 1980s, officials said, there was little need for enforcement actions against thrifts. The Bank Board established the Office of Enforcement in 1986 to help speed the process of taking legally enforceable action.

The Director of the Office of Enforcement said that the time between when a district bank requests enforcement action and when it is taken varies according to (1) the supporting information the district bank provides and (2) whether or not the thrift cooperates or protests the action through litigation.

According to the director, there is no difference in how the Office of Enforcement responds to a district bank's request for action against a state- or federally chartered thrift. Federal regulators should notify state regulators when they determine that enforcement action against a state-chartered thrift is warranted (12 U.S.C. 1730 (o)). If state officials take action that federal regulators deem adequate, then federal enforcement action might not be taken. According to the Director of the Office of Enforcement, state regulators did not cause any delays in enforcement action against the 26 failed thrifts in our sample.

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## Doubts About Authority to Regulate State-Chartered Thrifts

Bank Board officials also told us that before 1985 they viewed their authority to issue regulations to prevent state-chartered thrifts from engaging in higher-risk activities as “questionable.” Bank Board officials also stated that they believed the executive and legislative branches of the federal government had a strong policy of preserving “states’ rights.” Thus, the officials said they were hesitant to act in certain instances, especially where state law gave thrifts specific powers which federal laws did not address. However, in other instances, the Bank Board justified actions related to regulating state-chartered thrifts by citing prior administrative practices and legislative histories.

Twenty of the 26 failed thrifts we reviewed were state-chartered. While the Bank Board limited federally chartered thrifts in making certain “direct investments” (such as equity securities, real estate, service corporations, and operating subsidiaries), state-chartered thrifts often were authorized to make such direct investments without limit under state law. Moreover, FSLIC did not have regulations which placed limitations on the type and amount of direct investments insured thrifts could make.

In 1985, after many thrift failures, the Bank Board issued the first regulation to limit the use of direct investment authority by all insured thrifts. In addressing its authority to issue the regulation, the Bank Board cited its “long-standing position, supported by legislative history and prior administrative practice, that the NHA [National Housing Act] authorizes the Board to regulate state-chartered institutions....”

In a court case challenging the Bank Board’s authority to issue a regulation limiting the activities of state-chartered thrifts, the court ruled that under the provisions of the National Housing Act and the Federal Home Loan Bank Act, the Bank Board had the authority to issue regulations for federally insured thrifts, notwithstanding the fact that state law provided for unrestricted direct investment activities for the state-chartered institutions.<sup>3</sup> The court’s decision clearly confirmed FSLIC’s supervisory and regulatory authority over all insured thrifts. Thus, while the Bank Board told us that at times it viewed its authority to regulate state-chartered thrifts as “questionable,” we believe there should have been little doubt that the Bank Board had the necessary legal authority to promulgate regulations needed to ensure that all

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<sup>3</sup>Lincoln Savings and Loan Association vs. Federal Home Loan Bank Board, 670 F. Supp. 449 (D.D.C. 1987) aff’d, 856 F. 2d 1558 (D.C. Cir. 1988).



insured thrifts, regardless of their charter, operated in a safe and sound manner.

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### Specific Actions Taken by the FHLB System to Improve Supervision and Regulation

Since 1985 as more thrifts failed and the financial condition of FSLIC deteriorated, the Federal Home Loan Bank System has taken many actions to improve its oversight of thrifts and, more specifically, to address the kinds of problems identified in our sample of failed thrifts. (See chapters 2 through 6.) We asked the Bank Board's Office of Regulatory Activities (ORA) to provide us with information on these actions.<sup>6</sup> ORA cited the issuance of new or revised regulations and policy guidance as the Bank Board's primary action to address the specific characteristics of failed thrifts. Specifically, in their written comments on a draft of this report, the Bank Board stated that during the period from 1984 to 1986 the Board issued directives on supervisory and enforcement action, especially as they related to net worth, growth, and higher-risk lending programs. ORA also cited changes in personnel and processes as well as an overall change in philosophy about how to supervise and regulate thrifts.<sup>7</sup>

According to ORA officials, the quantity and quality of examiners and supervisors has increased and improved. Because of Office of Management and Budget (OMB) and Office of Personnel Management (OPM) restrictions on the number of examiners the Bank Board could hire, as well as salary and other benefits they could receive, the Bank Board reassigned the examination function to the district banks in 1985. As employees of district banks, the examiners are not subject to the OMB and OPM restrictions. As a result, the number of examiners and supervisors increased from 1,063 in June 1985 to 2,068 in June 1988. ORA maintains that the transfer of these functions to the district banks enabled the Bank System to attract not only greater numbers of examiners but also more experienced personnel because the district banks could pay more competitive salaries than are authorized for federal employees.<sup>8</sup>

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<sup>6</sup>The Bank Board created ORA to establish national supervisory policies and procedures and to oversee the examination and supervisory function carried out at the district bank level.

<sup>7</sup>We did not assess to what extent any of these changes or actions have been or are effective. However, as mentioned previously, other ongoing GAO work is assessing enforcement activities.

<sup>8</sup>As stated earlier, in September 1986 the Bank Board established specific standards regarding the frequency of examinations. We believe that how well such a standard is implemented depends, in part, on the quality and quantity of the examination staff.

In addition, ORA stated that consistency in examinations and supervision among the district banks is being fostered through training. Completion of a core training curriculum is now mandatory for examiners. Examinations and monitoring are also being improved, according to ORA, through expanding the scope of examinations and enhancing financial monitoring of thrifts.

A major philosophical change, as described by the Director of ORA, involves emphasizing an overall concept of safety and soundness as opposed to specific, detailed regulations with which thrifts must comply. The ORA Director stated that this change was called for in the Competitive Equality Banking Act of 1987<sup>9</sup> and that bank regulators were already operating in this type of framework. Accordingly, ORA made changes in the reference materials used by examiners and supervisors. A new series of regulatory handbooks, which embody this philosophical change, provides specific procedures that should be performed when examiners evaluate a thrift. ORA officials told us

"...they [the handbooks] emphasize the importance of an examiner or supervisor evaluating the ability of management to safely undertake or engage in various activities. The emphasis is on the prudence of activities rather than technical compliance with regulations which may or may not specifically address a given situation. All procedures are tiered to emphasize the overriding importance of management and a board of directors to provide appropriate policy guidance and then sufficiently monitor adherence to those policies."

In October 1984, the House Committee on Government Operations reported that the Bank Board systems and procedures for dealing with criminal misconduct and insider abuse were inadequate.<sup>10</sup> It recommended that the Bank Board revise its basic policies and procedures and that it establish special units in the 12 district banks to deal with these problems. In response to this, ORA pointed to "the development of a formalized national fraud and insider abuse program," including a formal program within each district bank, as another action taken to improve the examination and supervision process. In addition, regulatory handbooks now provide specific guidance regarding insider abuse and possible criminal activity.

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<sup>9</sup>Section 407 (a) of the act provides that the Bank Board "shall issue guidelines which provide greater flexibility for supervisory agents, examiners, and other employees and agents of the Board, FSLIC, and the [district] banks in applying regulations, standards, and other requirements of the Board [and FSLIC] with regard to particular situations or particular thrift institutions." (12 U.S.C. 1437 note)

<sup>10</sup>Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions (House Report 98-1137, October 4, 1984).

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## Conclusions

The continuous record of violations of law, regulations, and related unsafe practices discussed throughout this report were documented in examination reports and reflected in the poor examination ratings the 26 failed thrifts received. In some instances, regulators took actions intended to prevent further illegal or harmful practices. However, Bank Board regulators were not always able to successfully halt the thrifts' practices that eventually contributed to their failures. In view of the operating pattern of these thrifts, we believe that documentation regarding the failed thrifts indicates that aspects of the timing, nature, and extent of supervisory and enforcement actions related to these cases were questionable.

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## Agency Comments and Our Evaluation

In commenting on a draft of this report, the Bank Board stated that the report erroneously implied that the regulatory violations and unsafe or unsound practices found at the 26 failed thrifts in our sample occurred repeatedly and/or remained uncorrected. The Bank Board further stated that supervisory actions halted a majority of the regulatory violations and unsafe or unsound practices at these thrifts. In addition, it attributed the failure of these institutions to economic conditions and deficient management practices prior to the supervisory actions which halted such practices. The Bank Board's comments also cited a number of recent changes to the regulatory system to ensure that the regulatory violations and unsafe or unsound practices cited in the report do not recur. The Bank Board believes these changes should be discussed in the report. The Bank Board's comments on the draft report which provide a description of other regulatory efforts has been included as appendix III.

Based upon the documents and other evidence we obtained, we noted that the regulatory violations and unsafe or unsound practices were occurring at many of the failed thrifts over an extended period, often years. We do not agree with the Bank Board's assessment that supervisory actions successfully halted these violations and practices. In fact, elsewhere in its comments on the draft report, the Bank Board acknowledged that problems in regulatory, examination, and supervision activities existed in the past and expressed the belief that, with the recent changes in these activities, the 26 failures could not happen now.

In addition, we disagree that economic conditions primarily caused these institutions to fail. As discussed in chapter 8, we noted that both the solvent and failed thrifts in our sample were affected by economic downturns in some regions. However, we believe that the effect on these

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thrifts was to expose the weak management and poor internal controls that existed at these thrifts, thus exacerbating the effect of adverse economic conditions and increasing their losses.

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# Legislative Actions Needed to Strengthen Oversight and Management

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Over the past year, the financial plight of the savings and loan industry and FSLIC, its insurer, has been widely recognized. The previous chapters have described the kinds of practices carried out by a minority of the industry which we believe were largely responsible for its current predicament, as well as some of the regulator's attempts to deal with such practices. In February 1989, the administration presented its proposal for resolving the crisis, which was introduced in the Congress as S. 774 and H.R. 1278. This chapter discusses additional measures that we believe the Congress should consider in acting on the administration's proposal.

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## Current Structure of the FHLB System Not Conducive to Effective Oversight

As previously discussed, the Bank System has taken a number of steps to strengthen regulation<sup>1</sup> and examination. However, these actions do not address a fundamental conflict created by the Bank Board's and the district banks' roles in both promoting and regulating the industry.

This review, as well as our other work related to the thrift industry, identified a basic structural flaw in the current Bank System organization, namely its conflicting responsibilities for promoting the thrift industry while at the same time regulating and insuring it. We believe that such conflicting responsibilities at times may hamper the Bank System's ability to satisfactorily fulfill all of these roles. Moreover, without fundamental changes to fully address these structural deficiencies and conflicts, there is little assurance that the long-standing, repeated violations and unsafe practices found in 26 of FSLIC's most costly failures described in this report could not recur in the future.

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## Conflicting Roles and Responsibilities Within the Federal Home Loan Bank System

The current structure of the Bank System includes several entities that have roles in overseeing thrift activity: the district banks, the Office of Regulatory Activities (ORA), and offices within the Bank Board itself. In 1985, the Bank Board delegated its responsibility to examine and supervise thrifts to the 12 district banks. Thus, the district banks, like the Bank Board itself, now have the dual role of promoting and regulating the thrift industry.

The Bank Board created ORA in 1986 as a separate entity to monitor the district bank examination and supervision functions, as well as for other

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<sup>1</sup>As used in this report, regulation, in addition to rule-making, includes taking appropriate supervisory action in the event of noncompliance with those rules.

purposes.<sup>2</sup> Within the Bank Board, the Office of Enforcement (OE) reviews district bank requests to the Board to invoke its legal enforcement authority (see chapter 9) and can conduct special investigations of a thrift to determine if enforcement action is warranted. Moreover, when a district bank, OE, and ORA believe a thrift's problems cannot be resolved without FSLIC assistance, they and the Bank Board's Office of General Counsel recommend how FSLIC should resolve the thrift's problems (by liquidating it or merging it with another thrift, for example). The Bank Board must approve any recommendation for FSLIC to take over a troubled thrift. Thus, under the current structure, FSLIC itself, as the insurer of the thrift industry, does not have the ability to monitor, supervise, or exercise its legal authority over any thrifts; these activities and its legal powers can be exercised only through the Bank Board.

The involvement of so many different entities has created a complex federal regulatory and enforcement framework. It also creates the appearance of conflict for both the Bank Board (which charters and promotes thrifts and provides regulatory oversight) and especially the district banks (which provide banking services and examine and supervise the thrifts and which have thrift industry executives as a majority of their board members).

Our previous work pointed to the need to establish an independent insurer. Accordingly, we recommended that FSLIC be disengaged from the Bank Board and given independent status.<sup>3</sup> Implicit in this independent status would be both the authority and resources to regulate and examine the industry. Such an independent status, along with the necessary resources, would allow the insurer not only to establish stringent controls on improperly operated and undercapitalized thrifts but also to protect the interests of the insurance fund.

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<sup>2</sup>ORA states it is an entity outside the Bank Board whose employees are not federal employees subject to title 5 of the United States Code. We concluded in B-226708, September 6, 1988, that ORA should be regarded as a part of the Board and its employees should be treated as Board employees.

<sup>3</sup>See Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47, February 21, 1989) and Bank and Savings and Loan Insurance Funds: Financial Condition and Proposed Reforms (GAO T-AFMD-89-3, March 10, 1989).

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## Management Reports Would Strengthen Current FSLIC Audit Requirement

As discussed in chapter 5, the Bank Board currently requires that insured savings and loan institutions have annual audits. We believe that additional measures would enhance the effectiveness of this requirement. Specifically, reports by thrift management on internal controls and on compliance with laws and regulations would significantly strengthen current reporting requirements. Establishing and maintaining an effective internal control structure is one of management's most basic responsibilities. The extent, nature, and ultimate significance of the problems noted earlier point to an increasing need for greater accountability on the part of thrift management. As discussed below, management reporting on internal controls and on compliance with laws and regulations, coupled with a requirement for auditors to read and comment on the reports, would help establish accountability, instill greater management discipline, and encourage thrift management to operate institutions in a safe and sound manner.<sup>4</sup>

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## Report on Internal Controls

Internal control weaknesses were pervasive at the failed thrifts which we reviewed. Virtually all the deficiencies in management and operating practices noted in chapters 2 through 5 represent internal control weaknesses of a serious nature. Moreover, violations of laws and regulations, fraud and insider abuse, and related unsafe practices were further facilitated by other weak or nonexistent internal control procedures.<sup>5</sup>

In response to recommendations made by the National Commission on Fraudulent Financial Reporting,<sup>6</sup> the Securities and Exchange Commission (SEC) issued on July 19, 1988, an exposure draft on a proposed new rule requiring a "Report on Management's Responsibilities." This report would be included in annual submissions for those companies required to register with the SEC. According to the exposure draft, this management report would contain a statement of management's responsibilities to prepare financial statements and other financial data, as well as its responsibility to establish and maintain an effective internal control

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<sup>4</sup>We have also recommended similar management reporting requirements for insured banks. See Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO AFMD-89-25, May 31, 1989).

<sup>5</sup>As discussed in chapter 2, the broad objectives of internal controls are to (1) safeguard assets, (2) ensure accuracy and reliability of data and compliance with policies, applicable laws, and regulations, and (3) promote management efficiency. See appendix II, which contains a description of the internal control structure as contained in the AICPA's Statement on Auditing Standards Number 55, "Consideration of the Internal Control Structure in a Financial Statement Audit."

<sup>6</sup>See Report of the National Commission on Fraudulent Financial Reporting (October 1987), pages 44-46. This report is also commonly referred to as the "Treadway Commission Report."

structure. Such a report would also include management's assessment of the effectiveness of the internal control structure and a statement of how management has responded to any significant recommendations concerning such controls made by its internal auditors or independent accountants. In the exposure draft, the SEC emphasizes that the proposed requirements would not increase management's existing responsibilities but would merely require management to acknowledge them.

The SEC proposal is directed towards companies subject to the reporting requirements of the Securities Exchange Act of 1934. However, because many of the weaknesses discussed in this report were under thrift management's direct control, we believe a similar management report to federal regulators would be appropriate for federally insured thrifts. Such a report should contain statements by management (1) describing its responsibility for preparing financial statements and establishing and maintaining an effective internal control structure and (2) stating management's assessment of the effectiveness of the internal control structure. The board of directors and other key officers of the thrift should sign the management report. We believe that such a report would increase thrift management's sensitivity to actions needed to ensure that effective internal controls are in place to operate in a safe and sound manner.

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## Report on Compliance With Laws and Regulations

Since thrifts operate in a regulated environment designed to ensure their safety and soundness, management reporting should also address compliance with those laws and regulations which have material consequences on thrift operations.<sup>7</sup> As discussed in chapter 6, regulators cited extensive violations of laws and regulations for the failed thrifts included in our review. Accordingly, federal regulators could best identify those laws and regulations which have material consequences on the safety and soundness of thrift operations.

Specifically, in a report on compliance with laws and regulations, thrift management should (1) describe its responsibility for complying with laws and regulations related to the safety and soundness of thrift operations and for establishing methods to monitor compliance and (2) assess the thrift's compliance with laws and regulations related to the safety and soundness of thrift operations.

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<sup>7</sup>Thrifts may be also subject to a variety of laws and regulations not directly related to the safety and soundness of their operations, such as laws pertaining to employment, occupational safety, local zoning laws and so forth, which would not be relevant to the concept of management reporting as discussed in this report.



In our opinion, a management report on compliance with laws and regulations would increase management's awareness of the importance of legal and regulatory requirements as well as the potential consequence of noncompliance.

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### Role of the Independent Auditor

The proposed SEC rule does not specifically address the role of the independent auditor. Rather, it assumes that existing responsibilities under generally accepted auditing standards<sup>8</sup> would require the independent auditor to read the disclosures included in the proposed report and to consider whether such information included a material misstatement of fact.<sup>9</sup> We believe that the credibility of the thrift management reports would be enhanced by establishing a requirement that, as part of a financial statement audit, independent auditors of insured thrifts not only read and consider but also report on management's assertions regarding internal controls and compliance with laws and regulations. An independent auditor's report on these management assertions would provide additional disclosure and would benefit federal regulators by providing an independent assessment of assertions contained in the reports.

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### Actions to Ensure That Audit and Reporting Requirements Achieve Their Intended Objectives

Independent audits or management reports should be construed not as substitutes for the examination and supervision processes, but rather as a source of additional information to enhance and strengthen such processes. If regulators are to take full advantage of audit and management reporting requirements, they must ensure that procedures exist which enable them to (1) receive and review audit and management reports in a timely manner and (2) promptly initiate appropriate follow-up actions. Regulators should enforce deadlines for insured thrifts to submit copies of all required reports soon after the audits are completed. Further, regulators should establish a system to monitor the receipt of such reports and follow up on any which are delayed. As discussed in chapter 5, troubled institutions have often taken longer to submit audit reports or are sometimes unwilling to do so. Bank System personnel

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<sup>8</sup>Such responsibilities are contained in the AICPA's Statement on Auditing Standards Number 8, "Other Information in Documents Containing Audited Financial Statements."

<sup>9</sup>GAO recommended in its recent report entitled, *CPA Audit Quality: Status of Action Taken to Improve Auditing and Financial Reporting of Public Companies* (GAO/AFMD-89-38, March 6, 1989), that the SEC require the auditor to review and publicly report on the management report.

stated that some district banks have developed or are currently developing informal monitoring systems. Consideration should be given to developing a national system to monitor receipt of required reports.

The audit and management reports could serve as a valuable source of information to enhance supervisory monitoring of thrifts. Regulators should promptly compare the thrifts' regulatory financial reports with audit and management reports and investigate any significant discrepancies. Moreover, regulators should review such reports carefully and promptly since not all thrifts are examined annually. Further, regulators should evaluate audit reports to identify any inconsistencies between the reports and thrift examination findings. In addition, regulators should closely monitor cases in which a thrift frequently changes auditors, which can also indicate potential problems.<sup>10</sup> (See chapter 5.) Clearly, the information gained from audit and management reports would be a useful indication of situations warranting closer supervisory monitoring or the need to revise examination schedules.

Additionally, regulators should develop guidance for items to be included in management reports. For example, regulators should identify those specific laws and regulations which have material consequences on the safety and soundness of thrift operations to be reviewed and reported on.

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## Administration Proposes Changes to the Thrift Industry

In February 1989, the President sent to the Congress a major reform and financing initiative to resolve the nation's savings and loan industry problems.<sup>11</sup> The administration's proposal, among other things, separates the Federal Savings and Loan Insurance Corporation from the Federal Home Loan Bank Board and consolidates it with the Federal Deposit Insurance Corporation (FDIC), creating a single agency to administer federal deposit insurance. The plan proposes that separate insurance funds be maintained for banks and for savings and loan institutions. Premiums

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<sup>10</sup>On October 11, 1985, the Bank Board issued Bulletin PA 7a-4, "Change in Accountants: FHLBB Procedural Requirements," which requires a thrift to file a notice with the district bank within 15 days of terminating its auditor. The notification is required to indicate reasons for termination and to discuss disagreements with the auditors during the previous 24 months. The terminated auditors must file a letter with the district bank indicating whether they agree or disagree with the thrift's statements. We have not evaluated the level of compliance with this bulletin or its effectiveness in combating the problems related to changing auditors which we noted in chapter 5.

<sup>11</sup>Although we are not in a position to comment on all aspects of the proposal, we believe that the results of this review address specific issues which the Congress should consider in developing legislation related to reform in the thrift industry. Specifically, we believe that our review provides insights related to restructuring regulatory and insurance activities.

from each industry would be used only for its own insurance fund, thus avoiding the commingling of funds.

Such a measure is intended to create one strong, independent insurer (FDIC) with an overriding mission of providing insurance to depositors and maintaining the security of the deposit insurance fund. Although we agree that under the proposal the considerable expertise of the consolidated FDIC will be available to deal with case resolution issues, we believe that additional measures will be required for the agency to deal with regulatory and examination issues. We agree with the President's proposal to consolidate FSLIC with FDIC. However, the multiple roles of the Bank System as promoter, charterer, banker, and primary regulator of the thrift industry would continue under the President's proposal.

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### Conflicting Roles Not Fully Addressed in the Administration's Proposal

The President's proposal recognizes that a structural flaw currently exists and separates the insurance function from the Federal Home Loan Bank System. However, the plan, as announced, would leave the primary regulatory and examination functions within the Bank System, although the insurer would be provided with limited authority to regulate and examine thrifts. Thus, to a large degree, the insurer would remain dependent upon the Bank System to regulate and examine thrift activities. However, we believe that legislation to restructure the thrift industry should provide for transferring certain regulatory functions and the examination function from the Bank System to the insurer.

As discussed in the preceding chapter, the quantity and quality of examiners and supervisors were increased by transferring these activities to the district banks, which were not subject to the personnel and salary restrictions that applied to the Bank Board. In order for an independent regulator to deal effectively with the problems in the thrift industry, its ability to attract and retain sufficient numbers of qualified examiners should not be impaired. If the proposed legislation is amended to transfer this function to the insurer, FDIC will need to establish compensation levels, consistent with its authority, to attract and retain qualified and experienced personnel.

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### Proposal Contains Provisions for Enhanced Enforcement Powers and Higher Capital Standards

The administration's proposal would provide the insurer new authorities to regulate thrifts and make determinations on the eligibility of institutions to be granted federal deposit insurance or to maintain their existing insurance. The proposal also contains provisions to enhance or supplement existing supervisory enforcement authorities, including

those related to (1) temporary cease and desist orders, (2) removal or suspension of insiders involved in the affairs of regulated financial institutions, (3) expansion of civil money penalties, and (4) termination of insurance for engaging in significant unsafe and unsound practices or otherwise posing undue risk to the insurance fund.<sup>12</sup>

We support the intent of the provisions to expand enforcement authority as contained in the proposal. Although we believe that expanded enforcement authority can provide the necessary tools to help ensure the safety and soundness of the deposit insurance fund, such measures may not achieve their intended effect if they are not aggressively utilized by the regulators and insurer. As discussed in chapter 9, our other ongoing work evaluating the effectiveness of the Bank Board's enforcement activities is addressing these provisions in more detail.

The administration's proposal would also provide for more stringent capital standards for the thrift industry. These standards would be phased in over 2 years and would require institutions to maintain capital ratios of 6 percent or greater by the end of that period. We also concur with the intent of this provision. Essentially, capital represents the amount at stake by the owners of an institution, and, in theory, the greater this amount, the greater the incentive is for them to operate an institution prudently. Conversely, as we have discussed in testimony before the Congress,<sup>13</sup> there appears to be some correlation between low capital and an institution's willingness to engage in unsafe or unsound practices, such as entering into imprudent or riskier business activities.

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## Conclusions

We believe that a need exists to establish an independent structure for oversight and regulation of the thrift industry. Currently, the Federal Home Loan Bank System has multiple, and often conflicting, roles as promoter, regulator, examiner, supervisor, and banker of the thrift industry. Accordingly, we believe that the Congress should amend the proposed reorganization of thrift regulatory and insurance activities to provide the insurer certain regulatory functions and the examination function to provide the insurer the means to better protect the integrity of the deposit insurance fund. In addition, such an arrangement would help to reduce the existence of conflicting roles, which we view as a

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<sup>12</sup>In December 1987, regulators from both the banking and thrift industries informally proposed certain legislative enforcement measures. Regulators suggested such measures to provide the tools necessary to ensure a safe and sound insurance fund.

<sup>13</sup>Resolving the Savings and Loan Crisis (GAO/T-GGD-89-7, February 22, 1989).

structural flaw in the current system. However, the insurer would need adequate resources to fulfill these regulatory and oversight functions. Thus, we believe that the examination staff, currently located within the 12 district banks, should be transferred to the insurer.

Adherence to sound internal controls, management practices, and financial reporting practices is essential to ensure the safety and soundness of the nation's financial institutions. The pervasive nature of internal control weaknesses cited for the failed thrifts we reviewed, however, demonstrates that thrift management did not implement and maintain adequate internal controls to ensure safe and sound thrift operations or compliance with laws and regulations. This clearly points to the need for an increased awareness of this responsibility and for greater management accountability. Continuation of independent audits with added management reporting on internal controls and on compliance with laws and regulations which have material consequences on thrift operations would provide a means to increase such an awareness and strengthen accountability. Moreover, audit and management reporting requirements would fill a void in the financial services industry's current disclosure system and provide an additional safeguard for the nation's thrifts.

The management reporting requirement would be strengthened by requiring that the thrift's independent public accountant read, consider, and report on management's assertions on internal controls and on compliance with laws and regulations. In view of the extensive internal control weaknesses regulators identified and the importance of thrift industry laws and regulations, the benefits of the independent audit and management reports will far outweigh any additional costs or the minimal expansion of management's and the independent auditor's existing responsibilities involved. Moreover, while independent audits of thrifts and management reporting are not substitutes for adequate examination and supervision, such requirements would help federal regulators fulfill their examination and supervision functions. However, regulators must establish measures to ensure the prompt receipt, review, and follow-up of audit and management reports.

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## Agency Comments and Our Evaluation

In commenting on a draft of this report, the Bank Board stated that attention should be focused on continuing improvements in the examination and supervision process, rather than on legislative requirements for audit and management reports. We do not disagree with continuing to improve the supervision and examination process. In fact, our proposed

audit and management reports are a necessary complement to the examination and supervision process to ensure that thrifts have adequate systems of internal controls. The Bank Board mentioned that recent initiatives to issue guidance related to thrift operations include adequate internal controls. However, the existence of guidance does not secure management's commitment to or even acknowledgement of its responsibilities. Although supervision and examination efforts, as well as related guidance, stress the importance of sound internal controls and compliance with laws and regulations, we believe that required management reporting would enhance accountability and provide greater discipline for thrift management. Such reporting would require thrift management to acknowledge its responsibilities for establishing and maintaining a system of internal controls and to report on the effectiveness of the system on an annual basis. Also, requiring the independent auditor to read and consider management's assertions about its system of internal controls will provide the independent review of internal controls which is needed to better ensure the safety and soundness of the thrift industry.

The Bank Board also stated that its roles as promoter of the thrift industry to foster home financing, charterer, and regulator are incorporated into the statutory mission of the Federal Home Loan Bank System. Although such roles were statutorily established, we believe that the current statutory structure of the Bank System results in inherent conflicts which may hinder the Bank System from successfully fulfilling these roles. We also believe that the failure of the Bank Board over the years to recognize and deal with the risks that insolvent thrifts posed to FSLIC is sufficient justification for separating these conflicting roles. The Bank Board further cited the example of the cooperative relationship between the Office of the Comptroller of the Currency (OCC) and FDIC in regulation and examination. We agree that a cooperative relationship does exist between FDIC and OCC, as well as with the Board of Governors of the Federal Reserve System. However, FDIC, as insurer, has no promotional mission, as does the Bank Board. Moreover, FDIC—the federal deposit insurer—is the primary federal regulator for approximately two thirds of all federally insured banks.

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## Recommendations

We recommend to the Congress that legislation restructuring regulatory and insurance activities of the thrift industry include provisions for certain regulatory and examination responsibilities for the insurer.

We further recommend that, as a condition for deposit insurance, the Congress enact legislation requiring each insured thrift to

- prepare an annual management report which (1) describes management's responsibility for preparing financial statements and for establishing and maintaining an effective internal control structure and (2) contains management's assessment of the effectiveness of the internal control structure;
- prepare an annual management report which (1) describes management's responsibility for complying with laws and regulations related to the safety and soundness of thrift operations and for establishing methods to monitor compliance and (2) contains management's assessment of the thrift's compliance with laws and regulations related to operations; and
- have the thrift's independent auditor report on the management assertions described above and submit such reports with the independent auditor's audit report to the thrift's regulator.

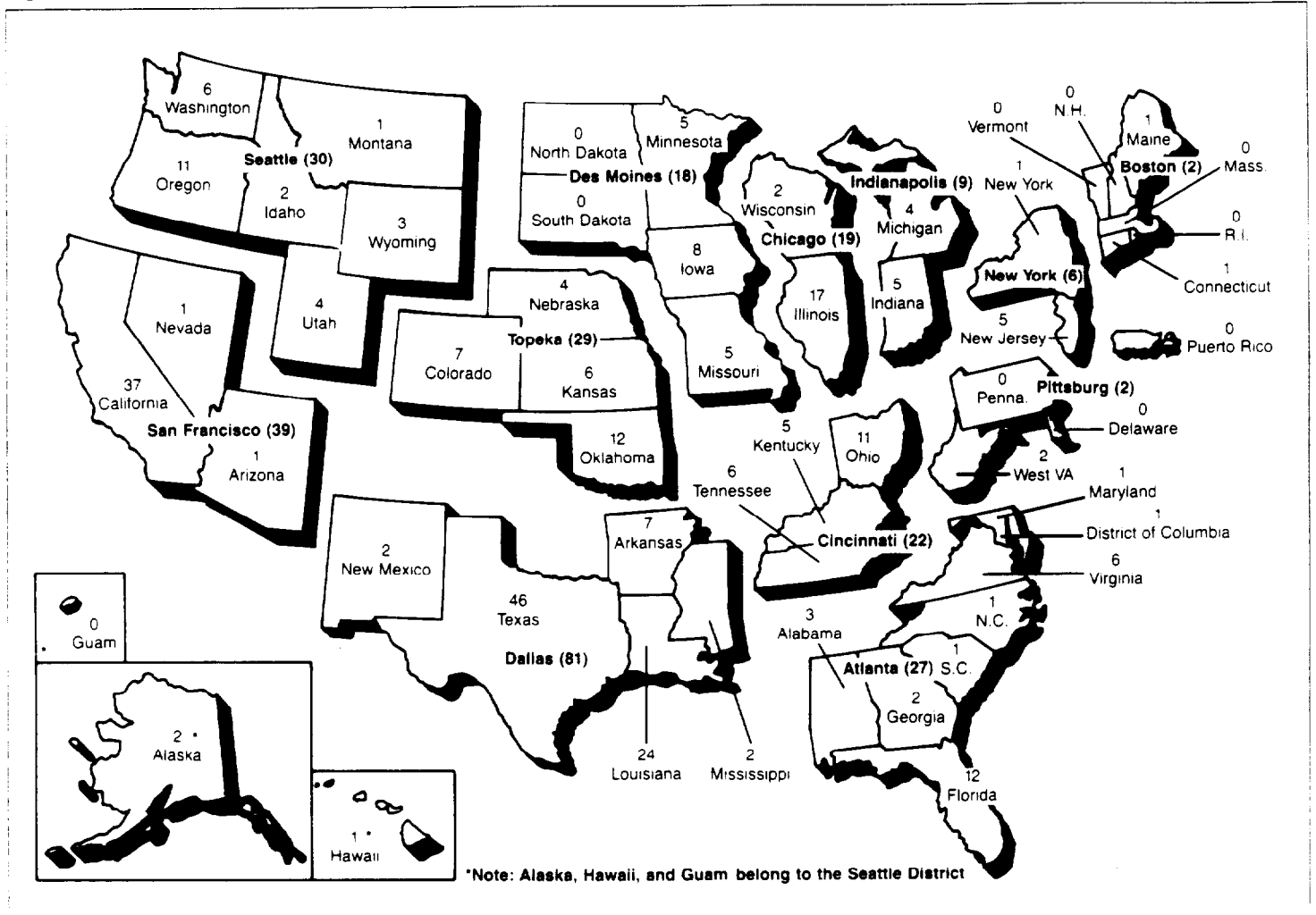
We also recommend that the insurer identify applicable laws and regulations which have material consequences on the safety and soundness of thrift operations to be reviewed and reported on in management reports.





# Geographic Distribution of Failed Thrifts

Figure I.1: Geographic Distribution of 284 Failed Thrifts Between January 1, 1985, and September 30, 1987



**Appendix I**  
**Geographic Distribution of Failed Thrifts**

**Table I.1: Insolvent and Solvent Thrifts in Our Sample**

<b>Attribute</b>	<b>Insolvent thrifts</b>	<b>Solvent thrifts</b>
<b>Geographic location</b>		
Texas	10	10
California	8	8
Idaho	2	2
Oregon	2	2
Iowa	1	1
Florida	1	1
Tennessee	0	1
Arizona	1	1
Arkansas	1	0
<b>Asset size</b>		
Over \$1 billion	11	11
\$1 billion and below	15	15

# Internal Controls

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In April 1988, the American Institute of Certified Public Accountants issued Statement on Auditing Standards Number 55, "Consideration of the Internal Control Structure in a Financial Statement Audit," which clearly describes the three elements of an entity's internal control structure as follows.

1. Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods to communicate the assignment of authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.
2. Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.
3. Control Procedures: The policies and procedures in addition to the control environment and the accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

# Comments From the Federal Home Loan Bank Board

Note GAO comments supplementing those in the report text appear at the end of this appendix.

**Federal Home Loan Bank Board**  
OFFICE OF THE CHAIRMAN



1700 G Street, N.W.  
Washington, D.C. 20552  
Federal Home Loan Bank System  
Federal Home Loan Mortgage Corporation  
Federal Savings and Loan Insurance Corporation

M. DANNY WALL, Chairman

April 10, 1989

Mr. Frederick D. Wolf  
Assistant Comptroller General  
General Accounting Office  
441 G Street, NW  
Washington, D.C. 20548

Dear ~~FRED~~ Sir:

Thank you for the opportunity to comment on the GAO's draft report on the attributes of a sampling of failed thrift institutions. Bank Board staff have thoroughly reviewed the report and have prepared comments on each chapter. Those comments follow.

First, however, we would like to take issue with what we believe to be an erroneous implication made in the report - that many regulatory violations and unsafe or unsound practices found at these thrifts occurred repeatedly and/or remained uncorrected, which leaves the impression that lack of supervisory or enforcement action contributed to the thrifts' failures. In fact, supervisory actions did halt a majority of regulatory violations and unsafe or unsound practices at these thrifts, and should not be assumed to be a contributing factor to the failures. This does not, of course, mean that those institutions were "saved." Even though many of the violations were stopped by supervisory or enforcement action and the institution placed under "control" by the agency, economic conditions and the results of prior deficient management nonetheless caused these institutions to fail. The report and the Executive Summary should appropriately be qualified to indicate this so that the public is not left with an inaccurate impression of supervisory effectiveness.

See comment 1

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Comments From the Federal Home Loan  
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The report also should take into account the enhancements the Board has made in its regulatory system to ensure that the regulatory violations and unsafe or unsound practices cited in the report do not recur.

Since 1985, the Board has taken a variety of steps to improve and enhance the quality of regulatory oversight within the Federal Home Loan Bank System. Major initiatives have been implemented or proposed in the areas of regulation and policy, staffing and training, regulatory procedures, oversight and monitoring, enforcement action, and quality control.

Specifically, in the area of regulation and policy, the Board has adopted or proposed restrictive regulations and instituted guidelines on growth, equity risk investments, minimum capital requirements, individual minimum capital requirements, capital directives, risk-based capital, early intervention, uniform accounting practices, classification of assets, mortgage derivative products and mortgage swaps, interest rate risk, and investment in high yield (junk) bonds.

The Federal Home Loan Bank System recognizes the necessity of retaining a staff of qualified professionals to deal with the complex activities in the thrift industry today and has made a significant effort to develop the System's human resources. The number of examiners and supervisors in the Bank System has doubled since 1985. (The increase in the examination staff was 63%.) These staff positions have been filled by individuals with related educational backgrounds, many with advanced degrees, and by individuals with previous regulatory or thrift experience.

The Bank System has adopted a core training curriculum for examination and supervisory staff members required as part of a mandatory accreditation program. Minimum performance and experience standards also are required for accreditation as a "Federal Thrift Regulator". The Bank System's Office of Education, established in 1984, provides much of the coursework required of examiners and supervisory staff for the accreditation program and offers other coursework as well.

Comprehensive regulatory handbooks for examiners and supervisors were issued in 1988. The Thrift Activities Handbook directly addresses the activities at insured thrift institutions while the service corporation and holding company handbooks direct regulatory oversight of these related entities to determine their impact upon regulated institutions.

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Regulatory procedures emphasize safety and soundness as a goal and employ a "top down" approach to evaluate management's effectiveness in running an institution. Such procedures call for the use of a customized regulatory plan to guide and coordinate regulatory activities of each institution according to its areas of vulnerability.

A capital markets division has been created within the Board's Office of Regulatory Activities to monitor, analyze, and provide guidance and technical assistance on capital markets instruments and portfolio management strategies. A series of releases that cover significant trends and developments in the capital markets area are used to disseminate information to the Federal Home Loan Banks. In addition, a capital markets examination team with special expertise in capital markets instruments and hedging activities has been formed to examine capital markets activities nationwide.

A special compliance division has also been established in the Office of Regulatory Activities. This division reviews consumer compliance issues, trust activities, and electronic data processing (EDP) systems. A team of compliance experts will be utilized to perform the compliance review function in future examinations.

The monitoring of thrift examinations off-site has increased significantly since 1985 when the Bank Board began to perform systematic and routine monitoring activities on a national basis. The system resulting from this effort includes an examination data system (EDS), a Supervisory Action Control System (SACS) that identifies significant events and substantive issues requiring supervisory action, and the Out Report System (ORS) that permits ready access to special and cumulative reports for institutions.

The Thrift Financial Report has been changed substantially to meet the information needs of examination and supervision functions. Enhancements include the collection of data on interest rate risk, asset quality, cash flow, and trading accounts, among others.

A new system that will permit the monitoring of regulatory actions undertaken with regard to any insured thrift is being implemented. The program will also ensure that adequate rehabilitation efforts are undertaken at troubled institutions.

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A peer review program is now an integral part of Bank System operations. The program allows for detailed independent reports of the current effectiveness of the Agency Functions operations of the Federal Home Loan Banks. Internal quality assurance programs at each Bank have evolved from the peer review program and quarterly meetings with representatives of the Office of Regulatory Activities and Principal Supervisory Agents work to ensure the implementation of effective supervisory and regulatory policies and procedures.

Finally, the Board continues its active enforcement activities, litigation efforts, and identification and referral of suspected instances of criminal conduct. It is Board policy that prompt, fair, firm and appropriate action be taken to ensure correction of violations of laws and regulations, unsafe or unsound practices or other activities that unnecessarily expose the FSLIC to risk.

Board litigation efforts resulted in awards of \$105 million in 1988 and this total reflects only those recoveries that resulted from suits of directors, officers and other professionals. Active lawsuits are pending against a number of accounting firms. The Board's efforts have also been effective in securing restitution of funds lost to the FSLIC as part of criminal sentences.

The Board actively participates in and supports the National Bank Fraud Working Group and sixteen regional bank fraud working groups. Each Federal Home Loan Bank has, on staff, an individual whose responsibility is to coordinate and act as a liaison with the U.S. Department of Justice on criminal referrals and suspected fraudulent activity.

On the issue of suspected criminal conduct, a clarification is in order. The report findings appear to have caused another public misperception which stems from the report's use of a broad definition of fraud and insider abuse taken from the Federal Home Loan Bank Board's March 1988 report to Congress addressing prevention of future insolvencies. To properly employ the definition, it must first be realized that it is written from an examiner's perspective. Rather than providing a list of items that, when found, establish insider abuse or fraud, much of it is a list of "red flags",<sup>1</sup> i.e., if these items are found, the examiner should suspect insider abuse or fraud and pursue further examination or investigation in order

See comment 2

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Page 5

to make a determination. The distinction can easily be seen when the following definition of insider abuse provided in the board's thrift activities handbook, section 135 (which was published in September 1988, after this study began) is reviewed:

the term insider abuse is used to refer to a wide range of activities by officers, directors, major shareholders, agents, and other controlling persons in financial institutions that are intended to benefit such insiders or their related interests, without regard for the safety or soundness of the institutions they control.

Thus, the key elements are: (1) benefit to insiders; and (2) disregard for the safety or soundness of the institution. Applying this definition, many of the examples cited in the Report would be insufficient to make a determination either of insider abuse or fraud (a higher standard). For example, payment of consulting fees to insiders, use of their companies by the association, and putting an insider's friends and relatives on the payroll, while indicating that an examiner should look further, would not indicate insider abuse unless it also was shown that the institution paid an excessive amount for services provided. If adequate value was received, the action would not be perceived to be without regard to safety or soundness, and it would not be abusive. Similarly "high-risk speculative ventures" would not be an insider abuse unless an insider profited and the venture did not provide the institution with a reasonable probability of a return that would compensate it for its risk.

A better definition of insider abuse would be the one quoted above (which should be used at page 46 of the report). Unfortunately, substitution of a different and better definition in the report would have unknown consequences because we do not know how it would affect the GAO's conclusions with respect to the cause of the failure of each of the 26 institutions.

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1/ The Report appears to observe this distinction on page 35, where it refers to these matters as "characteristics" of fraud.



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We are distressed that GAO representatives themselves, in discussing the Report's conclusions, appear to assume that any such incidence of "fraud or insider abuse", as broadly defined, is criminal in nature. This is absolutely untrue and if the report is leading the GAO's own representative to that conclusion, then clarification is mandatory.

Our additional comments and recommendations on individual sections of the report follow.

Executive Summary

Following the report's limited release, some inaccuracies have surfaced repeatedly in Congress or the press concerning its content.

The misinterpretations include the notion that the 26 failed thrifts which are the subject of the report were randomly selected and that the report's findings of the activity at these 26 thrifts is representative of the type of activity at all failed thrifts for the time period covered in the report. While these matters are adequately addressed in the body of the report, they also should be highlighted in the Executive Summary to prevent further public confusion.

In order to dispel the notion of random selection, page two of the report, the "Background" section of the Executive Summary, should include a statement that the sample of 26 thrifts was "judgmentally selected" or "specially selected to reflect cases where the larger losses occurred." This now is indicated only on page seventeen of the Report. Page three of the report, the "Results in Brief" Section of the Executive Summary, should include a qualifying sentence to the effect that while these 26 thrifts did account for over fifty percent of the FSLIC losses for all failed thrifts covered by the time period of the report, they represent only about ten percent of the then total number of these thrift failures; and, therefore, the high percentage of cited misconduct at the 26 thrifts cannot and should not be assumed to be representative of most failed thrifts. In our experience, most thrift failures resulted from a combination of factors including distressed economic conditions, poor board of director oversight, and management deficiencies, although fraud was a significant contributing factor, we believe, in about twenty-five percent of failures.

See comment 3

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See comment 4.

In the section labeled, "Regulators Were Often Unsuccessful in Resolving Problems Examinations Identified", the text reads, "GAO's review did not include a review of the effectiveness of the regulators." Nonetheless, GAO implies in the Executive Summary that better regulation should have been evident and that the structure of the Bank system precludes effective regulation. Such conclusions are not supported by the data presented in the report.

Chapter One - Introduction

See comment 5.

In the section entitled, "The District Banks", the final paragraph on page 15 reads, "If the supervisory agent and ORA determine that the problems cannot be resolved without assistance from FSLIC, they can recommend that FSLIC take responsibility for the thrift." This action, on the part of the agent and ORA is actually more defined. The sentence should read, "...they will transfer responsibility for the thrift to the FSLIC.

Chapter Two - External Factors Affecting all Thrifts

Now in chapter 3.

In the section entitled, "Changes in the Law", the final paragraph on page 27 reads, "...The Executive Branch of government had a very strong policy of preserving "states rights". In fact, the Congress also was, and for the most part is, fully supportive of states' rights.

See comment 6.

Chapter Three - Officers and Directors Breached Their Fiduciary Duties, Including Those Relating to Internal Controls

Now in chapter 2

In the section entitled, "Passive Boards of Directors", the first paragraph on page 36 reads, "Federal regulations specify the active role a board of directors must take." The regulations actually do not specify that directors take an active role although that is implied in the many responsibilities assigned to directors in the regulations. It would be more accurate if "guidelines" replaced the word "regulations" in the sentence cited since the most specific pronouncement by the Board on directors' responsibilities and duties is contained in R-Memorandum 62.

See comment 7

Now in chapter 4.

In the same section and on the same page, the text reads, "...a board must approve appraisers used for loans the thrift originates..." In fact, the regulation requires that management - meaning directors and officers - develop guidelines and adopt procedures pertaining to the hiring of appraisers. The directors do not have to directly approve appraisers.

See comment 8.

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In the section entitled, "Loans to Borrowers Exceeded the Legal Limit", the final paragraph on page 41 contains the limitation for aggregate loans to one borrower. Because the examples in the section detail abuses relative to the overextension of commercial credit to one borrower, the more restrictive limitation for commercial loans to one borrower should be presented, i.e., outstanding commercial loans to one borrower may not exceed 15 percent of the thrift's unimpaired capital and surplus.

Chapter Four - Business Decisions and Strategies

In the section entitled, "Volatile Deposits Solicited", there is a discussion of jumbo brokered deposits. No mention is made in this discussion of the change in the law made by the Congress that brought insurance levels up to \$100,000. Further, the discussion fails to point out that the Board attempted to curb the potential for abuse in brokered deposits when it issued its brokered deposits regulation in 1984. That regulation was overturned by the courts.

In the section entitled, "Riskier Investments Made", the discussion focuses on problems associated with riskier investments, particularly direct (or equity risk) investments. The discussion fails to mention the issuance of the Board's 1985 direct investment rule or the amendments made in 1987 that further tightened the rule. (The rule is mentioned briefly on pages 129 and 130 but in a different context.)

Chapter Five - Unsafe Underwriting and Loan Disbursement Practices

In the section entitled, "Appraisal of Property and Projects", on page 61, the text reads that an appraisal should be prepared by an appraiser appointed by the thrift's board of directors. As noted in the comments on chapter 3, the regulation requires management - directors and officers - to adopt procedures relative to the hiring of appraisers. The directors are not required to "appoint" appraisers.

In the section entitled, "Appraisal of Business Thrifts Acquired", there is a description on page 63 of three specific factors a thrift should consider when acquiring a business. These factors are deemed to be "Bank Board guidance". There is, however, no official document issued by the Board that contains these factors.

Now in chapter 2  
See comment 9

Now in chapter 3  
See comment 10

Now in chapter 3  
See comment 11

Now in chapter 4  
See comment 12

Now in chapter 4  
See comment 13

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Chapter Six - Deficiencies in Financial Information and Records  
were Common at Failed Thrifts

On page 77, the report states that..."the lack of Bank Board guidance on the accounting for such transactions may have hampered examiners in some cases." In fact, accounting guidance on this subject has been repeatedly asked of the American Institute of Certified Professional Accountants (AICPA) and the Financial Accounting Standards Board (FASB). In order to adhere to the generally accepted accounting principles (GAAP), the Board has attempted to follow AICPA/FASB pronouncements. There has been a very real lack of accounting guidance in this area.

Chapter Seven - Investigations and Legal Activities Related to  
Failed Thrifts

Chapter Eight - Characteristics of Solvent Thrifts

There is an inconsistent treatment of ADC loans and other non-traditional lending in these chapters. ADC and non-traditional loans are seen as unsafe practices in chapter seven but in chapter eight are presented as evidence of a healthy diversification of assets. The report seems to imply that a high percentage of ADC or non-traditional loans is unsafe, rather than that the loans are unsafe per se. The point could be made clearer if it were stated in chapter seven that an overreliance on such loans was unsafe.

Chapter Nine - Actions Related to the Long-Standing Problems  
Identified Through the Examinations and  
Supervision Process

On page 114, the report states that the Board had no standards for examination frequency until late 1986. This is not accurate. A nationwide program for targeted examinations with differing scopes began in 1983. Prior to that, each regional office of the Board's Office of Examinations and Supervision (in which examiners were based prior to their transfer to the District Banks) had standards for examination frequency and each had their own minimum scopes.

In the section entitled "Supervisory Efforts to Correct Problems identified in Examinations" on page 120, the report notes that Bank Board directives state that supervisory actions should vary according to the severity of the violations or unsafe practices as well as to the responsiveness of management to take corrective action. More than a mere notation of directives should be made. From 1984 to 1986, the Board issued very specific directives on supervisory and enforcement action, especially as they related to

Now in chapter 5

See comment 14.

Now in chapter 7

See comment 15

See comment 16.

See comment 17.

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net worth, growth, and high-risk lending problems. These should be cited.

The report at pages 122-124 discusses and defines enforcement actions as cease and desist orders, temporary cease and desist orders, removal and prohibition orders and termination of insurance proceedings.<sup>2/</sup> In essence, the report quantitatively describes only certain of these enforcement actions without qualitatively reflecting other significant enforcement involvement at these 26 thrifts. Complete information concerning all enforcement action taken at these thrifts was provided to the Government Accounting Office at their request on September 23, 1988. The report should properly reflect the information set forth in the letter, which is described below.

The report at page 124 does not include two prohibition orders or a temporary cease and desist order. These actions should be included on this page along with the information presently there. The Report also overlooks other significant enforcement actions for which we achieved voluntary resolutions. These include: 1) a negotiated supervisory agreement at one thrift; 2) a voluntary suspension and subsequent settlement agreement removing a chairman of the board from a second thrift and prohibiting his future employment in the thrift industry; 3) the separation of a major stockholder from a third thrift; and 4) a Report of Investigation of securities violations issued for a fourth thrift.

Of equal importance, yet also overlooked, are Section 407 formal examinations conducted by the Office of Enforcement. Six resulted in the formal enforcement actions described on page 124 of the report, as modified by this letter. In addition, all of the aforementioned voluntary resolutions followed after we conducted 407 formal examinations. One formal examination is continuing at the present time to gather evidence for possible prohibition actions against certain individuals. Several Section 407 examinations did not result in the types of enforcement action described above primarily because the institutions were placed under FSLIC control while the formal examination was in process, making further enforcement action unnecessary. Nonetheless, because the evidence produced in these investigations was turned

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<sup>2/</sup> It should be noted that termination of insurance of accounts is not an effective supervisory or enforcement tool. Insurance remains in force for two years after a termination proceeding is concluded. Such a proceeding may, itself, take several years. Moreover, such action may precipitate a deposit run which is not in the FSLIC's best interest.

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over to FSLIC fee counsel pursuing the civil recovery actions against officers and directors that are discussed in Chapter Seven of the Report, they also should be included.

The report does not appear to include Management Consignment Programs (MCPs). MCPs are a very strong supervisory tool and often are an effective and expeditious means of gaining control of an institution. In many cases they are more effective than formal action for the removal, prohibition or suspension of officers since that action may involve a very lengthy legal process, during which time, the officers remain employed at the thrift. MCPs, should, therefore, also be included.

Chapter Ten - Legislative Actions Needed to Strengthen Oversight and Management

The draft report recommends three major legislative actions to help prevent a recurrence of the pattern of regulatory violations and unsafe practices documented in the examination reports that were prevalent in 26 failed thrifts.

- 1) Responsibilities for the examination and supervision of thrifts should be transferred out of the Bank System to the insurer.
- 2) Management reports on internal controls and compliance with laws and regulations that materially affect safety and soundness should be required in order to increase management accountability.
- 3) Independent auditors should be required to read, consider, and report on management's assertions on internal controls and on compliance with laws and regulations.

With regard to the latter two recommendations, the proposed audit and management reporting requirements are accomplished easily enough and can serve as a supplemental tool for the examination and supervision process. These reports, however will not correct the major problem identified in the GAO draft - the need for a timely and effective supervisory and enforcement response to problems identified in the examination process. Attention should be focused on continuing improvements in the examination and supervision process, rather than on legislative requirements for audit and management reports. Many of the improvements in our regulatory system, cited at the beginning of this letter, have focused precisely on the need and our intent to ensure better internal controls in the institutions we regulate.

See comment 20.

See comment 21.

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The report contends that, "... the Federal Home Loan Bank System has multiple and often conflicting roles as promoter, regulator, examiner, supervisor, and banker of the thrift industry." Although acknowledging that the Board has made numerous regulatory improvements in the last few years, including new or revised policies and regulations and changes in personnel and processes, the report concludes that the System's multiple roles constitute an inherent conflict that impedes the System's ability to satisfactorily fulfill any of these roles.

This conclusion and the first recommendation are premature, unnecessary, and unwarranted. The recent improvements in regulatory policies, examinations, and supervision in the Bank System are highly significant. In any case, they have not been adequately tested to conclude that, "...there is little assurance that the repeated violations and unsafe practices of the 26 failures could not reoccur in the future." On the contrary, these changes demonstrate that the Board has recognized past problems and moved aggressively to correct them. Indeed, we believe these 26 failures could not happen now.

In addition, the President's proposal will separate the FSLIC from the Board and will create a single agency to administer federal deposit insurance. The proposed bill would statutorily emphasize that the Bank Board's purpose, with respect to helping provide home finance, must be consistent with the safe and sound operation of insured institutions. The proposal will also significantly enhance the power of the insurer and the primary regulator to act to prevent unsafe actions that jeopardize the insurance fund. If adopted, the President's proposal will provide both the insurer and the primary regulator with sufficient power to address risks without transferring the examination and supervision function from the Bank System.

The GAO's main concern, that the insurer not be a captive of the "promotional" and chartering aspects of the System, is essentially groundless. The report never makes clear what is meant by promotional responsibilities. If the GAO means to refer to the reason behind the statutory creation of the Bank System and the FSLIC - to foster home financing - then it should be noted that this is not a promotional responsibility. It is a statutory mission. The report discusses the problems associated with having the promoter and the insurer as one entity but never discusses the policy reasons as to why they were initially joined nor the policy implications of separating them now. In any case, the aims of the Board's supervisory and regulatory divisions and the insurer are identical - to ensure the safe and sound operation of all

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FSLIC-insured institutions, federally- or state-chartered. The cooperative relationship between the OCC and the FDIC in examinations, supervision, and regulation is a clear example of such a system at work, and is the proper model to follow.

As a final comment, we believe that footnote 1 on page 137 of the draft is inaccurate and unnecessary. GAO fails to mention its own determination in B-226708.3, December 12, 1988, p. 2, that ORA employees are not civil servants: "the fact remains that their employees are not actually federal employees." Accordingly, footnote 1 should be revised as follows:

1/ ORA is a joint office of the Federal Home Loan Banks whose employees are not federal employees subject to title 5 of the U.S. Code.

Sincerely,



M. Danny Wall  
Chairman

See comment 22



The following are GAO's comments on the Federal Home Loan Bank Board's letter dated April 10, 1989.

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## GAO Comments

1. This issue is addressed in "Agency Comments and Our Evaluation" in chapter 9.
2. As noted, the definition of fraud and insider abuse cited in the report was the definition the Bank Board provided to the Congress in complying with the reporting requirements of the Competitive Equality Banking Act of 1987. We recognize there may be no universally agreed upon definition of the term "fraud and insider abuse"; accordingly, we used the term as the Bank Board defined it in its official, formal communication to the Congress. Nonetheless, a review of the characteristics noted at the individual thrifts substituting the definition contained in the Bank Board's response would result in a conclusion that fraud and insider abuse existed in at least 23 of the 26 failed thrifts. In this regard, it should be noted that we do not currently, nor did we previously, state that fraud and insider abuse caused the failure of these thrifts. As discussed in chapter 1, a combination of many factors caused the failure of these institutions. This report does not attempt to assess the degree to which each of these factors contributed to the failures of the 26 institutions. Instead, the report describes those factors that existed at the failed institutions.
3. The judgmental sample criteria and qualifying language regarding applicability to other failed thrifts were added to the executive summary.
4. See the "Agency Comments and Our Evaluation" sections in chapters 9 and 10.
5. We have modified the report to clarify this point. Although district bank personnel and the Office of Regulatory Activities can transfer responsibility for a thrift to FSLIC, FSLIC must agree to accept the case.
6. The report reflected the conversation held with Bank Board officials. We have modified the report to incorporate the view the Bank Board expressed in its written comments that the legislative branch also was supportive of preserving states' rights.

7. We have modified the report to indicate that the active role of the board of directors is implied by the many responsibilities assigned to them by regulation.

8. In discussions with Bank Board officials regarding this comment, they agreed that during the period of our review, thrift directors were required by regulation to appoint appraisers. The regulations were subsequently modified, eliminating the requirement for direct board appointment.

9. We have included the restrictions on commercial lending to a single borrower.

10. We have modified chapter 3 to include the Bank Board's regulatory efforts to limit brokered deposits.

11. We have modified chapter 3 to indicate that in 1985 the Bank Board made regulatory efforts to limit direct investment activities. Further discussion of such efforts is included in chapter 9.

12. See comment 8.

13. No change necessary to the report. On August 15, 1985, guidance regarding the acquisition of business entities was revised by memorandum R-28c, "Guidelines for the Review of Records Relating to the Acquisition of Business Entities by Insured Institutions or Their Service Corporations," which included the criteria for evaluation of a business acquisition as discussed in the report. This guidance superseded memorandum R-28b, which was issued April 16, 1976, and included the same criteria discussed in the report. In subsequent discussions with Bank Board officials, they indicated that this guidance had been overlooked when responding to the draft report. They agreed that such guidance did exist and was properly characterized in the report.

14. We have modified chapter 5 to include the Bank Board's comments regarding the lack of guidance provided by the accounting profession. However, we disagree with the implication that the Bank Board could not, for regulatory purposes, issue accounting guidance which differed from generally accepted accounting principles (GAAP). In fact, prior to passage of the Competitive Equality Banking Act of 1987, the Bank Board had issued several accounting provisions known as regulatory accounting principles, which differed from GAAP.

15. We have modified chapter 3 to indicate that overreliance on such loans may be detrimental to a thrift.

16. We have modified chapter 9 to acknowledge examination criteria prior to 1986. Subsequent to their written comments, Bank Board officials provided us with documents that provided general examination criteria for examinations prior to 1986. An excerpt from the Bank Board's Manual of District Operations dated July 1978 states, "Institutions which historically adhere to safe and sound practices and compliance with regulations will be examined annually or at intervals consistent with Board policy and Office of Examinations and Supervision [currently Office of Regulatory Activities] directives." It further provided that any institution designated as a problem institution could be examined at any time. These examination criteria gave supervisory agents broad discretionary authority over the timing of examinations.

In 1983, a memo to District Directors discussed restructuring the examination process but did not specify criteria for examination frequency. It was not until the Office of Examination and Supervision issued an examination scheduling memorandum (SP 69) in September 1986 that definitive guidelines for the maximum time between examinations were established. Thus, we believe that the report accurately reflects the lack of uniform, specific standards regarding examination frequency prior to late 1986.

17. We have included reference to such directives in chapter 9.

18. We have modified the report to provide the more detailed information on the prohibition orders and the temporary cease and desist order included in the Bank Board's comments. In addition, we have modified the report to distinguish between administrative (informal) actions and formal enforcement actions as specified in the enforcement section of the National Housing Act and the Office of Enforcement's (OE) letter of September 23, 1988. For the purposes of this report, we do not consider those "other actions" to be formal enforcement actions as provided in the law or in OE's letter. Those actions have been included in the administrative actions discussed in chapter 9.

19. As stated in the Bank Board's comments, section 407 investigations may lead to formal enforcement actions; however, we do not consider the investigations themselves to be formal enforcement actions. As a result, we did not modify the report.

20. The report discloses examination, supervisory, and enforcement actions which preceded the institutions' failure. We modified chapter 9 to clarify this issue. As discussed in chapter 1, we considered institutions to have failed if FSLIC had taken over management, replacing the board of directors and management (as is the case in the Management Consignment Program). Accordingly, we do not consider conservatorship actions, such as the Management Consignment Program, to be enforcement actions prior to failure.

21. See "Agency Comments and Our Evaluation" in chapter 10.

22. Our opinion in B-226708.3, dated December 12, 1988, cited by the Bank Board, addressed whether employees of the Office of Regulatory Activities can be held liable for receiving compensation in excess of federal employee salary schedules. In concluding that the employees could not be held liable, our opinion only recognizes that these employees do not, in fact, have the legal status of federal employees because they were not formally appointed in the civil service. This opinion was a follow-up to B-226708, September 6, 1988, in which we concluded that employees of the Office of Regulatory Activities should have been appointed as employees of the Federal Home Loan Bank Board, and thus as federal employees. We reaffirmed this conclusion in a recent letter to Senator Pryor, B-226708.4, March 15, 1989. For the reasons stated in these opinions, we continue to believe the ORA employees should be appointed as federal employees and that the Bank Board's failure to do so constitutes a circumvention of federal civil service laws.

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