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Follow-up Audit of the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks

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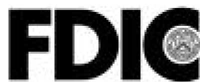

Federal Deposit Insurance Corporation Office of Audits
Washington, D.C. 20434 Office of Inspector General

DATE: February 20, 2002

TO: Michael J. Zamorski
Director, Division of Supervision

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Follow-up Audit of the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks* (Audit Report No. 02-004)

This report presents the results of our follow-up audit of a 1999 Office of Inspector General (OIG) study of the Division of Supervision's (DOS) efforts to monitor and assess risk at insured institutions for which the Federal Deposit Insurance Corporation (FDIC or the Corporation) is not the primary federal regulator (PFR).[1] In a memorandum to the FDIC Chairman in October 1999,[2] we reported that other federal regulators had occasionally restricted the FDIC's efforts to participate in safety and soundness examinations at institutions for which the Corporation is not the PFR. Such restrictions had limited the FDIC's ability to assess risks to the deposit insurance funds. We also reported that because of limitations in the information routinely provided to DOS by the other regulators pertaining to the nation's largest banks, DOS managers expressed serious concerns that they may not be able to adequately assess the risks that the country's largest non-FDIC supervised banks pose to the insurance funds.

The objective of this follow-up review was to assess the progress that the FDIC has made since the issuance of our previous memorandum and to make recommendations that might improve the Corporation's effectiveness in working with the other federal regulators. We conducted our audit from March through November 2001 in accordance with generally accepted government auditing standards. As the Office of Inspector General for the FDIC, we reviewed the issues addressed in this report solely based on information provided by the FDIC in its efforts to effectively carry out its mission. We did not perform audit fieldwork at the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), or the Office of Thrift Supervision (OTS). A detailed discussion of the scope and methodology of our audit is included in Appendix I.

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[1] A bank's primary federal regulator is determined by the bank's charter and whether a bank is a member of the Federal Reserve System. The FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System. The Office of the Comptroller of the Currency (OCC) is the primary federal regulator for all national banks. The Board of Governors of the Federal Reserve System (FRB) is the primary federal regulator for state chartered banks that are members of the Federal Reserve System. The Office of Thrift Supervision (OTS) is the primary federal regulator for federal and state-chartered savings associations.
[2] Audit Memorandum to the Chairman – *Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks,* October 19, 1999.

RESULTS OF AUDIT

In both our reviews, we noted that DOS managers have generally developed good working relationships with their regional counterparts in FRB, OCC, and OTS. In our first review, covering the 42-month period ending in March 1999, we identified 90 instances where DOS had participated in examinations with the other federal regulators. However, the FDIC has not always been able to promptly secure permission to participate in examinations of banks supervised by the OCC and OTS. Specifically, we learned of three situations that occurred during 1998 where these regulators turned down initial DOS requests to participate in scheduled safety and soundness examinations, and the end result in two of these cases dramatically illustrates the importance of regulators working together to effectively deal with evolving risks in the banking industry. One case involved an OCC supervised bank, the First National Bank of Keystone, Keystone, West Virginia, and the other case, Superior Bank, FSB, Hinsdale, Illinois, an institution supervised by OTS. Both banks were ultimately closed by the regulators (Keystone in September 1999 and Superior in July 2001) and both have captured congressional and national attention because of the significant loss estimates associated with these institutions. As of December 31, 2001, the combined estimated loss for the two banks was $1.13 billion - losses that will ultimately be borne by the federal deposit insurance funds. The OCC's and OTS's initial reluctance to allow DOS examiners to evaluate a number of concerns related to the activities of these banks may have prolonged their periods of operation and increased deposit insurance fund losses.

Our follow-up review did not identify any additional instances where another regulator turned down an FDIC request to participate in an examination. However, DOS officials informed us of several cases where examiners experienced delays in receiving requested information from another regulator or were not provided sufficient time during examinations to review certain bank conditions.

In our 1999 memorandum, we suggested that the Chairman (1) request delegated authority from the FDIC Board to initiate special examinations without having to secure the concurrence of the primary federal regulator or the approval of the Board or (2) seek a legislative change to vest this authority in the Chairman. Following Keystone's failure and the issuance of our memorandum, Representative James Leach, the former Chairman of the House Committee on Banking and Financial Services, introduced legislation on November 16, 1999 (H.R. 3374) designed to strengthen the FDIC's ability to monitor and assess risk in those financial institutions for which the FDIC is not the primary federal regulator. Following a hearing on H.R. 3374 in February 2000, no action was taken on the legislation based on the strength of the Comptroller of the Currency's representations during the hearing that there should be no problems with the FDIC's access to OCC regulated banks and that any disputes with the FDIC would be resolved at his level. The bill expired at the end of the 106th Congress. Subsequently, the FDIC Chairman did not request a delegation of authority from the Board. Based on the results of our follow-up review, we believe the circumstances supporting our previous suggestion have not substantially changed, and that changes in the industry and the consequences of additional failures have

increased risk to the deposit insurance funds. Accordingly, we are now formally recommending that the FDIC's special examination authority be strengthened.

In our previous review, we also pointed out a number of factors that significantly limit the FDIC's ability to effectively monitor the financial risks posed in the country's largest banks, those with over $25 billion in assets (sometimes referred to as "megabanks"). At that time, 37 of the 39 largest institutions were supervised by OCC, FRB, and OTS. We reported that DOS officials had to evaluate risk exposures in megabanks by using information that is mostly historical in perspective and filtered or interpreted by the other regulators before it is made available to the FDIC. These same conditions continue to exist, with 35 of 38 megabanks supervised by the OCC, FRB, or OTS. Additionally, we observed in our previous report that DOS was prevented from gaining valuable insights into the operations and risks of the nation's largest national banks because the OCC would not allow DOS personnel to attend meetings between OCC examiners and bank management. Over the past 2 years this situation has not changed. DOS personnel are attending bank management meetings with FRB and OTS, but not with OCC.

We are, therefore, reaffirming the position we expressed in our prior review by recommending that the Director of the FDIC's DOS develop agreements with the other bank regulatory agencies to provide the FDIC with the real-time information and access to megabanks necessary to carry out the Corporation's responsibilities as the insurer. Consistent with this recommendation, the FDIC worked with the OCC, FRB, and the OTS during the latter part of 2001 to develop an interagency agreement to improve the Corporation's access to banks for purposes of performing special examinations and to provide DOS with more timely data on large banks. On January 29, 2001, the FDIC Board authorized implementation of the agreement that includes a provision for the FDIC to assign a dedicated examiner to each of the eight largest banking organizations.

In our 1999 memorandum, we also suggested that the Chairman direct DOS to: identify the specific information that DOS needs to monitor the insurance risk presented by megabanks and other insured institutions; establish well defined criteria for case managers to use in evaluating the insurance risks posed by non-FDIC supervised megabanks; and clearly articulate DOS's monitoring goals and objectives. DOS initiatives undertaken since the completion of our previous fieldwork, such as instituting changes to improve the efficiency of its large bank supervision program and providing specific instructions to case managers in response to our memorandum, have met the intent of our suggestions. Accordingly, we are not making any recommendations that specifically pertain to these matters.

BACKGROUND

Legislative and Regulatory History

The FDIC's special insurance examination authority is contained in subsection 10(b)(3) of the Federal Deposit Insurance Act (FDI Act). This subsection provides FDIC examiners the power to make special examinations of any insured depository institution, whenever the FDIC Board of Directors determines such an examination is necessary, to determine the institution's condition for insurance purposes. During 1995, the Board delegated authority to the Director of DOS to

perform examinations, visitations, and/or other examination activities with the concurrence of the PFR. However, under the current delegation, DOS examiners do not have the authority to perform an independent on-site evaluation of a bank's activities, even if the bank is in a troubled condition, without the approval of the bank's PFR or the FDIC Board of Directors. The five-member Board is composed of the FDIC Chairman and Vice Chairman, the FDIC Director, the Comptroller of the Currency, and the Director of the Office of Thrift Supervision. The FDIC Vice Chairman position was vacant as of the date of this report. A more detailed history of the Corporation's special examination authority is presented in Appendix IV.

Extent of Special Examination Activities

As required by current law, the FDIC maintains and protects separate insurance funds for banks and savings associations and shares supervisory and regulatory responsibility for FDIC-insured institutions with FRB, OCC, OTS, and state authorities. As shown in Table 1, the FDIC is the PFR for approximately 5,600 federally insured state-chartered commercial banks that are not members of the Federal Reserve System.

Table 1: Primary Federal Regulators and the Institutions They Supervise

Primary Federal Regulator	Type of Bank Charter	Number of Institutions	Total Assets ($ in millions)
FDIC	State Non-Member	5,616	$1,468,152
OCC	National	2,231	3,414,579
FRB	State Member	991	1,644,645
OTS	Thrifts/Savings	1,067	933,972
OCC-FRB-OTS	Subtotal	4,289	$5,993,196

Source: Fourth Quarter 2000 Banking Profile

In carrying out its responsibilities as the insurer, the FDIC also monitors the conditions of about 3,200 national and state member banks, and more than 1,000 thrift institutions. For the 17-month period ending February 28, 2001, we noted that DOS participated in the examination of 71 banks and thrifts regulated by the OCC, OTS, and FRB, or approximately 1.7 percent of the institutions that the FDIC monitored for insurance purposes over that time period.

Changes in the Banking Industry Environment

In our 1999 memorandum, we pointed out that since the early 1990s, the major banks have been rapidly developing into enormous and complex financial conglomerates. The continuing consolidation of the industry has resulted in fewer and fewer financial institutions controlling an ever-expanding percentage of the nation's financial assets. The largest banks operate highly complex branch networks, have extensive international and capital market operations, and work on the cutting edge of technologically sophisticated finance and business. There are about 8,800 banks nationwide – down from more than 12,000 in 1990. In a relatively short period of time,

the industry has undergone such a widespread consolidation that relatively few institutions now control almost half of the total bank assets of all FDIC insured depository institutions, about $3.6 trillion.

This trend toward the consolidation of financial resources is placing increasing risks on the deposit insurance funds. As of March 31, 2001, there were 38 megabanks in the country. The consolidation of banks serving different markets can moderate risk, decrease earnings volatility, and moderate the effect of economic downturns on the largest institutions, thereby decreasing the likelihood of failure. However, consolidation in the banking industry presents additional risks for the FDIC in its unique role as the deposit insurer because the deposit insurance funds[3] face larger potential losses from the failure of a single large institution.

In addition to controlling a high percentage of banking resources, today's megabanks are frequently involved in non-traditional and highly complex business activities. The financial conditions faced by the largest banks can change direction with very little warning. In addition, the enactment of the Gramm-Leach-Bliley Act of 1999,[4] which permits affiliations between insured banks, financial holding companies, and various subsidiary relationships including securities and insurance firms, may pose new challenges not only to the banking industry but also to each of the cognizant regulators. For these reasons, the need for coordination, cooperation, and sharing of timely and accurate information among the regulators is essential.

Consequences of Additional Failures

Closing additional institutions with insurance fund losses on the magnitude of the Keystone and Superior failures could have a significant effect on the banking industry. FDI Act section 7(b), Assessments, requires the FDIC Board of Directors to set semiannual assessments for insured depository institutions if the required reserve ratio of the insurance fund balance to estimated insured deposits falls below 1.25 percent. In a speech before America's Community Bankers on October 30, 2000, the former FDIC Chairman stated that if fund payouts push the fund below the 1.25 percent threshold, banks would face a 23 basis point premium spike that could reduce the pre-tax net income of all FDIC-insured institutions by almost $9 billion, which, in turn, could lead to a nation-wide lending contraction of more than $65 billion. This would create considerable stress on an already struggling economy.

Based on the estimated amount of insured deposits and the balances of the insurance funds as of September 30, 2001, losses of approximately $1.8 billion to the Bank Insurance Fund (BIF) and approximately $1.1 billion to the Savings Association Insurance Fund (SAIF) would require

[3] The FDIC operates two insurance funds: the Bank Insurance Fund (BIF) insures deposits in commercial banks and savings banks, and the Savings Association Insurance Fund (SAIF) insures deposits in federal savings and loan associations, federal savings banks, and state savings and loans.
[4] Signed into law by President Clinton on November 12, 1999, the Gramm-Leach-Bliley Act provides financial organizations with flexibility in structuring new financial affiliations through a holding company structure or a financial subsidiary, with appropriate safeguards.

institutions insured by the respective fund to begin paying deposit insurance premiums.[5] Thus, there is a compelling need for all the regulators to cooperate fully in order to minimize the losses associated with any bank failure that does occur and ensure the industry's stability. Appendix III contains a discussion of loss rates and the amount of losses required before institutions would have to pay insurance premiums.

SPECIAL EXAMINATION ACTIVITIES

In responding to emerging safety and soundness concerns in financial institutions for which the FDIC is not the PFR, FDIC examiners have at times been denied permission to evaluate conditions on-site or to gain timely access to information relevant to situations that represented significant risks to the insurance funds. In our opinion, there has been a reluctance on the part of other PFRs to allow the FDIC to participate in examinations because the agencies wanted to avoid over-burdening institutions and, as is the natural tendency, preclude possible second-guessing by the FDIC. Also, given the time and effort required to prepare a Board case, DOS officials have been hesitant to petition the Board in situations where their suspicions were not backed up by substantial proof. Further, during the past several years, it is our perception that DOS believed it was unlikely that such cases would be approved because Board of Directors' vacancies left the FDIC in a minority position. The frequency of the FDIC's participation in examinations conducted by the PFRs has more than doubled since the time period covered during our 1999 review, and we found no additional instances where DOS was not allowed to participate in an examination. However, the FDIC continued to encounter instances where its efforts to address risks from the perspective of the insurer had been constrained by other PFRs.

While section 10(b)(3) of the FDI Act provides the FDIC special authority to examine any insured depository institution for insurance purposes, current procedures contained in the FDIC Board's 1995 delegation to the DOS Director can prevent the FDIC from using its authority. Under the delegation, the FDIC cannot conduct a special examination of a financial institution, no matter how serious its financial condition, over the objection of the PFR unless DOS can successfully present a case before the FDIC Board to justify DOS's involvement. Thus, under certain circumstances, the FDIC lacks the independence to promptly and directly respond to emerging risks within a particular institution from the perspective of the insurer.

When evaluating the effectiveness of the current delegation, it is important to recognize that the FDIC's responsibilities are broader than those of the other PFRs. In addition to supervising state nonmember banks in the role of a primary regulator, the Corporation is also responsible for managing the insurance funds, ensuring that failing institutions are resolved in the least costly manner, and maximizing the value of failing banks' receivership assets.[6] Each of these responsibilities involves the need for the FDIC to have prompt and direct access to information that may be directly controlled by one of the other PFRs. With respect to its supervision responsibilities, DOS requires direct and timely access to information, and at times bank

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[5] Because the reserve ratio of premiums held by the FDIC to deposits insured exceeds the 1.25 percent ratio established by FDIC regulation, most banks and thrifts were not paying insurance premiums as of the date of this report.

[6] A receiver is an agent (in the instance of a failed institution, the FDIC) appointed by a failed institution's primary regulator to manage the orderly liquidation of the failed institution.

management, for two primary reasons: first, to assess insurance risk to ensure that the FDIC, as underwriter for the insurance funds, is being properly compensated for the risk presented by all insured institutions, including those not directly supervised by DOS; and second, to ensure that insured institutions are supervised and regulated prudently.

Additionally, under the current delegation, situations could occur where the heads of the OCC and OTS, both of whom are members of the FDIC Board, would be voting on requests for special examination authority after actions had been taken by their respective organizations to oppose DOS requests to use that authority. Further, in situations where one or more of the Board's positions are vacant, the vital balance between the regulators' various interests implicit in the Board's structure is not preserved and the FDIC's independence to exercise special examination authority is impaired. As of the date of this report, the Board has operated with one vacancy, the Vice Chairman position, since January 2001, and during the 1990s one or more Presidentially-appointed Board positions frequently were vacant. Accordingly, our office has strongly urged that vacancies be filled as promptly as practicable in order to afford the FDIC the balanced governance and sustained leadership essential to the agency's continued success.

As the insuring agency, the FDIC strives to keep abreast of developments that occur in all institutions to determine their potential risks to the deposit insurance funds and to assign institutions to categories within the risk-related premium system. When increases in risk raise concerns with the FDIC, the Corporation may ask to participate in the primary federal regulator's next examination. Under FDI Act section 10(b)(3), the FDIC's Board of Directors can authorize FDIC examiners to conduct a special examination of any insured depository institution for insurance purposes. While the FDIC's usual practice is to review and rely on the examination reports of the other regulators, this special examination provision of the Act serves as an internal control by which the FDIC, as insurer, can provide a secondary level of on-site review for institutions perceived to pose a higher risk profile. However, the effectiveness of this internal control can be reduced by the current delegation from the FDIC's Board because DOS must first obtain the concurrence of the primary federal regulator or go through the process of preparing a Board case and seeking Board approval.

The FDIC's lack of independence to determine when and where DOS can obtain information related to safety and soundness and insurance concerns is inconsistent with the Corporation's authority when ruling on rating differences with the other PFRs. In accordance with section 327 of the FDIC's Rules and Regulations, the FDIC has the final word when assigning ratings for insurance purposes, which impact the insurance premium assessments banks are assigned. The FDIC uses a risk-based premium system that assesses higher rates on those institutions that pose greater risks to the insurance funds. In order to assess premiums on individual institutions, the FDIC places each institution in a risk category using a two-step process based first on capital ratios (the capital group assignment) and then on other relevant information (the supervisory subgroup assignment). The FDIC makes capital group assignments in accordance with section 327.4(a)(1) of the FDIC's Rules and Regulations. The FDIC also makes supervisory subgroup assignments based on the Corporation's consideration of supervisory evaluations provided by the institution's PFR, in accordance with section 327.4(a)(2) of the FDIC's Rules and Regulations. Thus, while the FDIC has full authority to assign risk ratings for insurance purposes, it does not have the equivalent autonomy to obtain the information needed to assign the ratings.

In our current review, we again assessed the cooperation the Corporation has received from OCC, FRB, and OTS in carrying out its responsibilities to protect the insurance funds. For the period October 1, 1999 through February 28, 2001, DOS requested and was allowed to participate in 89 examinations with the other regulators in 71 small and medium sized banks and thrifts – those with assets less than $25 billion. Table 2 summarizes the location and the number of instances where DOS participated in examinations during the 17-month period reviewed.

Table 2: Number of Instances Where FDIC Participated in Examinations of Small and Medium Sized Institutions as Reported to the FDIC Board of Directors for 10/1/99 through 2/28/01

	Primary Federal Regulator			
DOS Region	OCC	OTS	FRB	Total
Atlanta	7	4	2	13
Boston	1	0	0	1
Chicago	12	7	3	22
Dallas	5	3	5	13
Kansas City	9	3	4	16
Memphis	8	0	2	10
New York	1	3	0	4
San Francisco	6	3	1	10
Total	49	23	17	89

Source: OIG Analysis of Examination Activities for Deposit Insurance Purposes

When dealing with issues related to small and medium sized banks, DOS managers believe that at the regional level, they have developed effective working relationships with their regulatory counterparts at the FRB, OCC, and OTS. However, DOS managers brought to our attention a number of situations where they believe that their examiners were not provided with the information or time to fully assess the risks present in banks supervised by OCC and OTS. We did not hold discussions with officials from OCC, OTS, or FRB regarding these situations, which are discussed below.

- During an OCC examination of a national bank in July 2000, OCC examiners became aware of loan portfolio irregularities. Although an OCC investigation revealed serious asset quality problems resulting from hazardous lending practices and alleged fraud and insider abuse, OCC did not notify DOS. DOS learned of the situation only when a DOS official contacted OCC while following up on an inquiry made by a third party. Despite OCC assurances that DOS would be kept advised of significant findings of the ongoing investigation and examination, DOS was not made aware of the extent of the bank's losses or

the CAMELS composite 5 rating[7] until DOS received the examination report in January 2001. The bank's previous CAMELS composite rating (1999) had been a 2. We were also advised that DOS experienced difficulties and delays in obtaining information from OCC officials that was needed to calculate an accurate capital ratio. A DOS examiner participating in a subsequent on-site visit to the bank was able to obtain the necessary information. However, for a period of time, the FDIC lacked timely and necessary information to assess and prepare for potential losses to the insurance funds.

- During December 1999, the FDIC entered into a project with the FRB, the OCC, and state banking departments. The project involved a joint effort to examine several financial institutions with different charters. Relationships with the various FRB and state banking department personnel were considered excellent. Information was readily shared and views from each agency were welcomed. However, DOS experienced difficulties with the OCC, especially during the early stages of the project. DOS informed us that the OCC denied FDIC and FRB examiners the right to copy bank documents to retain for later use and did not provide them to the two agencies until from several weeks up to several months later.

  In one of the national banks examined during the project, the OCC would only allow FDIC personnel to input data onto a spreadsheet. No additional examination tasks were assigned to the DOS staff, and the OCC examiners did not accept DOS comments, conclusions, and suggestions. During the offsite review of this institution, DOS examiners noted what they considered to be instances of improper insider transactions. They requested copies of minutes from Board of Directors' meetings and that the bank's directors be questioned about their activities during a planned return visit to the bank. The OCC cancelled the return trip over the objections of DOS, and the OCC did not provide DOS with copies of the Board meeting minutes for several months. As of July 2001, the OCC's planned investigation of the insider transactions had not begun. The OCC also requested and received documents from the various national banks involved in this project that it did not share with either the FDIC or FRB.

- During April 2001, DOS participated in a full-scope safety and soundness examination of a thrift supervised by OTS. Near the end of the examination, the OTS and DOS realized that several significant issues could not be resolved within the time that the OTS had allotted for

[7] The CAMELS rating for an institution is part of the Uniform Financial Institutions Rating System which is used to evaluate the soundness of institutions on a uniform basis and to identify institutions requiring special attention. This rating system assigns a numerical score from 1 to 5 for each institution, with 1 signifying the highest rating and least degree of supervisory risk and 5 signifying the lowest rating and the highest degree of supervisory risk. The CAMELS acronym represents each of the factors that are rated: Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk.

the exam. One of the issues was support for the thrift's valuation and modeling of subprime residual assets[8] and subordinated debt.[9] The OTS examiner in charge asked his regional office for additional time to complete the examination but was turned down. Thus, DOS was not provided sufficient time to discuss the findings with OTS and resolve differences prior to the exit meeting with bank management. At the end of the examination, DOS did not agree with certain OTS conclusions and ratings. During August 2001, the OTS advised DOS that OTS concurred with the FDIC's rating position and was lowering the bank's rating to a composite 3.

- During DOS's participation in a July 2000 examination of a bank supervised by the OTS, DOS and OTS examiners had differences in opinion on several issues including accounting treatments and the bank's rating. OTS held its exit meeting with bank management before DOS's concerns could be resolved, and the DOS examiners were not free to discuss their position during the meeting. Ultimately, the OTS agreed with DOS that the institution's composite rating should be lowered from a 3 to a 4.

While none of the banks described in the above examples have caused losses to the deposit insurance funds, these situations demonstrate how another regulator can restrict access to information the FDIC believes necessary to fully assess its insurance risks.

In performing our 1999 review, however, we noted three instances where another regulator denied the FDIC's initial requests to participate in safety and soundness examinations, and in two of these situations, the banks were subsequently closed. One case involved The First National Bank of Keystone, Keystone, West Virginia. On September 1, 1999, the OCC closed Keystone, a $1.1 billion institution, after finding evidence of apparent fraud that resulted in the depletion of the bank's capital. In February 1998, the OCC received and denied DOS's request to participate in its August 1998 examination. As a result, DOS prepared a Board case seeking approval to participate in the exam. In our opinion, DOS had a sound basis for wanting its examiners to participate in the exam.

In June 1998, prior to DOS presenting its case to the Board, the OCC reversed its position. Thus, the Board never heard the case. In reversing its position, however, the OCC restricted the number of DOS examiners that were allowed to work in the bank. This situation illustrates how the FDIC's special examination authority can be subject to constraints imposed by the PFR and can limit the FDIC's ability to assess risks to the deposit insurance funds. As of the date of this report, the loss to the Bank Insurance Fund associated with the closing of Keystone was estimated to be $780 million.

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[8] Residual assets represent claims on the cash flows resulting from the securitization process that remain after all obligations to investors and any related expenses have been paid, which normally include funds to build reserves and pay loan losses, servicing fees, and liquidation expenses. When the loans for the pools originate, they bear a stated interest rate. The securities are issued to investors at a lower rate than the stated rate on the loans. The difference between the rate that the loans are paying versus what the pools are paying to investors is called the residual.

[9] A subordinated note or debenture is a form of debt issued by a bank or a consolidated subsidiary. When issued by a bank, a subordinated note or debenture is not insured by a federal agency, is subordinated to the claims of depositors, and has an original weighted average maturity of 5 years or more.

Another significant example involved an OTS-supervised institution, Superior Bank, FSB, Hinsdale, Illinois. On December 28, 1998, the Director of DOS's Chicago Regional Office sent a letter to his OTS counterpart requesting that a DOS examiner be allowed to participate in OTS's next examination of Superior, scheduled to begin in January 1999. The letter cited a number of concerns relative to the bank's situation, including that Superior's asset structure included substantial investments in residual interest securities. According to DOS officials, OTS regional management orally denied the request in January 1999.

We believe that the concerns detailed in DOS's request presented sufficient justification for obtaining permission to participate in the exam. As an alternative, the OTS allowed DOS's case manager and a regional capital markets specialist to meet offsite with OTS examiners about a week prior to the close of the exam. However, DOS found that meeting with examiners rather than participating directly in the examination resulted in a limited benefit. Over the succeeding months as the bank's situation deteriorated, DOS continued to encounter difficulties in obtaining the OTS's full cooperation.

On July 27, 2001, Superior Bank was deemed insolvent and the OTS appointed the FDIC as receiver. The bank held assets of $2.3 billion, and the loss to the Savings Association Insurance Fund is estimated to be $350 million. At the request of the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, our office is reviewing the causes of Superior's failure and various aspects of the effectiveness with which the respective federal regulators supervised the institution prior to its closing. The Office of the Inspector General of the Department of the Treasury conducted a review of the circumstances leading to the thrift's failure in accordance with section 38(k) of the FDI Act. Final reports on these reviews were issued in February 2002, and the Senate Committee held a hearing on this subject on February 7, 2002.

The limitations placed on DOS's attempts to assess the problems related to Keystone and Superior, and the more recent instances where DOS's supervisory activities have been constrained by the other regulators, illustrate that FDIC officials are not always provided with the information and access to banks they believe are needed to assess risk for insurance purposes. The restrictions imposed by the current delegation of authority from the FDIC Board to DOS can hinder timely action on the part of DOS in several respects. First, in seeking concurrence from the PFR, the PFR can significantly influence the timing and scope of the FDIC's examination activities, reducing or blocking the benefit of the secondary level of review. Requiring concurrence by the primary federal regulator may impair the FDIC's independence, may limit the control value of the secondary level of review, and could be viewed as an organizational conflict. Second, requiring Board approval on a case-by-case basis could delay an FDIC special examination in a critical situation, delay the start of enforcement action based on examination results, and detract from the internal control established in the FDI Act. As mentioned earlier, the five-member Board includes the heads of the OCC and the OTS, thus providing these two individuals with the opportunity to participate in any Board decision on whether the FDIC should be allowed to carry out its special examination authority in an institution supervised by another PFR.[10]

[10]It should be noted that when special examination authority was first established in 1950, the FDIC Board consisted of three members: the Chairman, an FDIC Director, and the Comptroller of the Currency.

Accordingly, to ensure the effectiveness of the internal control offered by the special examination provision of the FDI Act and that the FDIC takes the most effective approach to monitoring risks to the deposit insurance funds, the FDIC Chairman needs the independent authority to authorize special examinations that supplement those of the other regulators. A statutory amendment or delegation from the Board could allow the FDIC Chairman to make an independent decision to initiate special examination activities based on criteria of increased or unusual risk to the funds, and not require case-by-case concurrence by the primary federal regulator or the Board's approval. As discussed previously, the heads of the OCC and OTS can impact FDIC independence in Board decisions during periods where one or more Board positions are vacant.

In our 1999 memorandum, we suggested that the former Chairman seek a legislative change that would vest special examination authority in the FDIC Chairman and thereby eliminate any requirements to secure the concurrence of the primary federal regulator or the approval of the Board. Alternatively, we suggested that the Chairman pursue a less complicated and more timely approach to resolving the current situation by requesting the FDIC Board of Directors to vest the Chairman with the authority to approve DOS requests for special examinations of insured institutions that pose significant safety and soundness concerns. However, it is critical to note that any delegation of authority granted by the Board to the Chairman could be rescinded or modified at any time by a majority of the Board members in a subsequent vote. Thus, the FDIC's independence and the effectiveness of DOS's secondary level of review could again be restricted. We therefore consider that seeking to change the current legislation is the preferred course of action for the Chairman to take and that revising the current Board delegation should serve as an interim measure.

Given the broad range of the FDIC's supervisory responsibilities, and because of the Corporation's role and responsibility as the deposit insurer for the nation's banking industry, there is a clearly defined need to strengthen the FDIC's authority to act in an independent manner in its efforts to evaluate insurance risk and gain access to financial records in banks supervised by the other PFRs. Vesting special examination authority directly with the FDIC Chairman would serve to strengthen the effectiveness of the Corporation's secondary level of review of safety and soundness concerns and lessen the potential impact that Board vacancies create relative to the FDIC's ability to quickly assess suspected insurance risk in an institution supervised by another regulator. The proper use of the FDIC's special examination authority would not duplicate or disrupt the other PFR's efforts, but would provide the FDIC with a more timely approach for gaining a firsthand understanding, along with the PFR, of potential risks facing both financial institutions and the insurance funds, or obtaining information critical to a resolution.

In an August 19, 1993 letter to the FDIC's Acting Chairman, the Chairman of the House Committee on Banking, Finance and Urban Affairs, and the Ranking Member of the Committee, stated that given the FDIC's responsibilities for prompt corrective action, as outlined in section 38 of the FDI Act, and as the backup regulator, the FDIC must be able to independently examine all depository institutions. They stated that "the FDIC has been granted specific responsibility for promoting the safety and soundness of the bank and savings association insurance funds and ensuring that insured institutions are supervised and regulated prudently. This responsibility

requires independent enforcement and examination authority and that is what Congress granted to the FDIC in the FDI Act." They also stated that they hoped that the FDIC would coordinate its examinations with the primary regulator to the fullest extent possible.

The FDIC has a need and a responsibility to develop information on core risk areas to facilitate analyses of insurance fund exposures and continually maintain an up-to-date understanding of specific vulnerabilities that could lead to significant insurance losses. As discussed earlier in the report, the failure of a single large institution, coupled with the losses sustained in recent failures, could cause the reserve ratio of the insurance fund balance to estimated insured deposits to fall below 1.25 percent. This, in turn, would require all depository institutions to begin paying insurance premiums.

For the FDIC to most effectively carry out one of its principal responsibilities, the insurance function, its Chairman needs to be provided with a greater degree of independence to exercise the Corporation's special examination authority. Based on the results of this follow-up review, the circumstances supporting our previous suggestions to strengthen the FDIC's special examination authority remain essentially the same, and changes in the industry have increased risks to the deposit insurance funds. Accordingly, we are making the following recommendations.

Recommendations

We recommend that the Director, DOS, initiate actions within the Corporation to:

(1) Pursue an amendment to Section 10(b)(3) of the FDI Act (12 U.S.C. section 1820(b)(3)) to vest special examination authority with the FDIC Chairman in consultation with the appropriate primary federal regulator.

(2) Seek a revised Board delegation that vests special examination authority with the FDIC Chairman in consultation with the appropriate primary federal regulator, as an interim measure pending a legislative amendment.

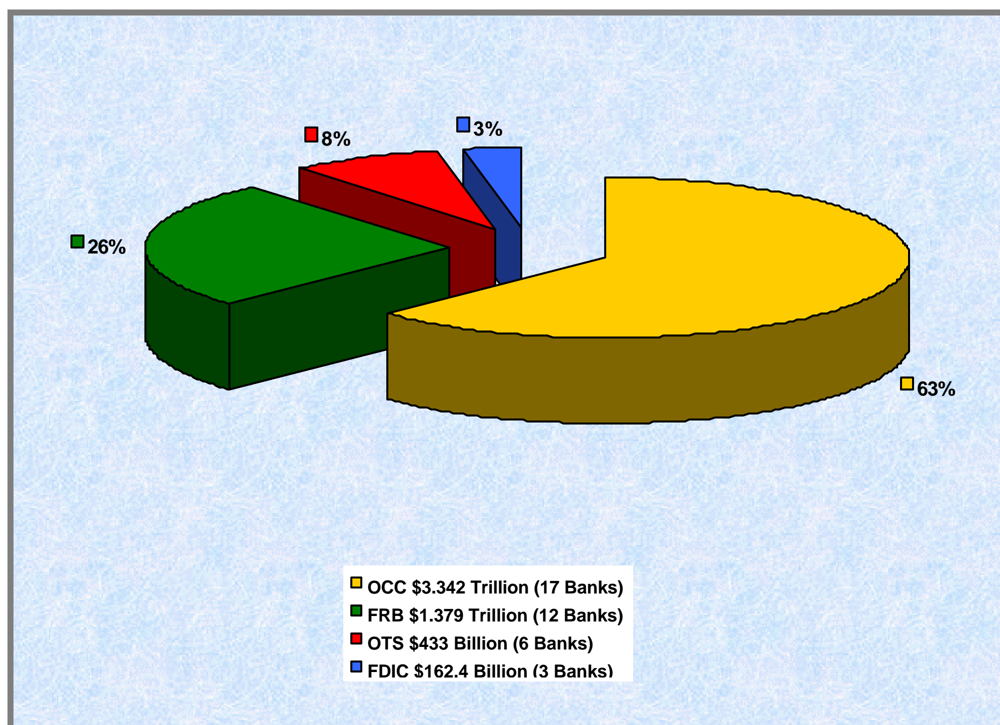
LARGE BANK MONITORING PROGRAM

Our follow-up review disclosed that DOS officials continue to evaluate risk exposures in megabanks by using information that is predominantly historical in perspective and sometimes filtered or interpreted by the other PFRs before it is made available to the FDIC. The FDIC does not have access to current and complete information in order to assess insurance fund risks. Because the FDIC does not have a presence in 35 of the country's 38 largest banks (see Appendix II), it is almost totally dependent on the other PFRs for monitoring the largest potential risks to the deposit insurance funds. In the absence of agreements with the other PFRs that would provide the FDIC with real-time information, and because DOS representatives have been denied a presence by the OCC in meetings between the regulators and management in the nation's largest national banks, the FDIC may not be able to adequately assess the risk that non-FDIC supervised megabanks present to the insurance funds.

A fundamental component of DOS's decentralized approach to megabank monitoring is the personal relationships that case managers develop with their counterparts in the other regulatory agencies. Case managers (CMs) are located in DOS's regional offices and are responsible for evaluating the level of insurance risk evident in their caseloads of financial institutions, which consist of banks supervised by the FDIC as well as the other regulators. Working with representatives from the other regulatory agencies, CMs must fully understand the operations of those institutions in their caseloads, develop supervisory strategies, and determine the deposit insurance risk ratings for each institution. A May 28, 1999 best practices memorandum sent to all DOS regional directors dealing with this subject states that a case manager's ability to develop strong and effective working relationships with primary regulator counterparts is considered critical to properly evaluate institution and systemic risks and to ensure that the FDIC's supervisory and insurance concerns are effectively and expediently communicated to the PFR.

To understand the significance of our observations relating to factors that are hindering the FDIC's effectiveness in monitoring and supervising the country's largest banks, it is important to relate our findings to our earlier discussion of the challenges facing the banking industry, and particularly our discussion of the ongoing consolidation process. Of the $5.3 trillion consolidated assets controlled by the 38 largest financial institutions, the FDIC is the primary federal regulator for only $162.5 billion in 3 institutions (see Figure 1). The failure of a megabank, along with the potential closing of closely affiliated smaller institutions, could result in huge losses to the deposit insurance funds.

Figure 1: Distribution of Consolidated Assets Between National, State Member, State Non-Member Banks and Thrifts as of 3/31/01[11]



Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01 and FDIC Institution List

Information Provided by the Other PFRs Focuses on Past Performance

One of the key conditions that has not changed significantly over the past 2 years is that the CMs have continued to evaluate risk exposures in the megabanks by using information that is historical in perspective, because much of the data received from the other PFRs and the banks is several months old. A substantial amount of the information that case managers use is dated because it has to be developed and processed through management channels at the other agencies before it is made available to DOS. While this information is useful, it does not sufficiently indicate for the CMs where the banks are planning to focus their future activities. In other words, the CMs do not have an adequate understanding of a bank's planned strategic initiatives, which is a key element in assessing risks to the insurance funds and the sufficiency of the funds to cover such risks. Having access to current and complete information is especially critical today when trying to gauge risk in a financial institution because of the speed with which shifts in investment focus can occur and electronic transactions can take place.

Case manager comments regarding their sources of information relative to large banks were consistent with what we were told 2 years ago. There are still two primary sources of information that the CMs use to monitor bank activities and the corresponding risks that they

[11] In July 2001, one of the banks supervised by the FDIC converted to a state member bank supervised by the FRB, thus lowering the number of megabanks directly supervised by the FDIC from 3 to 2.

present. The first source is information that is available to the general public: quarterly and annual bank financial statements filed with the Securities and Exchange Commission, press releases, newspapers and periodicals, and the Internet, which includes news stories, stock quotes/analyses, and reports from investment brokers. The second source is information provided by the PFR. Information routinely received from the PFR includes reports related to examination activities and assessments of risk in the institutions and a variety of quarterly and year-end financial reports prepared by the banks. In addition to containing material that is typically several months old, many information products the CMs receive or have access to are filtered since they are synopsized or interpreted by the PFR before they are made available to DOS. Such materials include, for example, summaries of meetings between examiners and bank managers and reports related to examination activities. Case managers also have access to examination-related data that are maintained on information systems developed by the OCC, the Supervisory Monitoring System, and by the FRB, the Bank Online National Database.

Presence in Meetings Would Allow the FDIC to More Adequately Assess Insurance Risk

One of the most sensitive and important matters covered in our review is the issue of the FDIC's presence in meetings between bank management and the primary federal regulator, meetings at which a bank's examination findings and/or a bank's plans to engage in new strategic initiatives are discussed. Attending such meetings provides the FDIC with the most effective and real-time means by which to evaluate insurance risks and is more effective than reading meeting summaries several weeks or months after meetings occur. DOS managers stated that the FRB and OTS are generally receptive to FDIC attendance at various management meetings. In the case of the OCC, however, little if any progress has been achieved since the issuance of our memorandum in October 1999. Specifically, the OCC still does not allow DOS examiners to attend meetings with bank management, other than meetings where basic information is also being made available to the public. Thus, for the 17 largest national banks and most national banks in general, FDIC representatives are not being afforded the opportunity to observe discussions relating to emerging risks, supervisory concerns, or new initiatives and management plans. We did not meet with OCC officials to discuss this issue.

During our conversation with one case manager, we were told of a situation that seems to exemplify the reluctance and increased concern that OCC's Washington officials apparently have regarding FDIC participation in OCC examinations compared to the examiners-in-charge who are located in the OCC's District Offices. During a meeting in Washington that was attended by DOS CMs, an OCC executive informed the CMs that it was permissible for them to work with their OCC counterparts in the regions to arrange for participation in examinations and meetings with bank management. He stressed that this process was to be used on an infrequent basis. Following the conference, a DOS case manager discussed the proposal with his OCC counterpart and they agreed that it would be beneficial for the FDIC to assist the OCC in an upcoming examination that targeted middle market lending.[12] They decided that one FDIC examiner would accompany the OCC to assist in loan review. An examination was starting within a month at another large national bank that was under the domain of the same OCC examiner. The case manager inquired if the FDIC could send the same FDIC examiner to that

[12] Middle market lending consists of commercial loans to companies with sales ranging from $50 million and up and lending relationships in the $5 million and higher range.

bank as well to assist in the targeted review of structured finance.[13] Both parties agreed to the proposal. After the FDIC examiner arrived at the first institution and worked approximately 3 days, the FDIC case manager received a call from his OCC counterpart notifying him that the FDIC's participation in the bank examination was to terminate immediately. No explanation was provided other than that this decision came from the OCC's Washington office and not from the OCC examiner in charge. The FDIC's participation in the next examination was also canceled.

A DOS executive told us that while the OCC has no written policies prohibiting FDIC attendance at meetings in large banks, OCC managers have verbally indicated that unless a bank is troubled, they will not invite the FDIC to attend meetings. DOS further asserted that sitting in on meetings for the purpose of becoming better informed of a bank's activities is not permitted by the OCC. In a memorandum to the former FDIC Chairman dated May 25, 1999, the DOS Director stated that a DOS Associate Director had been informed by a senior OCC official that OCC examiners have been specifically instructed not to invite FDIC examiners to attend quarterly meetings with bank management and to turn down requests for attendance made by the FDIC. Our conversations with many DOS case managers confirmed that they have been told that they are not welcome to attend OCC meetings with large banks. On December 16, 1999, the DOS Director and the Director, Division of Insurance, signed a memorandum to The Chairman's Working Group[14] that presented their position regarding the importance of allowing DOS representatives to attend meetings between bankers and their primary federal regulator. The memorandum stated in part:

> It is undisputed that a regulator can learn more, and therefore better understand the practices of an insured financial institution, by listening to bank management's presentations, ideas, strategic plans, and responses to the PFR. It also is undisputed that regulators must understand the practices and policies of bank management, at all levels, to adequately assess the company's risk to the deposit insurance fund. A common response by the PFR to the concept of FDIC presence at management meetings is to suggest that its examiners can effectively relay such discussions and presentations to the FDIC. We disagree. It is simply human nature to filter information and to relay information based on the presenter's value structure. In other words, the FDIC loses the ability to determine what is important or not important when such information is conveyed by a third party. Moreover, we may occasionally have information needs that are not identical to the PFR (for example, there may be times that we need to focus more on the insurance funds' risk to systemic issues than a specific bank only issue). Given the size, complexity, and speed upon which these entities move, FDIC presence is critical for complete and real time understanding of the institution, and allows us to better assess its risk to the deposit insurance fund, without adding any regulatory burden.

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[13] Structured finance relationships are a combination of cash-flow based structures and conventional asset-based loans used to finance mergers and acquisitions, business recapitalizations, and business expansions. They are characterized by a degree of financial leverage that significantly exceeds industry norms as measured by various debt, cash flow, or other ratios.

[14] A group formed by former Chairman Tanoue to address corporate operational and policy issues. Group membership included the Directors of Supervision, Insurance, and Research and Statistics, as well as the Corporation's General Counsel and Chief Operating Officer.

> The second point we would like to discuss is the role we would play at such meetings. As stated earlier, our premise is that we must hear, firsthand, the ideas and strategies of management. Concurrent with that premise, our role at these meetings could be limited mostly to an observation capacity; provided that we would not be totally mute if a few points of clarification were needed. Otherwise, we would commit to discuss any areas of concern or need for clarification with the PFR after any such meetings so as not to usurp its relationship with bank management. The PFR has expressed concern that FDIC presence at such meetings could stifle open communication. While we disagree with that assertion, as FDIC presence became routine such concerns would cease to be an issue. We all play a critical role in the banking sector and, we believe, principals of all the agencies support the free flow of communication between and among insured banks and the banking agencies. Bankers are aware of that as well.

According to DOS management, there have been numerous examples where the FDIC has participated in management meetings, without incident, at large banks supervised by FRB and OTS. Further, senior management officials of these large banking companies are receptive to the Corporation's presence and understand the FDIC's mission as deposit insurer. DOS believes that attending such meetings has greatly improved the Division's risk assessment capability.

We agree with DOS's assertion that the FDIC's presence in meetings between the regulators and bank management does not represent an increase in regulatory burden, and that as the insurer, the FDIC should attend such meetings. As we mentioned previously, DOS personnel are already attending such meetings with the FRB and OTS, and only the OCC seems to be resisting a more open climate of information sharing.

The FDIC's attendance at meetings may not necessarily provide DOS's CMs with the level of knowledge they will need to fully understand the risks posed by the largest and most complex banks, and a more complete grasp of megabank activities may only be achieved through an expanded commitment of DOS's staffing resources. Under the current case manager program, a single case manager may be responsible for simultaneously monitoring three megabanks. This equates to one-third of one person attempting to assess the risks in a bank where the PFR may have committed as many as 30 or more examiners on a full-time basis.

Because of the limitations under which case managers must operate, as discussed above, the FDIC will need to continue to pursue new ways to carry out its responsibilities, such as arranging for DOS personnel to be onsite at selected megabanks with the other PFRs. We understand that there is probably no single strategy that will meet all of the FDIC's information needs for each of the large institutions it monitors and that DOS's effectiveness in monitoring large banks supervised by the other PFRs may evolve over time along a variety of approaches.

In our 1999 memorandum, we suggested to the former Chairman that in order for the FDIC to attain a higher level of understanding of the risks posed by the megabanks, she needed to direct the highest levels of corporate management to develop information sharing agreements with the other PFRs. Such an agreement would especially be needed with the OCC, because the numerous megabanks it supervises are centrally managed from Washington (see Appendix II, Table 3).

The OCC has since verbally agreed to allow DOS to review examination workpapers. When we issued our draft report to DOS for comment, no other formal agreements had been entered into with the other regulators. However, on January 29, 2002, the FDIC's Board of Directors approved an agreement developed by the FDIC and the other regulators that establishes an FDIC examiner program at the eight largest megabanks and provides the Corporation with more autonomy to conduct exams in non-FDIC supervised institutions. The agreement is discussed in greater detail in the last section of this report, Corporation Comments and OIG Evaluation.

An outcome of the conditions under which the CMs are currently operating is that DOS does not always have a comprehensive up-to-date understanding of the emerging risks that may be developing in some of the largest banks in the country – those banks that present the greatest insurance risk. Effective supervision of the largest financial institutions, some with worldwide operations, requires continual monitoring and the commitment of extensive resources on the part of the OCC, FRB, and, to a lesser extent, OTS. Although the FDIC is not the PFR for most of the megabanks, it would be called on to deal with the failure of a megabank and the financial consequences. Thus, the Corporation has a compelling need to become more familiar with the activities of these institutions and with the current development of potential risks. Because the FDIC does not have the resources to duplicate the efforts of the other regulators and because such efforts would be disruptive to insured institutions, the Corporation must develop closer ties to its regulatory counterparts, particularly the OCC, and continue its efforts to obtain real-time information relative to megabank financial activities and initiatives. We are, therefore, reaffirming the position we expressed during our prior review and making a formal recommendation to address this matter.

Recommendation

We recommend that the Director, DOS:

(3) Work to develop agreements with the other bank regulatory agencies to provide the FDIC with the timely information and access to megabanks necessary to carry out the Corporation's responsibilities as the insurer.

CORPORATION COMMENTS AND OIG EVALUATION

On January 29, 2002, the DOS Director provided a written response to the recommendations contained in the draft report. The DOS Director agreed with the report's three recommendations and his response is presented in Appendix V of this report.

Following the failure of Superior Bank, FSB, in July 2001, the FDIC, OCC, FRB, and OTS formed a committee (Committee) and developed a proposal to address factors that have restricted the FDIC's special examination authority and the Corporation's concerns relative to information sharing. On January 29, 2002, the FDIC's Board of Directors acted on the Committee's proposal by authorizing an expanded delegation of authority to grant the FDIC more autonomy in terms of examining banks that pose a heightened risk to the deposit insurance funds. Under the delegation, DOS will be able to authorize special examination activities at banks with a

composite rating of 3, 4, or 5, or at banks that are undercapitalized as defined under Prompt Corrective Action,[15] without having to obtain the approval of the primary federal regulator. The new delegation also provides for the creation of a dedicated FDIC examiner program at the eight largest megabanks and is intended to provide more timely access to information related to those banks.

Prior to the issuance of this report, we had an opportunity to review the draft interagency proposal and discuss it with DOS management. We commended the Corporation's effort to address past problems in gaining access to and information on institutions for which the FDIC is not the primary federal regulator. We also expressed several concerns related to limitations the language of the agreement may place on the FDIC's statutory authority to independently assess risks to the deposit insurance funds.

We recommended in this report that the FDIC pursue a legislative change that would vest special examination authority in the FDIC Chairman. We believe this is the best approach to resolving problems related to the Corporation's special examination authority because any agreement is subject to interpretation and varying degrees of support when there is change among the leadership of the four federal banking agencies. The DOS Director stated in his response that DOS agrees with the recommendation and that revising Section 10(b)(3) of the FDI Act would achieve a more permanent solution to inefficiencies related to the FDIC's use of special examination authority. As a result, the Director stated that DOS has included amending Section 10(b)(3) in its Legislative Priorities list for 2002. The decision as to whether the FDIC pursues a legislative solution rests with the Chairman.

Recommendations 1, 2 and 3 will remain undispositioned and open until we have determined that corrective actions have been completed and are effective.

[15] Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized.

APPENDIX I

SCOPE AND METHODOLOGY

This is a follow-up review of DOS's efforts to monitor risk at insured institutions for which the FDIC is not the primary federal regulator. The objective of this review was to assess the progress that the FDIC has made since our previous review and to make recommendations that might improve the Corporation's effectiveness in working with the other federal regulators.

Our audit work included reviewing and analyzing monthly reports prepared by DOS and presented to the FDIC Board detailing instances where DOS had carried out special examination activities derived from Section 10(b) of the Federal Deposit Insurance Act. We reviewed DOS's nationwide special examination activities for the 17-month period ending February 28, 2001. We also identified, by regulator, those financial institutions with $25 billion or more in total assets. We visited DOS's Atlanta, Chicago, and New York Regional Offices and interviewed Regional Directors, Deputy Regional Directors, Assistant Regional Directors, and Case Managers. We also interviewed DOS officials in Washington. We reviewed policies, procedures, Regional Director Memoranda, and documents related to the closing of Superior Bank, FSB, Hinsdale, Illinois, on July 27, 2001. In addition, we contacted the DOS Regional Directors in Boston, Dallas, Kansas City, Memphis, and San Francisco to inquire about the cooperation received from the other federal regulators. Our analysis of cases those offices reported to us included a review of supporting documentation submitted by DOS.

As the Office of Inspector General for the FDIC, we reviewed the issues addressed in this report solely from the perspective of the FDIC in its efforts to effectively carry out its mission. We, therefore, did not hold discussions or solicit the opinions of FRB, OCC, or OTS officials regarding any of the matters addressed in this report, nor did we collect or review documents from these organizations.

APPENDIX II

BANKS SUPERVISED BY THE PRIMARY FEDERAL REGULATORS

Table 3: National Megabanks Regulated by the OCC as of 3/31/01

(000s Omitted)

Bank Name	Consolidated Assets	% of the Subtotal	Total Bank Assets	Total Bank Deposits
Citibank, N.A.	$944,327,000	28.26	$395,869,000	$283,656,000
Bank of America, N.A.	609,755,000	18.25	553,509,000	371,024,000
Wells Fargo Bank, N.A.	279,670,000	8.37	124,137,000	74,775,000
Bank One, N.A.	274,352,000	8.21	141,439,135	54,375,506
First Union National Bank	252,949,000	7.57	232,608,000	145,407,000
Fleet National Bank	211,741,000	6.33	200,887,000	134,530,000
U. S. Bank, N.A.	160,274,000	4.80	79,590,882	51,196,379
LaSalle Bank, N.A.	99,859,000	2.99	52,596,804	30,075,300
National City Bank	90,818,000	2.72	35,947,178	19,193,866
Keybank, N.A.	86,457,000	2.59	76,665,585	43,429,381
Wachovia Bank	75,606,000	2.26	68,284,706	45,692,667
PNC Bank, N.A.	70,966,000	2.12	64,533,206	45,653,355
Mellon Bank, N.A.	46,283,000	1.38	37,556,453	24,205,339
MBNA America Bank, N.A.	39,263,000	1.17	37,194,957	24,990,129
Union Bank of California	35,808,000	1.07	35,467,235	28,832,034
Union Planters National Bank	35,423,000	1.06	33,879,104	22,489,965
The Huntington National Bank	28,441,000	0.85	28,223,792	19,351,512
Subtotal	$3,341,992,000	100%	$2,198,389,037	$1,418,877,433

Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01 and FDIC Institution List

Table 4: State Member Megabanks Regulated by the FRB as of 3/31/01

(000s omitted)

Bank Name	Consolidated Assets	% of the Subtotal	Total Bank Assets	Total Bank Deposits
Chase Manhattan Bank	$713,624,000	51.76	$400,623,000	$243,608,000
SunTrust Bank, Atlanta	103,726,000	7.52	100,442,885	63,016,720
HSBC Bank USA	84,486,000	6.13	81,825,949	58,475,526
Bank of New York	73,073,000	5.30	70,232,359	50,844,619
Fifth Third Bank	71,468,000	5.19	33,787,198	18,809,311
State Street Bank & Trust Comp	67,605,000	4.90	62,662,689	38,049,837
Bankers Trust Company	60,472,000	4.39	41,874,000	20,380,000
Comerica Bank	50,270,000	3.65	36,402,611	22,213,569
SouthTrust Bank	45,957,000	3.33	46,018,713	28,795,385
AmSouth Bank	38,825,000	2.82	38,830,244	26,265,905
Northern Trust Company	38,197,000	2.77	31,862,721	18,985,064
Manufacturers & Traders Trust	30,924,000	2.24	30,038,291	20,325,853
Subtotal	$1,378,627,000	100%	$974,600,660	$609,769,789

Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01 and FDIC Institution List

Table 5: Thrift Megabanks Regulated by the OTS as of 3/31/01

(000s omitted)

Bank Name	Consolidated Assets	% of the Subtotal	Total Bank Assets	Total Bank Deposits
Washington Mutual Bank, FA	$219,925,000	50.75	$35,778,000	$14,775,000
California Federal Bank, FSB	61,768,000	14.25	61,691,429	24,922,588
World Savings Bank, FSB	56,732,000	13.09	56,770,025	31,500,004
Sovereign Bank, FSB	34,049,000	7.86	34,013,302	23,096,236
Charter One Bank, FSB	33,831,000	7.81	33,767,273	20,156,919
Dime Savings Bank of NY, FSB	27,050,000	6.24	27,045,326	14,650,266
Subtotal	$433,355,000	100%	$249,065,355	$129,101,013

Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01 and FDIC Institution List

Table 6: State Non-Member Megabanks Regulated by the FDIC as of 3/31/01

(000s omitted)

Bank Name	Consolidated Assets	% of the Subtotal	Total Bank Assets	Total Bank Deposits
Branch Banking & Trust Comp	$62,120,000	38.23	$49,465,937	$28,874,027
Merrill Lynch Bank USA	54,233,000	33.37	54,233,264	50,119,288
Regions Bank	46,143,000	28.40	43,359,045	3,057,223
Subtotal	$162,496,000	100%	$147,058,246	$82,050,538

Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01 and FDIC Institution List

Table 7: Comparison of Megabanks According to Primary Federal Regulator as of 3/31/01
(000s omitted)

Regulator	Consolidated Assets	% of the Total	Total Bank Assets	Total Bank Deposits
OCC	$3,341,992,000	62.86	$2,198,389,037	$1,418,877,433
FRB	1,378,627,000	25.93	974,600,660	609,769,789
OTS	433,355,000	8.15	249,065,355,	129,101,013
FDIC	162,496,000	3.06	147,058,246	82,050,538
Total	$5,316,470,000	100%	$3,569,113,298	$2,239,798,773

Source: OIG Analysis from DOS Large Insured Depository Institution Report as of 3/31/01and FDIC Institution List

APPENDIX III

INSURANCE FUND LOSS RATES

The FDIC maintains statistical information regarding the losses incurred by the deposit insurance funds resulting from the failure of insured institutions. The total estimated losses as a percentage of the institutions' total assets (loss rate) are detailed below.

Table 8: Estimated Loss Rates for All Failed Insured Depository Institutions for the Past 5, 10, and 15 Years

Years	1996-2000	1991-2000	1986-2000
Loss Rates	48.15%	9.50%	13.00%
# of Banks	22	331	1,335

Source: OIG Analysis from DOF's *Failed Bank Cost Analysis 1986-2000*

The loss rate percentage for the 5-year period is more than five times the loss rate for the 10-year period due to costly failures that were incurred in 1998 and 1999.

If the deposit insurance funds incur additional losses, all insured depository institutions could be required to begin paying insurance premiums. As of September 30, 2001, losses of approximately $1.8 billion against the BIF and approximately $1.1 billion against the SAIF would be sufficient to trigger insurance premiums for all institutions covered by the respective fund. Using the loss rates in the above table, we calculated the size of the financial institution or combination of institutions that would cause the BIF or SAIF to fall below the reserve ratio as shown in the tables below.

Table 9: Dollar Size of Insured Depository Institution(s) that Would Cause the BIF to Fall Below the Minimum 1.25% ($ in billions)

Loss Rates	48.15%	9.50%	13.00%
Institution Size	$3.7	$18.9	$13.8

Source: OIG Analysis from DOF's *Failed Bank Cost Analysis 1986-2000*

Table 10: Dollar Size of Insured Depository Institution(s) that Would Cause the SAIF to Fall Below the Minimum 1.25% ($ in billions)

Loss Rates	48.15%	9.50%	13.00%
Institution Size	$2.3	$11.6	$8.5

Source: OIG Analysis from DOF's *Failed Bank Cost Analysis 1986-2000*

APPENDIX IV

LEGISLATIVE AND REGULATORY HISTORY

The FDIC's special insurance examination authority is derived from Section 10(b)(3) of the Federal Deposit Insurance Act. However, under current delegated authority within FDIC, DOS examiners do not have the authority to perform an independent on-site evaluation of a bank's activities, even if the bank is in a troubled condition, without the approval of the bank's primary federal regulator or the FDIC Board of Directors.

With the addition of Section 10(b)(3) to the FDI Act in 1950, the Board of Directors of the FDIC was granted the unilateral authority it has today to examine any insured bank for insurance purposes without concurrence by the other federal or state regulators. This subsection, entitled Special Examination of Any Insured Depository Institution, provides that FDIC examiners shall have power, on behalf of the Corporation, to make any special examination of any insured depository institution whenever the Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of such depository institution for insurance purposes. The FDIC supported the addition of this authority to the FDI Act because, prior to that time, the FDIC's only access to information concerning banks for which it was not the primary regulator was through the primary federal regulator. The FDIC believed this authority was necessary to discharge its role as deposit insurer. Congress agreed, despite objection, that the special examination power could result in duplicative and burdensome examinations.

In 1982, the Board authorized the Division of Bank Supervision (DBS, now DOS) to assign FDIC examiners to participate in the examination of a national or state member bank when invited by the OCC or the Federal Reserve, respectively, and to negotiate with the OCC and the FRB on the "triggering points" for the issuance of such invitations. Subsequently, on December 23, 1983 the FDIC Board of Directors authorized FDIC examiners to participate in the examination of national banks, pursuant to certain terms and conditions contained in the "Cooperative Examination Program" agreed to by the OCC Senior Deputy for Bank Supervision and the FDIC Director of DBS as of December 2, 1983.

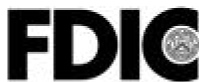
In August 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), created the Savings Association Insurance Fund and extended the FDIC's special examination authority to cover insured savings associations. In connection with these changes, the FDIC Board of Directors delegated authority to the DOS Director to: (1) initiate an examination or special examination of any insured savings association to determine its condition for insurance purposes and (2) work toward establishing a cooperative examination program with the OTS for insured savings associations. During 1989 and 1990, the FDIC examined many federally chartered savings and loan associations pursuant to a directive from then FDIC Chairman William Seidman.

The enactment of FIRREA also caused the composition of the FDIC Board of Directors to be increased from 3 to 5 members. The FDIC Vice Chairman and the Director of the Office of

Thrift Supervision were added to the Board, joining the FDIC Chairman, the FDIC Director, and the Comptroller of the Currency.

In 1993, the FDIC Board of Directors rescinded the earlier delegations of special examination authority unless extraordinary threats to a deposit insurance fund could be demonstrated. Any such examination would require Board approval. At the time the earlier delegation was rescinded, the FDIC Board was comprised of the Acting Chairman, the Acting Director of OTS, and the Comptroller of the Currency.

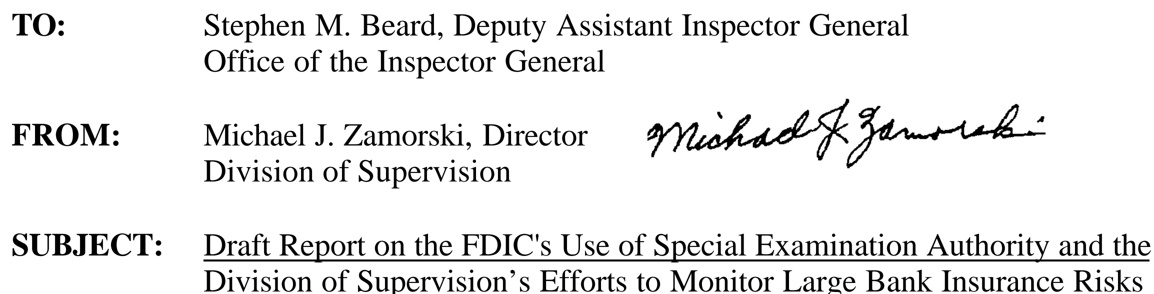
In March 1995, the FDIC Board of Directors delegated authority to the FDIC Director of DOS to approve special examinations: (1) when the primary federal regulator has invited FDIC participation, (2) for institutions rated CAMELS 4 or 5 or situations of potential or likely failure of an institution within a 1-year time frame and when the primary federal regulator does not object to FDIC's participation, and (3) for examination activities where there are material deteriorating conditions not reflected in an institution's current CAMELS rating and when the primary federal regulator does not object to FDIC's participation. In all other cases, DOS is required to prepare a case for presentation to the FDIC Board that is sufficient to justify FDIC participation over the objection of the primary federal regulator.



Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429

Division of Supervision

January 25, 2002



TO: Stephen M. Beard, Deputy Assistant Inspector General
Office of the Inspector General

FROM: Michael J. Zamorski, Director
Division of Supervision

SUBJECT: Draft Report on the FDIC's Use of Special Examination Authority and the Division of Supervision's Efforts to Monitor Large Bank Insurance Risks

The Division of Supervision (DOS) appreciates the opportunity to respond to this draft report. We share your concerns regarding the current limitations on the FDIC's use of Special Examination Authority, and we agree that these limitations restrict the FDIC's ability to assess emerging risks to the deposit insurance fund in a timely and efficient manner. Shortly after the Superior Bank, FSB, failure in July 2001, the FDIC, Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and Federal Reserve Board (FRB) formed a committee (Committee) to address the FDIC's special examination authority and supervisory information sharing. The Committee is finalizing a proposal that addresses these issues. The proposal will allow the FDIC greater flexibility in conducting timely assessments of insured depository institutions (IDI) that present heightened risk to the deposit insurance funds. Under the proposed program, the FDIC Board of Directors would delegate special examination authority for institutions presenting heightened risk to the deposit insurance funds to DOS. The Committee's proposal also addresses OIG concerns regarding FDIC access to megabanks and acquisition of timely information about those banks. The proposal establishes a dedicated FDIC examiner program for the eight largest institutions, and it sets forth protocols on enhanced information sharing that will allow more efficient and comprehensive analysis of large (megabanks) and small IDIs alike. The Committee's proposals will be presented to the Board on January 29, 2002.

Recommendations Concerning Special Examination Authority:

Pursue an amendment to Section 10(b)(3) of the FDI Act (12 U.S.C. section 1820(b)(3)) to vest special examination authority with the FDIC Chairman in consultation with the appropriate primary federal regulator.

We agree with this recommendation. The proposed program (discussed in detail below) addresses OIG concerns regarding the FDIC's special examination authority; nonetheless, a revision of Section 10(b)(3) of the FDI Act would achieve a more permanent solution to inefficiencies related to the FDIC's use of special examination authority. In that light, we have

already included amending 10(b)(3) in our Legislative Priorities list for 2002. The Chairman will decide whether the FDIC pursues a legislative solution to this problem.

Seek a revised Board delegation that vests special examination authority with the FDIC Chairman in consultation with the appropriate primary federal regulator, as an interim measure pending a legislative amendment.

We agree with this recommendation. As stated previously, a committee comprised of representatives of the FDIC, OTS, OCC, and FRB are in the final stages of developing special examination program that will, among other things, grant the FDIC more autonomy in terms of examining banks that pose a heightened risk to the deposit insurance fund. If the Board approves the Committee's proposal, responsibility for authorizing special examination activities at banks that pose heightened risk to the deposit insurance fund will be delegated to the Division of Supervision. Institutions that pose heightened risk to the deposit insurance funds will include IDIs with a composite rating of 3, 4, or 5; and IDI's that are undercapitalized as defined under Prompt Corrective Action.

Under the proposed program, the FDIC will be required to ask the primary federal regulator (PFR) if it can participate in examinations of IDIs rated 1 or 2 that are exhibiting material deteriorating conditions or other adverse developments. If the agencies (PFR and FDIC) cannot agree as to whether the FDIC should be allowed to participate in an examination, the two agencies' Representatives to the FFIEC Supervision Task Force will determine whether such a material deteriorating condition or adverse development exists. In the event the two representatives cannot agree, the Chairman of the FDIC and the principal of the relevant agency (or the Governor that is a member of the FFIEC in the case of the FRB) will determine whether FDIC participation is warranted. The FDIC will not prepare a separate report of examination for these activities except in situations where it anticipates an enforcement action.

The Committee's proposal will be presented to the Board on January 29, 2002.

Recommendation Concerning the FDIC's Efforts to Monitor Large Bank Insurance Risks:

Work to develop agreements with the other bank regulatory agencies to provide the FDIC with the timely information and access to megabanks necessary to carry out the Corporation's responsibilities as the insurer.

We agree with this recommendation, and the Committee's proposal will ensure that the OCC, OTS, and FRB provide the FDIC with the information and access that it needs to carry out its role as insurer. As discussed previously, the Committee's proposal will create a dedicated FDIC examiner program at the eight largest megabanks and ensure more timely access to relevant information related to those and other banks. The dedicated examiner program will work within existing supervisory programs of the appropriate agencies in order to avoid any increase in regulatory burden or duplication of effort. The proposal requires supervisory personnel of the primary federal regulator (PFR) to keep the FDIC's dedicated examiner informed of all material

developments in the supervision of the institution. The proposal also requires the PFR to invite the dedicated examiner to observe and participate in certain examination activities to ensure the FDIC has an understanding of the supervisory issues and risk management structure of the institution.

The dedicated FDIC examiner will be allowed to participate in selected supervisory reviews, including meetings with bank management relating to those reviews, if the relevant agency agrees that participation by the FDIC is necessary to evaluating the risk a particular activity poses to the deposit insurance fund. In the event the agencies' staffs cannot agree, the respective agencies' representatives to the FFIEC Supervision Task Force will determine whether FDIC participation is appropriate. In the event the two representatives cannot agree, the Chairman of the FDIC and the principal of the relevant Agency (or the governor that is a member of the FFIEC in the case of the FRB) will resolve the dispute.

The proposal will also require the OCC, OTS, and FRB to share relevant supervisory information related to large insured depository institutions with the FDIC. In addition, the Program will mandate quarterly meetings between the agencies to discuss the risk profile, current condition, and status of identified supervisory matters at large IDIs. The Program also requires FDIC participation of credits within the Shared National Credit Program in Large IDIs.

The Committee's proposals regarding the monitoring of large bank insurance risks will be presented to the Board on January 29, 2002.

Office of Inspector General

November 6, 2002
Audit Report No. 03-004

OCC's and OTS's Responses to the OIG's February 2002 Follow-Up Report on the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks (Audit Report No. 02-004)

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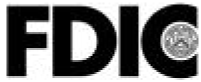

Federal Deposit Insurance Corporation
Washington, D.C. 20434 Office of Inspector General

DATE: November 6, 2002

TO: Donald E. Powell
Chairman

FROM: Gaston L. Gianni, Jr.
Inspector General

SUBJECT: *OCC's and OTS's Responses to the OIG's February 2002 Follow-Up Report on the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks* (Audit Report No. 02-004)
(Audit Report No. 03-004)

This report (No. 03-004) responds to comments that we received from the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) on our audit report entitled, *Follow-Up Audit of the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks* (Audit Report No. 02-004, dated February 20, 2002). The comments were provided in letters to the FDIC Chairman from the Comptroller of the Currency and the Director of OTS following the issuance of our report.[1] The OCC and the OTS letters to the Chairman are presented in their entirety as Appendixes I and II. These appendixes also present our views and comments on a number of specific points that the OCC and the OTS raised relative to our February 2002 report.

BACKGROUND

In a memorandum to the FDIC Chairman in October 1999, we reported the results of a study we conducted of the Division of Supervision's (DOS)[2] efforts to monitor and assess risks at insured institutions for which the Federal Deposit Insurance Corporation (FDIC) is not the primary federal regulator (PFR).[3] We reported that other federal regulators had in several instances restricted the FDIC's efforts to participate in safety and soundness examinations at institutions for which the

[1] The OCC's letter was dated May 30, 2002, and the OTS's letter was dated June 13, 2002.
[2] As part of an FDIC reorganization implemented on June 30, 2002, the Division of Supervision (DOS) merged with the Division of Compliance and Consumer Affairs (DCA) and was renamed the Division of Supervision and Consumer Protection (DSC). In most cases throughout the report, we refer to this Division as DOS.
[3] A bank's primary federal regulator is determined by the bank's charter and whether a bank is a member of the Federal Reserve System. The FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System. The OCC is the primary federal regulator for all national banks. The Board of Governors of the Federal Reserve System (FRB) is the primary federal regulator for state chartered banks that are members of the Federal Reserve System. The OTS is the primary federal regulator for federal and state-chartered savings associations.

Corporation is not the PFR. Such restrictions had limited the FDIC's ability to assess risks to the deposit insurance funds. We also reported that because of limitations in the information routinely provided to DOS by the other regulators pertaining to the nation's largest banks, DOS may not be able to adequately assess the risks that the country's largest non-FDIC supervised banks pose to the insurance funds. In our 1999 memorandum, we suggested that the Chairman (1) request delegated authority from the FDIC Board of Directors[4] to initiate special examinations without having to secure the concurrence of the primary federal regulator or the approval of the Board or (2) seek a legislative change to vest this authority in the Chairman. Doing so would give the FDIC Chairman the authority (under subsection 10(b)(3) of the Federal Deposit Insurance Act) to initiate examinations of any insured depository institution using FDIC examiners to determine the institution's condition for insurance purposes.

The objective of our follow-up review was to assess the progress that the FDIC had made since the issuance of our previous memorandum and to make recommendations that might improve the Corporation's effectiveness in working with the other federal regulators. We reviewed the issues from the FDIC perspective using the same information provided or otherwise available to the FDIC in its efforts to effectively carry out its mission as deposit insurer. We did not perform audit fieldwork at the OCC, OTS, or the FRB.

Our follow-up review did not identify any additional instances where another regulator turned down an FDIC request to participate in an examination. However, DOS officials informed us of several cases where examiners experienced delays in receiving requested information from another regulator or were not provided sufficient time during examinations to review certain bank conditions. With respect to the nation's largest banks (megabanks), our follow-up review showed that FDIC officials have continued to evaluate risk exposures by using information that is mostly historical in perspective and filtered or interpreted by the other regulators before it is made available to the FDIC. We also observed that the OCC had maintained its policy of not allowing DOS personnel to attend meetings between OCC examiners and bank management.

Based on the results of our follow-up review, the circumstances supporting our previous suggestions had not substantially changed, and conditions in the industry and the consequences of additional failures posed continuing risks to the deposit insurance funds. Accordingly, we recommended that the FDIC's special examination authority be strengthened through a legislative change. Additionally, we reaffirmed the position that we expressed in our prior review by recommending that DOS develop agreements with the other bank regulatory agencies to provide the FDIC with the real-time information and access to megabanks necessary to carry out the Corporation's responsibilities as the insurer. DOS agreed with our recommendations.

Following the failure of Superior Bank, FSB, in July 2001, the FDIC, OCC, FRB, and OTS formed a committee (Committee) and developed a proposal to address factors that have restricted the FDIC's special examination authority and the Corporation's concerns relative to information sharing. On January 29, 2002, the FDIC's Board of Directors acted on the Committee's proposal by authorizing

[4] The five-member Board is composed of the FDIC Chairman and Vice Chairman, the FDIC Director, the Comptroller of the Currency, and the Director of the Office of Thrift Supervision.

an expanded delegation of authority to grant the FDIC more autonomy in terms of examining banks that pose a heightened risk to the deposit insurance funds. Under the delegation, DOS will be able to authorize special examination activities at banks with a composite rating of 3, 4, or 5, or at banks that are undercapitalized as defined under Prompt Corrective Action,[5] without having to obtain the approval of the primary federal regulator. The new delegation also provides for the creation of a dedicated FDIC examiner program at the eight largest megabanks and is intended to provide more timely access to information related to those banks.

OBJECTIVE AND SCOPE

The objective of this review was to assess additional information provided by the OCC and the OTS on various issues and events addressed by our report and determine what, if any, modifications are needed to our February 2002 report. The body of this current report addresses the following three major issues raised in the letters:

- interpretation of the Special Examination Authority statute,
- the FDIC's need for unrestricted access to information on all insured depository institutions, and
- the OIG's compliance with government auditing standards in conducting the audit.

We performed the original audit in accordance with generally accepted government auditing standards and relied on that audit to fulfill certain objectives of this review. Specifically, we conducted this limited scope review between June and August 2002 in accordance with generally accepted government auditing standards, modified as follows. We did not assess internal control, review performance reporting, test for fraud and illegal acts, or test for compliance with laws and regulations. Further, we did not perform additional tests of the reliability of computer processed data. Instead, we relied on our original audit in order to avoid duplication of effort in these areas.

Finally, because we had received responses from the OCC, OTS, and FDIC on our February 2002 report and were limiting our work to determining whether our prior report required modification, we did not obtain written comments from them on this report. We met with and obtained DSC management's views after we had provided them an opportunity to review a preliminary version of this report. DSC disagreed with the characterization of certain events and facts described in the OCC and OTS letters, but noted that the responses referred to very dated situations. DSC also indicated that these situations have been overtaken by subsequent expressions of cooperation from the most senior levels of the OCC and OTS. DSC further indicated that it is pleased with the January 2002 interagency agreement, and that the relationship with the other PFRs is working well.

[5] Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized.

REVIEW RESULTS

Based on our review of the letters provided by the OCC and OTS, and meeting with FDIC officials, we reaffirm our prior conclusions and recommendations presented in our February 2002 report. This subsequent report contains no recommendations. Concerning the interpretation of the Special Examination Authority statute, we believe that the independence envisioned by Congress in vesting control over the exercise of special examination authority in the FDIC is fundamentally altered when an FDIC vacancy exists on the Board of Directors. In our view, that independence should be maintained at all times by vesting special examination authority in the Chairman. The OCC and the OTS expressed the opinion that the expanded delegation of authority by the FDIC's Board of Directors in January 2002 will resolve the concerns expressed in our February 2002 report relative to the FDIC's need for unrestricted access to information on all financial institutions. While the agreement represents progress for interagency examination coordination, it does not fully resolve the need for the FDIC to assess risks in well-rated institutions, and for a *Federal Deposit Insurance Act* amendment to vest special examination authority with the FDIC Chairman. Finally, our work on the audit met the Government Auditing Standards.

Interpretation of the Special Examination Authority Statute

The OCC and the OTS letters call into question our interpretation of the special examination statute. Their comments revisit a debate among various regulators during hearings in 1950 on the proposed amendments to the FDI Act through which Congress established the FDIC's explicit special examination authority. Section 10(b)(3) of the Federal Deposit Insurance Act authorizes examiners appointed by the Board of Directors "to make any special examination of any insured depository institution whenever the Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of such depository institution for insurance purposes." [12 U.S.C. §1820(b)(3)].[6] Congress emphasized, and the FDIC through then-Chairman Maple Harl accepted, that special examination authority would be invoked when the FDIC was unable to get sufficient information from the examinations of insured institutions by other primary federal regulators, not for the purpose of conducting duplicate examinations. (96 Cong. Rec. 15,145). In his response, the Comptroller of the Currency cites conference report language that discusses Congress's expectations relative to conditions when the special examination authority is to be used. Specifically, it states the authority should be used only in cases where, in the judgement of the FDIC Board of Directors, after review of the reports of the PFR, there are:

(1) indications that the bank may be a problem case, or
(2) the bank is in a condition likely to result in losses to the depositors or to the Corporation.

At the time of the 1950 amendments to the FDI Act, the FDIC's Board of Directors consisted of three members, one of whom (the Comptroller of the Currency) was an independent regulator. This meant that the FDIC, through its two Board members, could independently decide to exercise special examination authority even if opposed by the outside director. As a result of the

[6] The statute does not discuss who will be the appointed examiners to conduct special examinations.

1989 amendments to the FDI Act, the Board of Directors was increased to five members, two of whom (the Comptroller of the Currency and the Director of the Office of Thrift Supervision) are independent regulators. Therefore, the 1989 amendments preserved the independence of the FDIC to make determinations concerning the exercise of special examination authority by virtue of the majority of Board positions being internal to the FDIC. A quorum of the Board of Directors consists of a majority of the members, and positions on the Board held by individuals other than other the Comptroller and the Director of OTS were frequently vacant during the 1990s. Under these circumstances (i.e., a vacancy in one or more of the internal FDIC Board positions), decisions to invoke the FDIC's special examination authority could again require the *de facto* consent of independent regulators. The independence envisioned by Congress in vesting control over the exercise of special examination authority in the FDIC is thus altered fundamentally when an FDIC vacancy exists on the Board of Directors. That independence, in our view, should be maintained at all times by vesting special examination authority in the Chairman.

The FDIC's Need for Unrestricted Access to Information on All Insured Depository Institutions

In their letters, both the OCC and the OTS question the FDIC's need for unrestricted access to information on banks for which the Corporation is not the PFR. In addition to supervising state nonmember banks in the role of a primary regulator, the Corporation is also responsible for managing the insurance funds, ensuring that failing institutions are resolved in the least costly manner, and maximizing the value of failing banks' receivership assets.[7] Given the broad range of the FDIC's supervisory responsibilities, and because of the Corporation's role and responsibility as the deposit insurer for the nation's banking industry, there is a clearly defined need for the FDIC to act in an independent manner in its efforts to evaluate insurance risk and gain access to financial records in banks supervised by the other PFRs. The FDIC has a need and a responsibility to develop information on core risk areas to facilitate analyses of insurance fund exposures and continually maintain an up-to-date understanding of specific vulnerabilities that could lead to significant insurance losses. This need is especially crucial in the nation's largest financial institutions for which the FDIC is almost totally dependent on the other PFRs for monitoring the largest potential risks to the deposit insurance funds. As discussed in our February 2002 report, the failure of a single large institution, coupled with the losses sustained in recent failures, could create a situation where all depository institutions would be required to begin paying deposit insurance premiums.

The FDIC's lack of independence to determine when and where DOS can obtain information related to safety and soundness and insurance concerns is inconsistent with the Corporation's authority when ruling on rating differences with the other PFRs. In accordance with section 327 of the FDIC's Rules and Regulations, the FDIC has the final word when assigning ratings for insurance purposes, and these ratings impact the insurance premium assessments banks are

[7] A receiver is an agent (in the instance of a failed institution, the FDIC) appointed by a failed institution's primary regulator to manage the orderly liquidation of the failed institution.

assigned. Thus, while the FDIC has full authority to assign risk ratings for insurance purposes, it does not have the equivalent autonomy to obtain the information needed to assign the ratings.

Both the OCC and the OTS expressed the opinion that the expanded delegation of authority granted by the FDIC's Board of Directors in January 2002 will resolve the concerns expressed in our report and permit the FDIC to fulfill its responsibilities as the deposit insurer. We continue to believe, however, that while the agreement between the regulators represents progress for interagency examination coordination, it does not fully resolve legitimate FDIC needs. There are instances in which well-rated banks engage in risky or emerging activities that could jeopardize their safety and soundness if adequate policies and procedures have not been developed and implemented. DOS uses various off-site techniques to gather information on such activities. For example, information that shows one or more of the following conditions can indicate problems:

(1) inordinate growth within a short time frame,
(2) significant disparities in performance indicators between an institution and its peer groups, or
(3) allegations of fraudulent activities on the part of bank officials.

When the FDIC identifies such vulnerabilities, it has a need and responsibility, together with the PFR, to promptly investigate those vulnerabilities and assess and mitigate potential significant insurance losses.

We note that had the provisions of the agreement been in effect in the 1990s, for example, the agreement would not have ensured that the FDIC could have gained access to Superior Bank, when it originally requested to do so in December 1998, without first going to the FDIC's Board of Directors. Superior was a well-rated bank at that time, and it is unclear whether there was sufficient evidence of material deteriorating conditions at the bank to warrant the FDIC's involvement in a special examination. Had the FDIC and the OTS been working more closely together at that time, rather than a year later, losses to the insurance funds may have been reduced. With respect to the substance of our report, we would reiterate our conclusion that, to guarantee the FDIC's independence as insurer, we believe that statutory authority for the exercise of the FDIC's special examination authority should be vested with the Chairman via an amendment to the *Federal Deposit Insurance Act*. As we state in our report,

> Vesting special examination authority directly with the FDIC Chairman would serve to strengthen the effectiveness of the Corporation's secondary level review of safety and soundness concerns…The proper use of the FDIC's special examination authority would not duplicate or disrupt the other PFR' efforts, but would provide the FDIC with a more timely approach for gaining a firsthand understandi along with the PFR, of potential risks facing both financial institutions and the insurance funds…

It is our opinion that the existence of such statutory authority would recognize the FDIC's shared interest as insurer in minimizing losses to the insurance funds and serve to avoid FDIC access issues in the first place by fostering cooperation with the PFR.

Office of Inspector General Compliance with Government Auditing Standards

Both letters address the point that our office did not solicit input from OCC or OTS prior to issuing our report in draft or in final. The OTS letter in particular states that our office failed to meet the spirit and intent of the Government Auditing Standards promulgated by the General Accounting Office related to soliciting the views of responsible management officials. Because we did not provide OTS officials an opportunity to review and comment on the report before it was issued, the Director states that the report is not fair, complete, or objective. In our opinion, our work on the audit met the Government Auditing Standards.

The objective of our February 2002 review was to assess the progress that the FDIC had made in monitoring and assessing risk at insured institutions for which the FDIC is not the PFR. Thus, we viewed the FDIC as the auditee. Further, as the FDIC OIG, we do not have audit cognizance for Department of the Treasury activities and operations, including those of the OTS and the OCC.[8] Accordingly, as stated on page 1 of the February 2002 report, we relied solely on information provided by the FDIC and documentation obtained from FDIC officials. We repeat that scope limitation in several places in the report where it was relevant and appropriate to do so. Including such information is consistent with Section 7.14 of the Government Auditing Standards, which states that "Auditors should also report significant constraints imposed on the audit approach by data limitations or scope impairments." We further described our audit methodology in Appendix I of the report, Scope and Methodology, as required by Section 7.15.

The Government Auditing Standards also require that sufficient, competent, and relevant evidence be obtained to afford a reasonable basis for the auditors' findings and conclusions. We met this standard within the context of the scope limitation discussed above. As noted in our scope and methodology, our analysis of the cases where FDIC DOS officials expressed concerns over delays experienced in receiving requested information from another PFR or where DOS examiners were not provided sufficient time during examinations to review certain bank conditions included a review of supporting documentation provided by DOS. We relied on this documentation for our findings and conclusions. However, as noted in the report, a fundamental component of the FDIC's approach to monitoring institutions that are regulated by other PFRs is the personal relationships that case managers develop with their counterparts in the other regulatory agencies. As such, the case managers' requests for access to meetings and information associated with other regulators' institutions were largely communicated through phone calls and electronic mail, as were the responses. Accordingly, we often had to also rely on testimonial evidence provided by FDIC officials, or a combination of documentation and interviews, to support our findings and conclusions. Thus, we relied on the information used by case managers as they are the key officials responsible for monitoring risks in institutions supervised by the other PFRs. We evaluated the fulfillment of those responsibilities as part of our audit. This evidence was corroborated to the extent we considered necessary under the circumstances.

[8] Audit responsibilities for the OCC and the OTS are vested with the Department of the Treasury's Office of Inspector General.

With regard to reporting, the Government Auditing Standards require that auditors should report the views of responsible officials of the audited program concerning auditors' findings, conclusions, and recommendations, as well as corrections planned. The standards state that one of the most effective ways to ensure that a report is fair, complete, and objective is to obtain those views and comments in advance. As noted previously, we considered our auditee to be the FDIC and, within the Corporation, DOS. In the course of our audit, we met with representatives of DOS in selected regional offices and at headquarters to discuss our findings. We incorporated additional information and views obtained in those meetings into our draft report. The recommendations in our draft report were addressed to DOS. Accordingly, we requested and obtained official comments from the DOS Director. These comments are provided as an attachment to the final report. In addition, we made reference in our final report to the January 29, 2002, agreement between the FDIC and the other regulators that clarified the circumstances under which the FDIC can exercise special examination authority and that established an FDIC examiner program at the eight largest banks in the country. We added this information as required by Section 7.44 of the Government Auditing Standards, which states that noteworthy management accomplishments identified during the audit, which were within the scope of the audit, should be included in the audit report along with deficiencies.

Finally, consistent with FDIC policies and procedures, we included the audit report on the agenda for the March 15, 2002, meeting of the FDIC Audit Committee. The report was distributed to Committee members in February, discussed at the March meeting, and unanimously accepted by the Audit Committee for forwarding to the Board of Directors.[9] This meeting provided representatives of the OTS and the OCC an opportunity to express concerns with the report before it was made available to the Congress and to the public via the Public Information Center and our OIG Web site, as is our policy. Subsequent to the Audit Committee meeting, we transmitted the report to members of the Senate Banking and House Financial Services Committees on March 26, 2002. We notified FDIC senior management in advance that we would be releasing the report.

That being said, we respect the OCC's and the OTS's concerns with our reporting process in circumstances where our reports deal with matters materially affecting the other PFRs. We have indicated in meetings with the OCC and the OTS during this review, that in the future we will inform them of FDIC OIG audits that could significantly impact their operations and, when appropriate, allow them to review our draft reports. Accordingly, a preliminary version of this report was provided to the OCC and the OTS to apprise them of the content and presentation of issues.

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[9] The Audit Committee minutes reflect that "Director Gilleran indicated that the subject of an audit must be given an opportunity to review a draft of the report and submit comments. He suggested that to do otherwise is not good procedure. He indicated that OTS did not have an opportunity to review and submit comments regarding the report."

Appendix I

Letter from the Office of the Comptroller of the Currency and OIG Comments

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

O

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 30, 2002

Donald E. Powell
Chairman
Federal Deposit Insurance Corporation
801 17th Street NW
Washington, DC 20434

Subject: Report of the FDIC's Office of the Inspector General

Dear Chairman Powell:

I am writing pursuant to the resolution approved by the FDIC Board of Directors at its meeting on April 9, 2002, inviting the OCC to respond to the Report of the FDIC's Office of Inspector General ("OIG"), dated February 20, 2002 ("Report"). The Report covered two issues: (1) the FDIC's use of its special examination authority, and (2) the FDIC's efforts to monitor the largest banks in the country. As I stated at the April 9 meeting, I believe the Report is gravely flawed. In particular, there was an enormous amount of information directly relevant to the issues addressed in the Report that did not find its way into the Report's discussion of these issues. I have summarized below the areas where I have the greatest concerns with the Report, and I also enclose an analysis written by OCC staff addressing in more detail these and other issues raised by the Report. Insofar as matters pertaining to the OCC are concerned, the Report is so incomplete that it fails to accurately convey key events.

At the heart of the problem, I think, is the OIG's failure to solicit any input from the OCC, let alone allow the OCC to view the Report in draft, prior to finalizing the Report and delivering it to Congress. That decision alone is the source of many of the most serious flaws in the Report. As I note below, the Inspector General has recently informed us of a very constructive change in the OIG's process in this regard.

See pp. 7-8 of this report.

In any event, the allegations involving the OCC which the OIG relies upon as the basis for its recommendation to seek new federal legislation boil down to two interagency examination efforts involving national banks and repeated references to the failure of a third, the First National Bank of Keystone, West Virginia ("Keystone"). These few instances stand in contrast to the nearly 50 successful interagency examination efforts of national banks during the same time period.

For example, the Report ignores the numerous existing channels of interagency communication that I think we would both agree are functioning well. These include numerous written reports, regular interagency meetings and briefings, shared access to computerized supervisory information, as well as effective staff-level working relationships both in the field and in several designated interagency projects. The Report also virtually ignores the recently signed interagency agreement providing a framework for FDIC access to all problem banks (rated 3, 4, or 5), all undercapitalized banks, and the six largest national banks regardless of their condition. The Report fails to note or to integrate into its analysis or recommendations the fact that the procedures in this agreement directly address the recommendations made by the OIG in its earlier report on the same subject issued in 1999.

See comment 1.

See comment 2.

See pp. 5-6 of this report and comment 3.

I was also quite surprised and struck by the Report's discussion of the legislative history behind the FDIC's special examination authority. The Report suggests that Congress meant to empower the FDIC to examine national banks whenever the FDIC board feels it appropriate, for "insurance purposes." Viewed in its best light, this construction of the relevant legislative history is materially incomplete. The Report simply ignores key legislative history that explains the meaning of that language in the context of Congressional intent:

> [Congressional] conferees were firmly of the opinion that such authority is not to be utilized by the Corporation to embark upon a program of regular periodic examinations of such banks, which would only result in a needless duplication of effort. Such special examination authority is to be utilized by the Corporation only in a case where, in the judgment of the [FDIC's] Board of Directors, after a review of the Federal Reserve or Comptroller of the Currency examination reports, there are indications that the bank may be a problem case, or that it is in a condition likely to result in loss to the depositors or to the Corporation.

Conf. Rep. No. 3049, 81st Cong., 1st Sess. 1, *reprinted in* U.S.C.C.A.N. 3765, 3776-77 (1950).

See pp. 4-5 of this report.

This omission or misunderstanding may be the source of the Report's confusion regarding the relative roles of deposit insurer and that of an institution's primary federal regulator ("PFR"). The Report repeatedly compares the access to information available to the FDIC to that of the PFR. The inevitable result of this comparison is to advocate that the FDIC be permitted access to national banks equivalent to that of the OCC. Not only does this suggest a duplication of regulatory burden (expressly contrary to the legislative history), but in the case of the largest banks, this suggestion would significantly undermine the PFR's ability to maintain the close working relationships critical to the OCC's ability to carry out its mission of detecting and correcting problems in large banks. And, as you know, our recent interagency agreement provides the FDIC with examination access to the largest national banks, taking into account legitimate concerns about duplication of effort and regulatory burden.

See pp. 5-6 of this report.

In the case of large banks, the Report ignores the OIG's own recommendations made in its 1999 report on the same issues. That report recommended that the FDIC further refine its information needs, but the Report makes no assessment of whether the FDIC has indeed done so. Instead, the Report attempts to shift blame to the OCC by issuing a broader recommendation that the FDIC

See comment 3.

See pp. 5-6 of this report.

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convince the PFRs to enter into agreements to permit the FDIC greater access. Once again, the Report's failure to integrate the recent agreement among the banking agencies into its analysis is baffling.

See pp.5-6 of this report.

Finally, the Report suggests that the OCC's interaction with the FDIC on the Keystone bank worsened the exceptional circumstances of that case. In discussing Keystone (and the failure of a thrift regulated by the OTS), the Report uses several formulations of its accusation of the impact of the OCC's actions. At its worst, the allegation is:

> The OCC's and OTS's initial reluctance to allow DOS examiners to evaluate a number of concerns related to the activities of these banks *may have* prolonged their periods of operation and increased deposit insurance losses.

Report at 2 (emphasis added).

The suggestion that OCC restrictions on FDIC access to Keystone made the failure worse is a rehash of allegations that were discredited long ago. The facts reveal that the only action taken by the OCC to limit the FDIC's access to Keystone occurred in the 1998 examination, when the FDIC asked to send in three examiners, while the OCC permitted only two FDIC examiners to accompany the OCC on-site. The FDIC participated fully in prior examinations, bringing as many examiners as it wished. Similarly, the FDIC participated fully in the 1999 examination of Keystone, bringing as many examiners as it wished. The fraud at the heart of the Keystone bank—which existed when the FDIC brought as many examiners as it wanted to Keystone, and which was not discovered by them—was discovered by OCC examiners during the 1999 examination. While I personally regret that the OCC did not permit the FDIC to send in the one additional examiner they had requested during the 1998 examination, the OCC's handling of this case has been thoroughly investigated by other entities and there is ***no*** evidence that the OCC's interaction with the FDIC had any effect on the size or timing of the bank's failure. Any suggestion that the loss in Keystone might have been mitigated if only the FDIC had been allowed one additional examiner or that the Keystone failure might have been avoided entirely but for this restriction—which is how some in the press have read the OIG Report as implying—is simply preposterous.

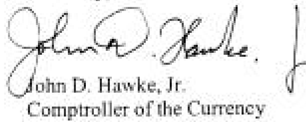
See comment 4.

I am confident that the recently signed interagency agreement, coupled with the OCC's continued commitment to cooperation with the FDIC, will permit the FDIC to fulfill its responsibilities as insurer of the country's deposits. For my part, I do not intend to allow the flaws of the Report to undermine the positive and effective relationship between us and our respective supervisory staffs. My staff and I stand ready to discuss further any of the issues in the Report, if you think it would be productive.

I respectfully request that this letter, together with the accompanying staff comments, be included in the FDIC's records together with the OIG Report. I recognize that the OIG may wish to comment on this submission, and I have no objection to any further comment from that office being similarly included in the FDIC's records.

-3-

Finally, I should point out that the Inspector General has recently informed us that in the future the OCC will be given an opportunity to comment on draft reports that raise policy questions that may be relevant to national banks, or that reflect adversely on the performance of the OCC. I applaud the Inspector General's decision in this regard, which should be mutually beneficial.


Sincerely,

John D. Hawke, Jr.
Comptroller of the Currency

enclosure

cc: James E. Gilleran, FDIC Director
John M. Reich, FDIC Director
Gaston L. Gianni, Jr., FDIC Inspector General

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Appendix I
Letter from the Office of the Comptroller of the Currency and OIG Comments

OCC Staff Comments
on the
FDIC Office of Inspector General
Audit Report No. 02-004

May 30, 2002

Summary of OCC Staff Comments

The Office of the Inspector General of the FDIC ("OIG") issued a report dated February 20, 2002, entitled "Follow-up Audit of the FDIC's Use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks" (hereinafter "OIG Report"). As the title of the Report suggests, the Report covered two issues: (1) the FDIC's use of its special examination authority in all insured banks, and (2) the FDIC's efforts to monitor the largest banks in the country.[1]

On the basis of its findings in (1), the OIG Report recommends that the FDIC seek federal legislation to expand its special examination authority. Regarding (2) large banks, however, the OIG Report recommends continuation of the FDIC's efforts to work cooperatively with other regulators to obtain the information the FDIC deems necessary, but the OIG Report stops short of citing issues in monitoring large banks as a basis for recommending legislative enhancement of the FDIC's special examination authority.

These Staff Comments first analyze the factual bases of the FDIC OIG's conclusions regarding special examination activities. The OIG Report examines a recent 17-month time period and discusses two instances of the FDIC's use of its special examination authority involving national banks during that time period. These two instances, along with a third from the 1999 OIG Report, form the factual basis of the OIG's current recommendation. However, the OIG Report's descriptions of these instances are misleading because they leave out or misreport a great deal of information relevant to understanding the flow of information between the agencies.

See comment 5.

See pp. 7-8 of this report.

One of these instances involved a recent interagency joint effort to respond to risks to numerous insured banks arising from a common customer who was engaging in a complex series of transactions. This effort was extraordinary—and successful. To respond effectively to the complexity of the situation, the FDIC, OCC, and FRB developed a systematic process for planning joint and simultaneous examinations of the various banks, sharing the information obtained, and revising the project's priorities and goals as necessary. In order to resolve interagency issues as they came up, the agencies' three project coordinators met weekly and the agencies' three senior supervisory officials met monthly. The OCC promptly provided the FDIC every piece of information it committed to provide—over 100,000 pages total—and continued its investigation of the national banks even after the interagency aspect came to an end. The most important facts from this joint project tell a clear story of successful interagency cooperation:

See pp. 7-8 of this report and comment 6.

[1] The OIG issued an earlier report on these same subjects in 1999. *See* FDIC OIG Audit Memorandum, "Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks," Oct. 19, 1999 (hereinafter "1999 OIG Report").

- The FDIC received all info due it from the OCC—approximately 100,000 pages.
- Extraordinary cooperation between the agencies:
  - Complex scheme involving 15+ banks
  - Weekly meetings of project coordinators
  - Monthly meetings of agencies' senior supervisory executives
  - Project priorities were always open to renegotiation
  - FDIC, OCC, and FRB signed an Information Sharing Agreement.
- OCC pushed hard in addressing the supervisory issues:
  - OCC lead 7 interagency on-site reviews at national banks.
  - OCC issued Orders of Investigation in 2001 & sent copies to FDIC.
  - OCC issued over 50 subpoenas for documents & testimony.
  - FDIC sought to shut down inquiry in 2001 without issuing Orders of Investigation or taking any individual enforcement actions.
- OCC wrote up the project's preliminary findings, with extensive supporting documentation, in October 2000, in part for presentation to law enforcement agencies.

None of this information is included in the OIG Report. It is particularly surprising that the OIG Report would cite this project as an example of poor communication—to the OCC, it was a model of interagency cooperation. Instead of mentioning the hard facts above, the OIG Report relies instead on comparatively minor gripes, many of which are simply false.

See pp. 7-8 of this report and comment 6.

Another instance relied upon by the OIG Report is the failure of the First National Bank of Keystone, West Virginia ("Keystone"). The OIG Report plainly treats Keystone as the single most important example involving national banks, even though the current OIG Report technically focuses on the a time period well after Keystone's failure and even though the OIG discussed Keystone in its prior report in 1999. Because of Keystone's centrality to the recommendations in the current OIG Report, these Staff Comments discuss Keystone as well. As in the two other instances, the OIG Report omits relevant information and a fuller description of the facts reveal that the OCC's actions had no material affect on the FDIC's access to information about the bank.

See comment 4.

Finally, these Staff Comments discuss the OIG Report's recommendation regarding the large bank monitoring program. The OIG Report makes no claim for statutory reform on the basis of the large bank monitoring program. The Comments discuss relevant information left out of the OIG's analysis of the program and ultimately agree with the OIG's recommendation that the FDIC further refine its requests for supervisory information from the primary federal regulators ("PFRs") of the large banks.

I. Special Examination Activities

The FDIC's special examination authority comes from a federal statute that empowers the FDIC to examine institutions supervised by the banking regulators, such as the OCC, OTS, or FRB, when the FDIC's board determines that it is necessary for the FDIC's "insurance purposes." *See* 12 U.S.C. § 1820(b)(3). Properly understood, this authority is limited to instances where there is a significant chance that the particular bank might fail, thereby exposing the FDIC's deposit

See pp. 4-5 of this report.

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Appendix I
Letter from the Office of the Comptroller of the Currency and OIG Comments

insurance fund to risk of loss. In addition to this statutory authority, the FDIC and OCC have formally agreed that the FDIC may accompany the OCC on any examination of a national bank in a troubled condition, i.e. one whose CAMELS composite is a 3, 4, or 5. The OCC routinely invites the FDIC to accompany it on examinations of other banks as well.

See pp. 4-5 of this report.

The OIG Report's primary recommendation is to expand the FDIC's statutory power to conduct special examinations. As support for its recommendation for federal legislation, the OIG Report states that in "several cases" during the 17-month period under review, the FDIC examiners from the Division of Supervision ("DOS") "experienced delays in receiving requested information from another regulator or were not provided sufficient time during examinations to review certain bank conditions." (OIG Report, page 2.) The OIG Report discusses only three such occasions, two of which involved national banks supervised by the OCC and the other a thrift supervised by the OTS. (In addition, the OIG Report repeatedly mentions FNB Keystone as another example involving a national bank, but it failed prior to the relevant time period covered by the Report, Oct. 1, 1999 to Feb. 28, 2001.)

See comment 5.

It is important to put these two instances in context. The current OIG Report mentions that during the relevant 17-month time period, the OIG counted 49 instances where the FDIC participated in OCC examinations of national banks (and another 23 instances where the FDIC participated in OTS examinations of thrifts). While the Report says nothing about the majority of these instances, it does note that: "When dealing with issues related to small and medium sized banks, DOS managers believe that at the regional level, they have developed effective working relationships with their regulatory counterparts at the FRB, OCC, and OTS." (OIG Report, page 8.) Nevertheless, on the basis of the alleged "delays" in two examinations out of 49 involving national banks (or three out of 72, including thrifts), the OIG concludes that the FDIC needs additional statutory power from Congress.

See pp. 5-6 of this report.

See comment 5.

This section first discusses in limited detail each of the two (out of 49) examinations involving national banks that occurred during the time period covered by the current OIG Report. In neither case does the OIG Report allege that the "delays" had any material effect on the FDIC's ability to carry out its mission as insurer. Unfortunately, the Report, which was not discussed with the OCC prior to publication, incorrectly characterizes many of the facts of these two joint agency efforts. Contrary to the impression created by the Report, both of these two joint reviews proceeded smoothly and effectively, without any material hindrance of the FDIC's access to information. Both examples also illustrate that the FDIC already has numerous, effective and overlapping channels to access all the information it might need.

See comment 7.

Finally, this section discusses the Keystone case, which occurred prior to the time period covered by the current OIG Report, but which nevertheless figures prominently in the OIG Report. Keystone is thus the third example of the FDIC's use of its special examination authority in national banks discussed in the OIG Report. As with the other two examples, however, the OIG Report omits material information about Keystone and presents other misleading information. There is no evidence to support the FDIC's suggestion that the OCC's restriction on the FDIC's access in any way made the failure worse.

See comment 4.

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A. OCC Examination in July 2000

The situation described on pages 8-9 of the OIG's Report involved a community bank, at which the OCC began a full-scope on-site examination in July 2000. Unlike the situation described below in section I.B., this examination followed the routine interagency processes, even though it would eventually reveal severe insider abuse in the bank's loans. The interaction between the FDIC and the OCC in this case illustrates well the several interagency channels through which the FDIC already receives timely information about national banks. No analysis of the FDIC's ability to access information is complete without a basic understanding of these channels of communication. Nevertheless, the OIG Report ignores them and makes three complaints about the FDIC's access to supervisory information in this case, all three of which are inaccurate and/or misleading.

First, the OIG Report asserts that the OCC did not notify the FDIC, until January 2001, that the bank's condition had worsened dramatically and the bank's rating had been downgraded from a 2 to a 5. This is incorrect in several ways. First, the FDIC had been given notice many times, starting almost a year earlier, that the bank's rating had been downgraded from a 2 to a 3. (Such a downgrade is significant because 3, 4, and 5 rated banks are considered to be in troubled condition and are generally subject to increased regulatory scrutiny.) The FDIC has real-time access to the OCC's computerized data-base known as the Supervisory Monitoring System ("SMS"), which records, among other things, the CAMELS composite and component ratings of each national bank. The OCC entered a downgrade from a 2 to a 3 into SMS in late January 2000. At any time thereafter, the FDIC could easily have seen in SMS that the bank was rated a 3. Following its standard practice, the OCC notified the bank of the downgrade in writing in February 2000. When the OCC changes a bank's composite CAMELS rating, the OCC routinely notifies the FDIC at the same time by sending it a contemporaneous copy of the written notice sent to the bank. The OCC sent the letter to the bank in February 2000, so the FDIC should have received a second notice of the downgrade at that time as well.

In addition, the FDIC also receives, twice a year, a computer tape of data on the condition of all national banks, for use in determining deposit insurance premiums. The OCC sent such tapes to the FDIC in March 2000 and September 2000 and both tapes indicated that the bank was rated a 3. Similarly, when the OCC transferred supervision of the bank in September 2000 to the OCC's Special Supervision and Fraud Division in Washington, the OCC notified the FDIC of the transfer by letter dated September 21, 2000. The letter explains that the bank was now in a "troubled condition," which again means that the bank's rating was a 3 or worse.

It also bears noting that in July 2000 the bank first appeared in the OCC's "Critical Bank Report," which is a monthly listing of problem banks. The July 2000 report showed the 3 rating. Subsequent reports included descriptions of the OCC's latest examination findings and supervisory strategy. Well before January 2001, these Critical Bank Reports indicated that the bank's rating was "in process" meaning likely to change again. The OCC provides this report to the FDIC each month as it is finalized, so the FDIC received numerous reports listing the bank as in troubled condition. Moreover, this particular bank was discussed specifically at several of the regular interagency meetings on problem banks.

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See comment 8.

Moreover, these channels of interagency communication are supplemented by the informal and effective working relationships between the respective field staff of the two agencies, in this case the Memphis Regional Office of the FDIC and the New Orleans Field Office of the OCC. All of these modes of interagency communication are well known and widely used by the supervisory staffs of the OCC and FDIC. It is therefore inconceivable that the FDIC did not know that the OCC had downgraded the bank to a 3 and considered the bank a troubled bank at the beginning of the July 2000 examination. None of this information is referenced or taken into account in the OIG Report.

Moreover, the OIG Report gives a skewed impression where it implies that the OCC withheld from the FDIC the OCC's decision to downgrade the bank's rating to a 5. As an initial matter, this accusation ignores the OCC's typical procedure of finalizing ratings by issuing a Report of Examination. In this case, the OCC issued the ROE in January 2001 and notified the FDIC immediately. More importantly, the OCC fully briefed the FDIC during the examination of its preliminary findings and conclusions, including estimates that the bank's 3 rating would be further downgraded to a 4 or 5. This took place in September 2000, at the same time that the FDIC was given ample opportunity to join the OCC examiners in their on-site work. *The OIG Report is completely mistaken in its allegation that the OCC supposedly downgraded the bank from a 2 to a 5 without notifying the FDIC.*

The second charge made in the OIG Report is that the OCC learned of serious insider abuse in July 2000 but did not share its knowledge with the FDIC, leaving the FDIC to learn about the fraud "only when" the FDIC received an inquiry from a party unidentified in the OIG Report. (OIG Report, page 8.) This too is inaccurate and misleading and, again, the facts reveal that the OCC gave the FDIC timely access to all information it requested and did not withhold information or delay briefing the FDIC.

See comment 8.

The OCC began the examination in July 2000. The OCC planned to examine various areas of the bank in a pre-determined sequence. During the earlier stages of the examination, the OCC received anonymous letters suggesting that the OCC look into particular loans. The OCC occasionally receives such tips, which can vary widely in their reliability, so while the tips were not initially taken as conclusive evidence of problems, the examiners did immediately decide to review those loans during that examination. The review of insider activities proceeded over several weeks' time. More anonymous letters appeared and the examination work began to reveal problems with the loans singled out by the tips. Thus, the OCC examination team realized there were serious fraud problems in late August or early September 2000.

It is inaccurate and misleading to say, as the OIG Report does, that the OCC "became aware" of the fraud in July 2000; that was merely when the examination began. Once aware of the problems, the OCC promptly informed the FDIC. In late August or early September 2000, as the OCC was coming to believe there were serious insider problems in the bank's loan portfolio, the FDIC's Assistant Regional Director in Memphis called the OCC's Assistant Deputy Comptroller in New Orleans to request a briefing on the OCC's examination findings. The Assistant Deputy Comptroller gave him a full update of the examination findings to date and future examination plans. At that time, the FDIC made no request to participate in the examination nor to receive

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additional information, other than to be kept up to date. Thus, the FDIC "became aware" of the insider abuse within days of the OCC becoming aware of it.

The Assistant Deputy Comptroller provided the requested update on September 26, 2000, by placing a call to the FDIC's Assistant Regional Director and again giving a full briefing of the OCC's examination findings and plans to date. In this call, the OCC Assistant Deputy Comptroller explained that he expected the bank would be further downgraded from a 3 to a 4 or 5 as a result of the examination, that the OCC had just moved quickly to suspend the bank's president, that the OCC had opened a formal investigation, and that he anticipated a long and thorough examination. After this second call, the FDIC could not have had any doubt as to the problems in the bank and the potential for the OCC to discover that the problems were more severe than known at the time.

Moreover, during this call, the Assistant Deputy Comptroller invited the FDIC to participate in the OCC's examination, but the FDIC's Assistant Regional Director did not accept the invitation at that time. On the basis of this conversation, the Assistant Deputy Comptroller informed his staff and the management of the bank to expect that FDIC would soon request—and be permitted—to join the OCC in its on-site examination. But it was not until February 2001 that the FDIC made such a request. (The OCC granted it within 24 hours.)

In addition, the OCC and FDIC specifically discussed this bank at several regular interagency problem bank meetings. In particular, at the September 20, 1999, problem bank meeting, the FDIC received a full briefing on the OCC's order of investigation, the suspension of the bank president, and the decision to transfer supervision to Washington. The information from this briefing could easily have been passed on to the FDIC's Assistant Regional Director.

For all these reasons, it is simply inaccurate for the OIG Report to claim that the FDIC was not informed of the downgrade in the bank's rating or its condition—any reasonably complete inquiry by the OIG would have revealed that the FDIC was directly informed of the OCC's examination findings as they were made. The OIG Report also ignored numerous other, existing channels of interagency communication that the FDIC inexplicably chose not to use.

The third complaint leveled by the OIG Report is somewhat vague, saying only that the FDIC "experienced difficulties and delays in obtaining information from OCC officials that was needed to calculate an accurate capital ratio." (OIG Report, page 9.) Like the other allegations in the OIG Report, this one makes no claim that either the requested information or the alleged delay were material to the success of the FDIC's insurance mission. In any event, it is true that an FDIC examiner made several requests for OCC information, but the OCC examiner who received the requests sent several shipments of examination documents to the FDIC and all of the requested information was sent out within a few days.

It should be clear from reading the complaints in the OIG Report about this examination that none of the alleged problems could have materially hindered the FDIC's ability to monitor the risks to the deposit insurance fund. None of the allegations, moreover, are well-founded. The FDIC had ample opportunity to take advantage of existing interagency channels of communication but chose not to. The OCC provided the FDIC with notification of the

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See comment 8.

downgrades in the bank's ratings on several occasions. The existing working relationships at the field level worked well in this case, as is typical.[2] The FDIC was updated on OCC examination findings at every request and no information was withheld or delayed. The OIG Report's criticisms of this examination are groundless.

See comment 8.

B. Joint Project Beginning in December 1999

The situation described on page 9 of the OIG's Report involved numerous banks, with both state and federal charters, supervised by the OCC, FDIC, and the FRB. Because of the unusual nature of this interagency project, it is important to give some background information before addressing the OIG Report's allegations. This background information—all of which was left out of the OIG Report—shows that the FDIC was given every opportunity to access supervisory information and participate in the OCC's examination process and analysis.

Several banks (both national and state-chartered) were involved in a dynamic series of transactions, directly and indirectly, with a group of individuals. The transactions posed myriad potential risks to the banks involved, including credit and transaction risks and conflicts of interest. The transactions also appeared somewhat unstable, possibly posing significant systemic risk to the several banks, and it became apparent to all three agencies in 1998 that interagency cooperation would be necessary to respond effectively to these risks. In this regard, this situation was not routine, but, like the examination described above, this case illustrates clearly just how well the agencies can and do share information cooperatively and effectively.

See comment 6.

The OCC's early supervisory efforts (prior to December 1999) resulted in the national banks involved improving their systems and controls in some relevant areas. However, the complexity of the situation required a greater degree of interagency cooperation. Accordingly, the three agencies met in Washington in January 2000 to establish a closer system of coordination of their monitoring of the multi-bank transactions at issue. The meeting included FDIC officials from its Memphis Regional Office, the supervisory office for the state non-member banks involved in the multi-bank transactions.

At the January 2000 meeting, senior officials from all three agencies met in Washington and immediately agreed that they must work together and share all relevant information obtained through each agency's respective examination authority. The agencies also agreed to participate in joint and simultaneous reviews and soon thereafter appointed Project Coordinators to head up the interagency effort. The Project Coordinators reported directly to the heads of the bank supervision divisions of their respective agencies (hereinafter "Principals"). The Project Coordinators quickly agreed to a mission statement and established five specific supervisory

[2] The FDIC's Regional Director in the Memphis office sent the OCC a letter dated April 16, 2001, which complained that the FDIC was not aware of the "the extent of the losses or the assigned rating until the [Report of Examination] was received in this office on January 22, 2001." The letter found it "disturbing" that the OCC had not informed the FDIC earlier and requested "better cooperation and communication" in future cases where national banks might possibly fail. As explained above, these allegations are baseless because the OCC kept the FDIC informed and initiated contact with the FDIC to provide updates and because the FDIC had several other means to obtain more information but chose not to use them. The OCC Field Office was shocked by the descriptions in the FDIC's April 16, 2001 letter, but decided not to risk harming the interagency working relationship at the field level by responding formally to the allegations.

areas of concern, which were prioritized according to the potential for system risk. The Project Coordinators worked by consensus, meeting weekly by conference call to discuss the latest findings, upcoming reviews, and investigative strategies. The Project Coordinators were encouraged to work through any disagreements by referencing the prioritized list of supervisory concerns, and to renegotiate the priorities at any time should developing events indicate that the focus of the joint effort needed to be modified. This system was fully in place soon after the January 2000 meeting in Washington. By all accounts, these weekly conference calls were informal, frank, and effective.

In addition to the weekly conference calls of the Project Coordinators, the agencies' supervisory Principals met monthly specifically to discuss this joint project. One question raised early on (by both the agencies' Principals and the Project Coordinators) was the need to issue Orders of Investigation to authorize use of the three agencies' statutory subpoena power. After several discussions, the three agencies agreed that it was best to wait until the agencies had used their examination authority in a more coordinated fashion to learn about the systemic concerns, and then follow up later, if deemed necessary, with separate formal investigations. The agencies recognized that the level of coordination would need to be close, but all three agencies agreed that the somewhat extraordinary system they formed to address the multi-bank issues should work well.

Despite the Report's suggestion that the FDIC had difficulty obtaining OCC cooperation, the system provided ample opportunity for each agency, including the FDIC, to raise concerns about access to information from each other's banks. The Project Coordinators often discussed particular requests for information. Due to the complexity of the situation and the sheer volume of information to be exchanged, prioritization of the information requests was essential. This is expressly why the Project Coordinators were encouraged to follow—or agree to modify—the prioritized list of supervisory concerns in dealing with all aspects of the joint project. For example, although many of the OCC's requests for information from the FDIC went unanswered, most of those requests did not involve information deemed vital to a high priority concern and so the requests were not aggressively pursued by the OCC. However, in the course of the joint project, the OCC provided approximately 100,000 pages of documents (filling over 35 boxes) to the FDIC and FRB, fulfilling each and every request for information from those agencies that fell within the purview of the joint project.

It also bears noting that the complexity of both the factual situation and the interagency coordination meant that the agencies needed to pay special attention to cataloging and indexing the documents obtained, in order to make the most effective use of them in any potential litigation or enforcement actions. At first the FDIC and the FRB questioned the need to formalize the agreed-upon system for tracking and sharing the information; both agencies cited the effective cooperation achieved to date in the joint project by the three agencies. After several months of discussion, however, both the FDIC and FRB came to agree with the OCC that a written agreement would facilitate the interagency effort by memorializing the agencies' agreement and system for sharing the information obtained through the joint effort. The agreement was signed in June 2000 by the three supervisory Principals.

See comment 6.

In October 2000, the OCC convened a meeting in Washington with the Project Coordinators, legal staffs, and examiners to review the joint effort's findings to date. The findings were summarized in a binder of material prepared by the OCC that formed the basis of subsequent referrals to and meetings with the SEC, Department of Justice, and IRS. The FDIC and FRB were fully informed of each of these meetings and attended many of them. The series of multi-bank transactions at issue ceased abruptly in early 2001 and so the need for the intense interagency cooperation subsided.

By all accounts, the joint effort was quite successful. The agencies were able to understand and monitor the credit risk and other exposures that the banks faced from the underlying situation and the agencies were well positioned to respond effectively. Neither the agencies' Principals nor the Project Coordinators have expressed criticisms of the OCC's handling of the joint project nor are there open requests from either the FDIC or the FRB for access to OCC information obtained through the joint effort. The Project Coordinators' conference calls continue even now, albeit on a monthly basis, and provide all three agencies with ample opportunity to discuss ongoing requests for information and updates on the status of each agency's findings.

This joint effort, in short, was a model of interagency cooperation. The keys to its success were the frequent meetings of both the Project Coordinators and the supervisory Principals that kept issues from building up, as well as the understanding that the agreed-upon priorities should control the group's efforts but could be renegotiated at any time. The OIG's Report makes no allegation that the problems it cites had any affect, material or otherwise, on the ability of any of the three banking agencies to fulfill their respective regulatory missions.

The OIG Report makes essentially five allegations regarding this joint effort. Each allegation is mistaken and there was no adverse affect on the FDIC's access to information. First, the OIG Report claims that the OCC withheld copies of board of directors minutes from a national bank. The truth is that the OCC examiners gave the FDIC examiners ample opportunity during and after the on-site review to make copies themselves. (This was before the information sharing system was agreed upon.) The OCC examiners fully expected the FDIC examiners to take advantage of the opportunity, but in any event there was no understanding at the time that the OCC examiners would have to make the copies for the FDIC.

Second, the OIG Report claims that the OCC canceled a return visit to that national bank over the objection of the FDIC. The truth is that the return visit was specifically discussed at several meetings of the joint team, including the weekly conference calls of the Project Coordinators. As with all such discussions and agreements, the three agencies reached agreement on a plan of action consistent with the agreed-upon supervisory priorities of the joint project. This agreed-upon plan did not schedule a return visit to the bank but instead put it off indefinitely. For the FDIC or OIG to complain now that the FDIC objected to the agreed-upon course of action is either completely disingenuous or the result of a severely incomplete investigation.

Third, the OIG Report complains that during one of the on-site reviews, OCC examiners "would only allow FDIC personnel to input data onto a spreadsheet." (OIG Report, page 9.) This somewhat trivial accusation is misleading at best because entry of data into the spreadsheet was the primary objective of the on-site review. When asked to perform the work, the FDIC

See comment 6.

examiner referred to data entry as "women's work" and refused to assist. When the FDIC supervisor backed him up, saying FDIC examiners don't do that sort of work, the OCC's lead examiner assisted in the data entry in order to get the job done. As to the further accusation that "[n]o additional examination tasks were assigned to the DOS staff" (OIG Report, page 9), additional tasks were assigned to FDIC examiners, according to their requests and the agreed-upon exam strategy.

Fourth, the OIG Report makes the somewhat vague claim that "the OCC examiners did not accept DOS comments, conclusions, and suggestions." (OIG Report, page 9.) In light of the extraordinary systems set up by the three agencies to discuss findings, examination procedures, and strategies, this accusation barely deserves comment. Once again, for the OIG Report even to make such an allegation in this project is either completely disingenuous or the result of a severely incomplete investigation.

Finally, the OIG Report asserts that the OCC has not opened formal investigations into the insider activities. This is demonstrably false. The OCC opened formal investigations in March 2001, and sent copies of these orders to the FDIC and FRB, at their request. Although it appears that the FDIC and FRB have not opened formal investigations, the OCC is continuing with its formal investigation of insider activities and has issued approximately fifty subpoenas to date. The OCC's investigation is still guided by the same set of supervisory objectives laid out at the beginning of the project, which included insider activities, though now that the higher priority goals have been achieved, the OCC's investigation is currently focusing on the lower priority supervisory issues. Even the most rudimentary investigation would have quickly disproved the allegation that the OCC is not investigating insider activities. The OCC stands by its commitment to "get to the bottom" of the matter. At the same time, the FDIC and FRB last year declared their intention to wrap up their work on the matter and issue conclusion memos.

See comment 6.

Compared to the successes achieved in this joint project, the allegations in the OIG Report are inappropriately focused on low-level problems and petty gripes. It is particularly disturbing that the OIG would rely on allegations such as these because so little investigative work was necessary to learn the truth. To this day, the OCC continues to stand by its commitment to provide any information relevant to the project to the other agencies upon request.

See report pp. 7-8.

C. OIG's Continuing Emphasis on Keystone

The OIG Report explains that it follows up on an earlier report of the OIG (dated Oct. 19, 1999), also concerning the FDIC's special examination authority and the large bank monitoring program. That report dealt extensively with the FDIC's interaction with the OCC in its examinations of the First National Bank of Keystone, Keystone, West Virginia ("Keystone"). The OIG Report just released contains no new information on Keystone. Nevertheless, the OIG Report devotes several pages throughout the Report to Keystone, for example pages 2, 5, 10, and 11 all have significant discussions of Keystone. At the same time, the Report devotes a single page, combined, to its discussion of the two other specific instances (discussed above) of the FDIC's use of its special examination authority in national banks.

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The OIG Report strongest allegation regarding Keystone is that the OCC's actions "*may have* prolonged [its] period[] of operation and increased deposit insurance fund losses." (OIG Report, page 2, emphasis added). As in the OIG's prior report, however, the current OIG Report gives no evidence for the claim that OCC's interaction with the FDIC made the situation worse. As in the section on special examination authority, the current OIG Report does not allege that the OCC's interactions with the FDIC had any material affect on the FDIC's insurance mission.

The facts are that the OCC's interaction with the FDIC had nothing to do with the failure, its size or timing. First, FDIC examiners accompanied the OCC in every examination of Keystone for the several years prior to the bank's failure on September 1, 1999. Second, with the one exception in the 1998, the OCC permitted the FDIC to bring as many examiners on-site as it requested. Third, in the 1998 examination, the FDIC originally asked the OCC for permission to have three FDIC examiners participate and, although the OCC initially refused, the OCC later permitted two FDIC examiners to participate in the 1998 examination.[3] Fourth, the FDIC participated in the 1999 examination of Keystone, bringing as many examiners as it wished (nine). In the 1999 examination, the interagency communication was constant, frank, and productive. Fifth, it was the OCC examiners who made the key factual discovery during the 1999 examination that resulted in the bank's closure. In sum, the entire allegation of OCC limiting access boils down to one additional examiner—two vs. three—in one examination, the year before the fraud was discovered. *It is inconceivable that this had **any** impact on the FDIC's ability to perform its insurance function.*

Similarly, many of the allegations made in the 1999 OIG Report lack merit.[4] For example, the 1999 OIG Report alleges that the OCC pulled the joint examination team out of the bank prematurely in the 1998 examination. This is incorrect. Prior to the 1998 examination, the OCC informed the FDIC of its examination plans, including number of planned work-days on-site. Contrary to the OIG's allegations, there was no commitment made in the 1998 examination to "remain on-site until all questions about the bank's accounting and record-keeping were answered and conclusions to exam objectives were completed." (1999 OIG Report, page 7.) This commitment was made instead in the 1999 examination. In the 1998 examination, examiners from the two agencies remained on-site for the pre-planned number of days and left according to plan, without comment or complaint by the FDIC. The joint team returned to the bank to perform some follow-up work, again without complaint by the FDIC. The suggestion that the OCC pulled the team early or reneged on a commitment to the FDIC is completely false.

See comment 4.

The current OIG Report also places tremendous emphasis on Keystone (and Superior Bank FSB) in its Appendix III, which generates statistical estimates of the loss severity risk to the deposit insurance funds from future failures of banks and thrifts. Appendix III does this by calculating a ratio of the total loss to the insurance fund for recent failures, as a percentage of the combined assets of these banks. It then compares similar figures from three overlapping time periods and concludes that losses as a proportion of assets are rising precipitously. Nowhere does Appendix

See comment 9.

[3] The FDIC's initial request, dated Feb. 13, 1998, referenced outdated OCC plans to begin the on-site work on Nov. 2, 1998. In fact, the OCC moved up the starting date to late August 1998. It also appears that the FDIC rotated one of the two examiner slots, so that three FDIC examiners did actually go on-site, though two of them took turns.
[4] FDIC OIG Audit Memorandum "Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks," Oct. 19, 1999.

III explain that the last time period includes the exceptional failures in Keystone and Superior FSB. Although, the statistical methodology in Appendix III is not spelled out, it is apparent that the methodology greatly skews the loss severity ratio because both the losses and the assets in Keystone (and Superior) were atypically large.[5] It appears that the whole point of Appendix III was to exaggerate the risk to the insurance fund of even a single failure, and thus to make the case for expanded special examination powers seem more weighty.

See comment 9.

The tone of the current OIG Report's discussion of Keystone, as well as the continued emphasis placed on it, indicate that the OIG believes that Keystone is a major factual basis for the OIG's recommendations. As such, Keystone is essentially a third example of allegedly poor interaction between the FDIC and OCC (in addition to the two discussed above in I.A. and I.B.), even though the current OIG Report purports only to be focusing on a time period, Oct. 1999 through Feb. 2001, well after the failure of Keystone.

But even if one assumes that these three incidents are worthy of criticism, it is important to put these three incidents into context. To do so, it is necessary to count up all the instances of successful interaction between the two agencies during the same time periods. This means picking up both the time period covered by the OIG's first report—42 months ending March 1999—and the 17-month time period covered by the current OIG Report. According to the 1999 OIG Report, the FDIC participated in 44 examinations of national banks. (1999 OIG Report, page 5.) The current OIG Report counts 49 examples of FDIC involvement in examinations of national banks. (OIG Report, page 8.) Therefore, for the combined period of 59 months, the FDIC participated in 93 examinations of national banks. Of these 93 instances, the OIG discusses only three instances in its two reports. Therefore, the OIG's recommendation for statutory reform is based on allegations from approximately three percent of the FDIC's joint examinations of national banks. For the other 97% of the joint examinations, the OIG presumably agrees that the interaction has been effective and open.

See pp. 5-6 of this report and comment 5.

II. Large Bank Monitoring Program

In its section on large bank monitoring, the current OIG Report makes two primary complaints about the OCC's systemic interaction with the FDIC: (1) the FDIC does not receive adequate information about the strategic plans of large banks, but instead receives primarily historical data, and (2) the FDIC needs more "real-time" information, unfiltered by the OCC, and such information is available only at meetings with bank management.

See comment 10.

As an initial matter, the OIG Report ignores the numerous ways in which the OCC already gives the FDIC access to supervisory information about large banks (even beyond those channels

See comment 11.

[5] It appears that OIG totaled up the losses to the funds for the several failures during the relevant time periods, and then separately totaled up the combined assets of these banks at the time of closing. After these two sums were generated, they were then divided to produce a ratio estimating the loss severity per bank failure. A more balanced statistical analysis would have recognized the atypical nature of Keystone (and Superior) and, at a minimum, commented on the huge leverage these cases have on the average ratio generated. A more reasonable methodology would have been to generate loss severity ratios for each failed bank first, and then average the ratios. This would have limited the leverage of these two exceptional cases. In addition, Appendix III includes no commentary on the much smaller number of bank failures recently and the potential for the smaller sample size to give less reliable statistics.

See comment 9.

discussed above that exist for all national banks). Perhaps the most significant is the FDIC's direct participation in the shared national credit ("SNC") program which reviews most of the largest credits in the banking system. Along with the several PFRs, the FDIC sends examiners into large national banks to assess the quality of SNC loans and participate in grading them. These credits make up a very significant portion of the asset structures of the largest banks in the country and the FDIC's participation in SNC gives it direct access to information on deal selection, loan structure terms, assignment of risk ratings, and quality of credit analysis. Another example is the FDIC's participation in Basel-related internal ratings-based ("IRB") pilot reviews conducted at large banks in 2001 and 2002. These IRB pilot reviews give the FDIC a direct role in determining the state of credit risk management practices relative to the proposed Basel II qualification standards and developing interagency supervisory guidance. The OIG Report mentions neither of these interagency projects, nor discusses how they fit into its recommendations.

On a more day-to-day level, the OCC also gives the FDIC frequent briefings on large banks. For example, the OCC's large bank Examiners in Charge ("EICs") brief DOS and other senior FDIC officials on the condition at each large bank company immediately after the EICs give their regular briefings to the OCC's Executive Committee. The OCC's Senior Deputy Comptroller for Large Bank Supervision meets regularly with the head of DOS to discuss large bank matters. The OCC's three Deputy Comptrollers for Large Banks regularly meet with DOS management. The OCC's large bank EICs and their team leaders meet at least quarterly with FDIC case managers to discuss risk assessments, CAMELS ratings and strategic initiatives in the large banks. The OCC examination staff takes seriously its responsibility to respond as soon as possible to requests for information from the FDIC. During the Y2K conversion and the aftermath of September 11, for example, the OCC gave frequent updates of significant issues at the large national banks. The OIG Report mentions none of these routine channels of information sharing, nor discusses whether modification of any of them would satisfy its recommendations.

See comments 1 and 11.

Although the OIG Report acknowledges, at the end of this section, that the FDIC and the PFRs signed a Memorandum of Understanding ("MOU") in early 2002 formalizing an FDIC role with respect to the eight largest banks in the country, the tone and conclusion of the section imply that the MOU is not sufficient. Ultimately, the section of the OIG Report is ambiguous in its critique and recommendation, because it does not integrate the MOU into its analysis of the alleged problems, nor does the OIG Report comment on whether the MOU suffices to implement the OIG's recommendation that the agencies reach agreement on procedures to increase the FDIC's access to supervisory information.

The OIG Report's first complaint in the large banks section is that the FDIC tends to receive only historical information about the bank's performance. While historical information is helpful, the FDIC needs to understand more about the future strategic plans of the large banks. This is reasonable, but the OIG Report does not address the obvious question of whether the OIG believes more must be done than simply clarifying the FDIC's specific information requests by including requests for information about the bank's future plans. This is, of course, one of the OIG Report's specific recommendations in this section, and it is a repeat recommendation from the OIG's 1999 report. This would seem the natural solution to a relatively simple problem,

See comment 12.

See comment 13.

See comments 12 and 13.

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even if it meant designing brief questionnaires. Unfortunately, the recommendation at the end of this section of the OIG Report does not explain whether the OIG views its recommendation or the recently signed MOU as sufficient to meet the FDIC's needs.

The OIG Report also spends a great deal of space arguing that the FDIC needs to participate in meetings with the OCC and management of the large banks in order to perform its insurance function. Despite the emphasis on meetings, the OIG Report does little to specify which information the FDIC needs to obtain from such meetings, other than to mention that meetings would help the FDIC understand the bank's strategic plans. There is no clear justification why meetings are the best source for such information; as noted above, other simpler solutions should work at least as well.

The OIG's underlying concern is that "[i]t is human nature to filter information" according to "the presenter's value structure." (OIG Report, page 17.) While there probably is a limit on humans' ability to relay information in a totally unbiased and objective manner, this does not necessitate giving the FDIC unfettered access to bank management, especially in 1 and 2 rated banks. Instead of focusing on access to bank management, it would make more sense for the OIG Report to discuss ways in which improved information technology among the banking agencies would improve the FDIC's access to information.

In its earlier report in October 1999, the OIG recommended that the FDIC (1) identify the specific information it deems necessary from the PFRs of large banks; (2) define specific criteria to be used by the FDIC in evaluating risk to the insurance fund posed by large banks, and (3) more clearly articulate the FDIC's monitoring goals and objectives regarding large banks. These recommendations should resolve the concerns identified in the OIG Report about the FDIC's monitoring of large banks, because they require the FDIC to clarify not only what precise information it needs, but also the supervisory and regulatory goals the FDIC is pursuing in requesting the information. The process of tying the goals back to the specific information should, not coincidentally, facilitate the FDIC's discussions with the PFRs about how best to provide the FDIC with the information it needs.

Unfortunately, the OIG Report does nothing to analyze whether the FDIC has acted effectively on the OIG's prior recommendations. Instead, the OIG Report simply issues a more general recommendation to "Work to develop agreements with the other bank regulatory agencies to provide the FDIC with the timely information and access to megabanks necessary to carry out the Corporation's responsibilities as the insurer." (OIG Report, page 19.) This broad recommendation could be read as subsuming all three recommendations from the OIG's 1999 report. In any event, the recommendation is silent as to whether the recent MOU satisfies the recommendation.

See comments 12 and 13.

Appendix I
Letter from the Office of the Comptroller of the Currency and OIG Comments

The following are the FDIC OIG's comments on the Comptroller of the Currency's letter.

OIG Comments

1. Although we did not present an in-depth discussion of the types of information routinely made available to DOS case managers, our February 2002 report does not ignore the channels that the OCC letter cites. We mention that information routinely received from the PFR includes reports related to examination activities and assessments of risk in the institutions and a variety of quarterly and year-end reports prepared by the banks (page 16 of the report). Also, on page 16, we state that case managers have access to examination-related data that are maintained on information systems developed by the OCC. In addition, we mention on page 8 of the report that DOS managers believe that at the regional level, they have developed effective working relationships with their counterparts at the FRB, OCC, and OTS. However, we also point out in the report that the usefulness of the information typically provided to the FDIC on the nation's largest banks is limited because it is historical in perspective and filtered or interpreted by the other regulators before it is made available to DOS.

2. Our February 2002 report discusses the interagency agreement on pages 3, 19, and 20. The major provisions of the agreement are also summarized on page 3 of this report.

3. The suggestions made in our 1999 memorandum are addressed on page 3 of our February 2002 report. We state the nature of the suggestions and that DOS initiatives met the intent of our suggestions.

4. In February 1998, the OCC received and denied DOS's request to participate in its August 1998 examination of Keystone. In June 1998, the OCC reversed its position but allowed only two DOS examiners to work in the bank. Additionally, the OCC ended the on-site portion of the exam after 15 work days and removed the examination team from the bank. An FDIC request to leave DOS examiners onsite was turned down by the OCC, leaving Keystone's accountants to continue balancing accounts and valuing residuals.

The Department of the Treasury's OIG issued a material loss report on Keystone's failure in March 2000. Treasury OIG's report states that despite finding significant problems over several years related to the bank's financial accounting systems and reports, unsafe and unsound practices, regulatory violations, and questionable management activities, OCC examiners generally did not perform more extensive examination procedures that might have revealed the true condition of the bank. The Treasury OIG report also states that Keystone experienced a ten-fold growth in its subprime business line between 1992 and 1999, without adequate accounting systems and controls, and despite regulators' concerns over bank management's lack of expertise in the area. We therefore believe that the losses associated with this failure may have been reduced had the bank been closed in 1998 rather than in 1999.

5. Our February 2002 report presents four recent examples, two relating to OCC-supervised banks and two relating to OTS-supervised institutions, and references three additional examples from our 1999 memorandum. Regardless of the frequency with which these incidents occur, we believe there is a clear need to strengthen the FDIC's authority to act in an independent manner in order for the Corporation to obtain unrestricted access to a bank and its records whenever its examiners deem it necessary to assess risk for insurance purposes.

6. As part of our review of the OCC's comments regarding this institution, we held further discussions with FDIC officials. We found that the FDIC's perspective on issues and events relating to the joint project involving the FDIC, OCC, and FRB, and particularly those events that occurred during the project's earliest phases, differs in certain respects from that of the OCC's. In the interest of promoting cooperative interagency relationships, neither we nor FDIC officials we interviewed as part of this review believe it would serve any useful purpose to pursue this matter further. More importantly, both the FDIC and the OCC agree that their cooperative and coordinated efforts resulted in making this complex project a success. Regarding the examination of the national bank that is discussed on page 9 of our February 2002 report, again the FDIC and the OCC hold differing opinions regarding a number of events. Concerning our report statement that as of July 2001, the OCC's planned investigation of the insider transactions had not begun, we were referring to a return visit to the bank that the OCC had planned. According to FDIC officials, the

interagency team never did return to the bank. FDIC officials do not take issue with the OCC statement that in March 2001, the OCC opened formal investigations of alleged insider transactions that occurred in this institution.

7. These examples are discussed in detail on pages 8 and 9 of our February 2002 report. Both cases illustrate situations where FDIC officials believe that they were hindered in obtaining sufficient information to assess insurance risk.

8. As part of our review of the OCC's comments regarding this institution, we held further discussions with FDIC officials. After revisiting the facts at our request, the FDIC agrees with the OCC that DOS officials were aware that this bank was rated a composite 3, as opposed to a composite 2, at the time it was downgraded to a composite 5. The FDIC and the OCC, however, present differing perspectives relating to the extent to which the OCC provided DOS with relevant and timely information on the worsening condition of this institution. In the interest of promoting cooperative interagency relationships, we do not believe it would serve any useful purpose to pursue this matter further. Appendix III, Table 8, of our February 2002 report illustrates the significant impact that failed institutions with high loss rates had on the deposit insurance funds.

9. Appendix III clearly states that the loss rate percentage for the 5-year period in Table 8 is more than 5 times the loss rate for the 10-year period due to the costly failures that were incurred in 1998 and 1999. Each time period covered in Table 8 includes the years 1996 through 2000 and therefore takes into account Keystone's failure. No attempt was made to exaggerate the effects of Keystone's loss. In fact, Table 8 does <u>not</u> include the loss estimate associated with the closing of Superior, $440 million as of June 30, 2002, because that failure occurred in July 2001. Additionally, within 1 year following Superior's failure, four other banks failed that have substantial loss rates (based on loss estimates as of June 30, 2002): Hamilton Bank, NA was closed on January 11, 2002 and has an estimated loss range of between $175 million and $225 million (loss rate range – between 14 percent and 18 percent); Oakwood Deposit Bank Company was closed on February 1, 2002 and has an estimated loss of $73.5 million (119 percent); NextBank, NA was closed on February 7, 2002 and has an estimated loss range of between $300 million and $400 million (loss rate range – between 45 percent and 60 percent); and Connecticut Bank of Commerce was closed on June 26, 2002 and has an estimated loss range between $46 million and

$146 million (loss rate range – between 12 percent and 37 percent). Due to the anticipated losses associated with these and other failures, and because of a change during the first quarter of 2002 relating to how banks calculate insured deposits, it is not clear as of the date of this report whether bank insurance fund payouts will cause the fund's reserve ratio to fall below the 1.25 percent statutory minimum. Should the reserve ratio fall below 1.25 percent and if the insurance fund is not recapitalized soon thereafter, all banks could face paying insurance premiums. Thus, as stated in our February 2002 report, there is a compelling need for all regulators to cooperate fully with each other in order to minimize the losses associated with any future failures.

10. Page 16 of our February 2002 report states that attending meetings provides the FDIC with the most effective and real-time means by which to evaluate insurance risks and is more effective than reading meeting summaries several weeks or months after meetings occur. The report does not state that attending meetings with bank management is the only source of current information.

11. Our February 2002 report presents numerous sources of information that FDIC case managers use to monitor bank activities and the corresponding risks that they present. These information sources are discussed on pages 15 and 16 of the report. Page 14 of the report also states that a fundamental component of DOS's approach to megabank monitoring is the personal relationships that case managers develop with their counterparts in the other regulatory agencies.

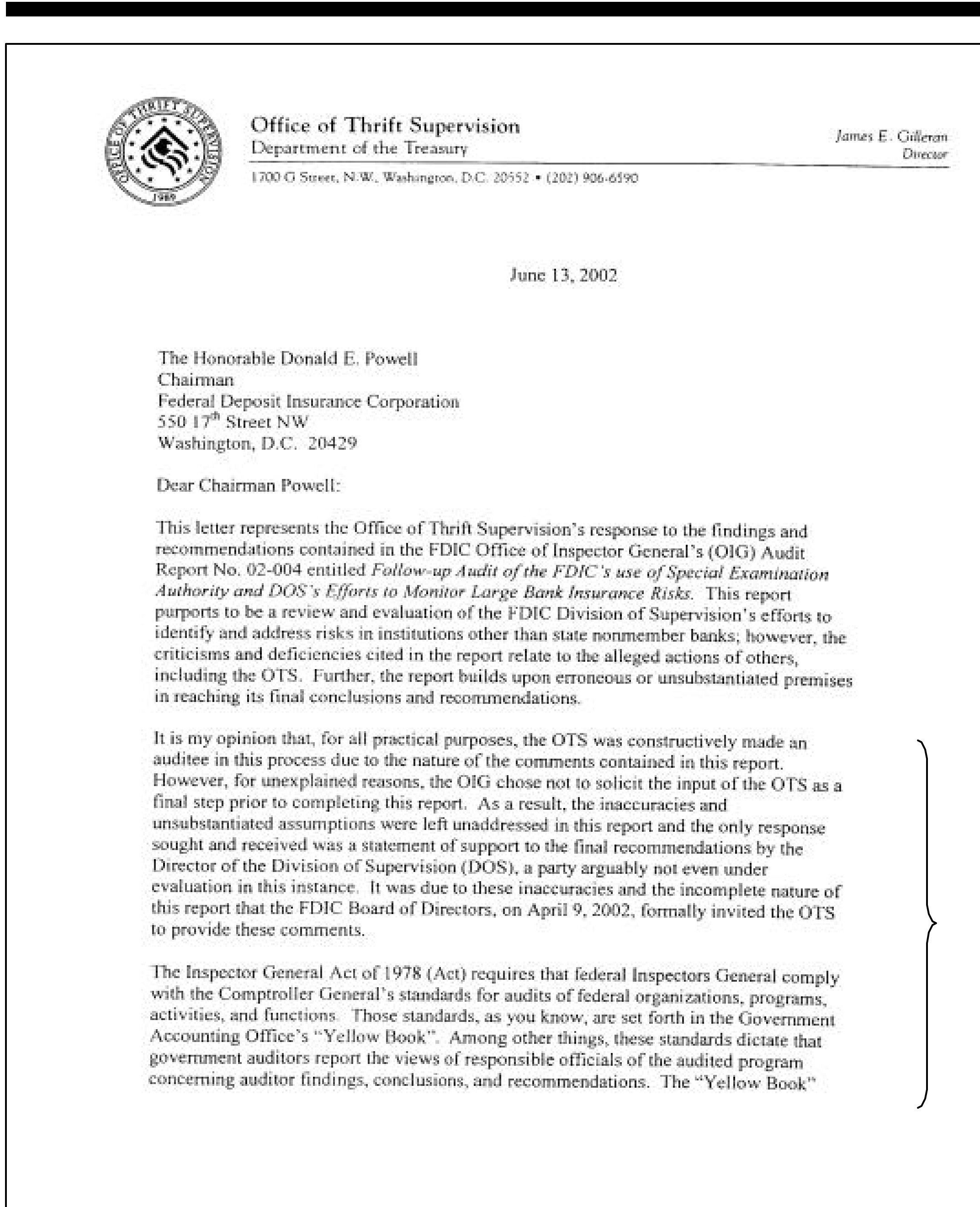
12. As stated in our February 2002 report, because of the unique characteristics of the nation's largest banks, there is probably no single strategy that will meet all of the FDIC's information needs for each of the megabanks it monitors, and the Corporation's effectiveness in monitoring large banks supervised by the other PFRs will continue to evolve over time along a variety of approaches. We believe that the interagency agreement authorized by the FDIC Board in January 2002, which includes a provision for FDIC personnel to be on site at selected megabanks with the other PFRs, will prove beneficial to the Corporation in carrying out its responsibilities. Over time, other initiatives and agreements will likely be developed between the regulators as they strive to address constantly changing conditions in the nation's economy, financial markets, and the banking industry. Given the overriding goals of safeguarding the deposit insurance funds and

ensuring the safety and soundness of financial institutions, the regulators will need to continue to work toward maximizing the extent to which they can share information and foster a spirit of cooperation in responding to and anticipating changing conditions and developing risks.

13. Our February 2002 report is a follow-up audit of a 1999 OIG study of the FDIC's use of special examination authority. The results of our prior study were provided to the FDIC Chairman in an audit memorandum dated October 19, 1999. The memorandum contained suggestions for the Chairman's consideration. The 1999 memorandum did not contain recommendations and did not require a written response.

Letter from the Office of Thrift Supervision and OIG Comments

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



Office of Thrift Supervision
Department of the Treasury
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James E. Gilleran
Director

June 13, 2002

The Honorable Donald E. Powell
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Dear Chairman Powell:

This letter represents the Office of Thrift Supervision's response to the findings and recommendations contained in the FDIC Office of Inspector General's (OIG) Audit Report No. 02-004 entitled *Follow-up Audit of the FDIC's use of Special Examination Authority and DOS's Efforts to Monitor Large Bank Insurance Risks.* This report purports to be a review and evaluation of the FDIC Division of Supervision's efforts to identify and address risks in institutions other than state nonmember banks; however, the criticisms and deficiencies cited in the report relate to the alleged actions of others, including the OTS. Further, the report builds upon erroneous or unsubstantiated premises in reaching its final conclusions and recommendations.

It is my opinion that, for all practical purposes, the OTS was constructively made an auditee in this process due to the nature of the comments contained in this report. However, for unexplained reasons, the OIG chose not to solicit the input of the OTS as a final step prior to completing this report. As a result, the inaccuracies and unsubstantiated assumptions were left unaddressed in this report and the only response sought and received was a statement of support to the final recommendations by the Director of the Division of Supervision (DOS), a party arguably not even under evaluation in this instance. It was due to these inaccuracies and the incomplete nature of this report that the FDIC Board of Directors, on April 9, 2002, formally invited the OTS to provide these comments.

The Inspector General Act of 1978 (Act) requires that federal Inspectors General comply with the Comptroller General's standards for audits of federal organizations, programs, activities, and functions. Those standards, as you know, are set forth in the Government Accounting Office's "Yellow Book". Among other things, these standards dictate that government auditors report the views of responsible officials of the audited program concerning auditor findings, conclusions, and recommendations. The "Yellow Book"

See pp. 7-8 of this report.

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goes on to state that one of the most effective ways to ensure that a report is fair, complete and objective is to obtain the advance review and comments by responsible officials and others. Because no effort was made to obtain a balanced and accurate view of the situation under review in this report, I believe the OIG has failed to meet the spirit and intent of applicable standards and responsibilities.

See pp. 7-8 of this report.

Both this report and the earlier 1999 audit of the same program are fundamentally flawed because they fail to support the basic premise upon which they are structured – that there is some compelling need for the information and access that the DOS managers suggest is lacking. Even assuming this premise was sufficiently supported, there was a failure to elicit from these managers any explanation of the types of information that they perceive as being required and lacking from the insurer's perspective. Simply stating that the FDIC needs different or more detailed information because it is the insurer is meaningless without some explanation of what this information is and how it would to be used. Absent such basic information, these conclusions are groundless since there is no analysis to establish that a weakness exists.

See pp. 5-6 of this report.

The report commences with the ambiguous statement that OTS and OCC "turned down initial DOS requests to participate in scheduled safety and soundness examinations, and the end result in two of these cases dramatically illustrates the importance of regulators working together to effectively deal with evolving risks in the banking industry" (Page 2). While unstated, the inference is that the primary federal regulators thwarted the deposit insurer's examination participation and that this restriction on FDIC participation resulted in or significantly contributed to the failure of these two institutions. Further, without a hint of factual support, the report draws the outrageous conclusion that "The OCC's and OTS's initial reluctance to allow DOS examiners to evaluate a number of concerns related to the activities of these banks may have prolonged their periods of operation and increased deposit insurance fund losses" (Page 2). I find it incomprehensible that a government entity can make such speculative claims – in a public document, no less – with no evidence or data offered in support of the claims.

See comment 1.

Report No. 02-004 is further flawed by the wholesale acceptance of DOS officials' statements that there were "several cases where examiners experienced delays in receiving requested information from another regulator or were not provided sufficient time during examinations to review certain bank conditions" (Page 2) and that, since the IG's earlier audit in 1999, the FDIC has "continued to encounter instances where its efforts to address risks from the perspective of the insurer had been constrained by other" primary federal regulators (Page 6). These observations are based solely upon statements provided by DOS case managers and are not further verified or refuted by the other parties to these events - the primary regulators. To my knowledge, there have been no instances where the FDIC has been thwarted in its efforts to either obtain information or participate in examinations of OTS-supervised institutions.

See pp. 7-8 of this report.

In the instance cited regarding the 1999 examination of Superior Bank, Hinsdale, Illinois, an alternate arrangement was worked out, apparently to the satisfaction of FDIC staff since the issue was never raised beyond the Regional Office level, whereby examination information was reviewed off-site.

See comment 2.

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Beginning at the bottom of Page 6 of Report 02-004, the comments seem to infer that, because the FDIC has enforcement authority for all insured institutions under the pre-conditions of Section 8(t) (the so-called "back-up" enforcement authority requiring, among other things, formal FDIC Board approval), there is some compelling need for the FDIC's direct and immediate independent access to both information on and relevant management of all institutions. I strongly disagree with this position. There is absolutely no justification for direct FDIC involvement, on a unilateral basis, in the examination and supervision of 1- and 2-rated institutions. Such an arrangement would undermine the authority and prerogative of the primary federal regulator, which Congress certainly did not intend. I also take issue with the report's statement that "With respect to its supervision responsibilities, DOS requires direct and timely access to information, and at times bank management....to ensure that insured institutions are supervised and regulated properly" (Page 7). This comment not only ignores the important differences in roles statutorily mandated for the deposit insurer and the primary federal regulators, it suggests that the very conduct and performance of the other primary federal regulators are subject to ultimate review and evaluation by FDIC staff. I believe you would agree that this suggestion of omniscience on the part of one federal bank supervisor is absurd.

The report next suggests that "FDIC's lack of independence to determine when and where DOS can obtain information related to safety and soundness and insurance concerns" (Page 7) creates problems in assigning risk ratings for insurance purposes. Again, I challenge the very concept of FDIC independence in non-problem institutions (1- and 2-rated) and I question the conclusion that FDIC must have "autonomy to obtain the information needed to assign the ratings" (Page 7) for insurance premium purposes. This would argue that the FDIC must do its own independent examinations for insurance purposes. While there have been differences of opinion in the past regarding actual ratings for insurance purposes, I am not aware of any instance where the accuracy or completeness of the information utilized for these rating purposes has ever been questioned or criticized by the FDIC. Indeed, the OIG itself concludes, in Evaluation Report No. 02-001 entitled *Evaluation of Rating Differences Between the FDIC and Other Primary Federal Regulators* (February, 8, 2002), that rating differences are rare and not an issue of concern. I fail to see that a problem exists.

See pp. 5-6 of this report.

Next, commencing on Page 9 of Report 02-004, the comments note that, out of 23 cases, two specific instances are cited where FDIC encountered difficulties in connection with its participation in examinations of OTS-supervised institutions. It is interesting to note that both of these cases involved the same FDIC Case Manager. The following comments respond to the points on Pages 9 and 10 regarding these two cases:

See comment 3.

Institution 1

"Near the end of the examination, the OTS and DOS realized that several significant issues could not be resolved within the time that OTS had allotted for the exam. One of the issues was support for the thrift's valuation and modeling of subprime residual assets and subordinated debt."

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- This statement is inaccurate and misleading. More than three weeks prior to the examination exit conference, the FDIC Capital Markets Specialist prepared a comprehensive 14-page analysis detailing the concerns of both OTS and FDIC; however, the FDIC examiner-in-charge did not transmit these concerns until two weeks later, leaving bank management insufficient time to respond prior to the exit conference. A comprehensive response was provided at the exit conference that was thoroughly reviewed and incorporated into the final examination report.

See comment 4.

"The OTS examiner in charge asked his regional office for additional time to complete the examination but was turned down. Thus, DOS was not provided sufficient time to discuss the findings with OTS and resolve differences prior to the exit meeting with bank management."

- This statement is also inaccurate. OTS records indicate that a full three weeks prior to the original examination completion date, the OTS Deputy Director approved a two-week extension of the examination. Additional examiners had also been assigned, resulting in a 33 percent increase in the OTS examination budget for this institution. The FDIC was on-site during this period and had ample time to discuss findings and resolve issues. Further, another six weeks elapsed before transmittal of the final examination report, allowing additional time for discussion and resolution of concerns. Additionally, the OTS invited the FDIC to participate in a follow-up field visit of this institution within six months of the completion of this examination. It was only in the FDIC's response to this invitation that the OTS first learned of FDIC's concerns regarding insufficient time for review.

See comment 5.

"At the end of the examination, DOS did not agree with certain OTS conclusions and ratings."

- At no point during the nine-week joint examination did the FDIC communicate any concern about the OTS' composite rating. This issue was raised only after the examination was completed and the exit conference held. Subsequent internal deliberations and discussions with the FDIC Regional Director led the OTS to conclude that a composite downgrade was appropriate.

See comment 6.

Institution 2

"During DOS's participation in a July 2000 examination of a bank supervised by the OTS, DOS and OTS examiners had differences of opinion on several issues including accounting treatments and the bank's rating."

- The only issue between the FDIC and the OTS was a matter involving allocated reserves for a particular loan portfolio. The OTS (not FDIC) had discovered that the institution was including these reserves as part of reported capital and determined that this was inappropriate. The FDIC concurred in this position, but

See comment 7.

wanted to treat the matter as an accounting issue while the OTS wished to treat it as a safety and soundness issue.

See comment 7.

"OTS held its exit meeting with bank management before DOS's concerns could be resolved, and the DOS examiners were not free to discuss their position during the meeting."

- The FDIC was on-site for 10 weeks. No objection was raised to the timing of the exit conference. At the exit meeting, the FDIC was directly asked if there were issues or concerns that should be raised with management, but no concerns were expressed.

See comment 8.

"Ultimately, the OTS agreed with DOS that the institution's composite rating should be lowered from a 3 to a 4."

- This comment provides a clear demonstration of the need for OTS feedback prior to issuance of this report. This institution's composite rating assigned by OTS had been a 4 continuously for two years prior to this examination, and a 4 rating was assigned following this examination. There was no lowering of the rating from 3 to 4. The OIG has subsequently suggested that the OTS examiner, during the course of this examination, had raised the possibility of an upgrade from 4 to 3, but ultimately concluded not to do so. The OIG comments seem to suggest that examiners who openly discuss such options do so at the risk of subsequent criticism. This hardly engenders an atmosphere of cooperative information sharing.

See comment 9.

Had the OIG followed accepted practice and obtained the complete facts regarding these cases, it would have discovered the one weakness that obviously needs addressing and should have been recommended for correction in the audit report – the FDIC's reluctance to raise issues of concern in a timely manner. FDIC's failure both to resolve issues of concern and failure to communicate such concerns to OTS in a timely manner contradicts the very basis for the FDIC's presence and involvement in these cases in the first place. Learning about them two years after the fact, through an Inspector General report that was never formally provided to the OTS, is not productive.

See pp. 7-8 of this report.

Irrespective of the questionable validity of this report's contents, the four agencies have jointly entered into an agreement that makes moot the concerns expressed by the OIG regarding FDIC access to information and institutions. I believe all the parties with relevant input agree that this joint arrangement is a rational approach for use both now and in the future. I hereby pledge the OTS' wholehearted support of the agreement and its intended objectives and suggest that the ill-conceived comments and conclusions expressed by the OIG in this report will have no adverse impact on the productive relationship the agencies have worked so hard to achieve.

See pp. 5-6 of this report.

I would also like to take this opportunity to voice my objection to the manner in which a related report, Audit Report No. 02-005 entitled *Issues Related to the Failure of Superior*

See comment 10.

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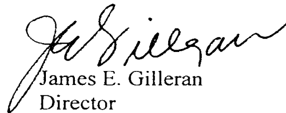
Bank, FSB, Hinsdale, Illinois, was prepared and published. This report documented the Office of Inspector General's review of the OTS's examination and supervisory efforts regarding this institution. Both OTS and FDIC staff were extensively interviewed in preparing this report. FDIC staff were afforded at least a week to review and comment on the contents of the report in draft; however, the OIG specifically chose not to afford the OTS the same courtesy even though the report was structured primarily as a critique of OTS performance. We made a personal request of the Inspector General that he allow us this opportunity; he chose instead to send the 131-page draft report to us on January 29 for informational purposes with the statement that any comments from the OTS must be received by February 1. I believe this, too, shows a disregard for "Yellow Book" standards.

See comment 10.

On a positive note, the Inspector General has advised me of recent procedural changes that will hopefully reduce or eliminate the opportunity for recurrence of these objectionable practices. The Inspector General has pledged that, in any instance where the actions or programs of another primary federal regulator are the subject of an OIG review, the OIG will afford that regulator the opportunity to review a draft of the report and an opportunity for comment. I also understand that FDIC has instituted a policy requiring senior management clearance on all management responses to OIG reports where comments involve matters of overall Corporation policy or position. I applaud these efforts.

I appreciate the Board's invitation for OTS comment on these matters of concern, and request that this letter be included in the FDIC's records together with the OIG report.

Sincerely,



James E. Gilleran
Director

cc: Board Member Hawke
Board Member Reich
Gaston L. Gianni, Jr., FDIC Inspector General

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and OIG Comments

The following are the FDIC OIG's comments on the Office of Thrift Supervision's letter.

OIG Comments

1. Our February 2002 report does not conclude or state that restrictions placed on the FDIC by the OCC or the OTS caused or contributed to the failure of Keystone or Superior. The report conveys our opinion that due to the nature of the activities that Keystone and Superior were engaged in until they failed, insurance fund losses may have been reduced had these institutions been closed in a more timely manner.

   The Treasury OIG issued a material loss review report on Superior's failure in February 2002. (*Material Loss Review of Superior Bank, FSB*, Report Number OIG–02–040, February 6, 2002). The Treasury OIG's report states that the high concentration levels of residual assets magnified the adverse effects of the accounting and valuation adjustments leading to Superior's insolvency. As early as 1993, OTS examiners had reflected some concerns about the risks associated with residual assets, $18 million at that time, or about 33 percent of tangible capital. OTS did little to either curb the rapid growth or concentrations that reached $977 million, over 345 percent of capital, as reflected in the 2000 examination. The Treasury OIG report also states that besides the rapid growth, there were other indicators that should have alerted examiners that Superior's activity was high risk: the level of Superior's residual assets clearly surpassed all other OTS-supervised thrifts, the underlying subprime loans supporting the residual assets were high risk, and Superior improperly reported residual assets in thrift financial reports beginning as early as 1993. OTS continually recommended but did not require Superior to reduce its residual asset growth and levels until July 2000. The Treasury OIG report states that Superior's mounting concentrations, the presence of several other high-risk indicators, and Superior management's unfilled prior commitments strongly suggest that earlier enforcement action was warranted. We therefore believe that closing the institution earlier would have reduced the anticipated losses resulting from this institution's failure. The basis of our opinion relating to losses associated with the failure of Keystone is discussed in OIG comment number 4 on pages 27 and 28 of this report.

2. Our February 2002 report states on page 11 that after denying the FDIC's request to participate in the OTS's 1999 examination of Superior, the OTS allowed DOS officials to meet off-site with OTS examiners about a week prior to the close of the exam. Our report further states that DOS found that this arrangement resulted in a limited benefit and that over the succeeding months as the bank's situation deteriorated, DOS continued to encounter difficulties in obtaining the OTS's full cooperation.

3. In conducting follow-up work related to this OTS statement, FDIC officials informed us that the two banks discussed in our February 2002 report were, and are presently, assigned to different case managers.

4. In conducting follow-up work related to this OTS statement, FDIC officials informed us that a comprehensive memorandum prepared by the FDIC Regional Capital Markets Specialist and representing the findings of both agencies was finalized and provided to the FDIC Examiner-in-Charge (EIC) and the OTS EIC on the same day. The written findings, which pertained to issues that had been discussed with bank management throughout the examination process, were presented to bank management 2 days later, which was 7 days prior to the exit meeting. Because the bank's response did not satisfactorily address many of the regulators' concerns, the FDIC prepared and provided the OTS with a second memorandum to be used in following up with the bank.

5. In conducting follow-up work related to this OTS statement, FDIC officials informed us that although the OTS approved a 2-week extension, there was insufficient time to (1) complete the exam in a number of important areas that included the construction loan portfolio, the adequacy of the bank's allowance for loan and lease losses, the adequacy of recourse reserves established to absorb losses associated with repurchased loans and (2) evaluate and respond to bank management's response regarding manufactured housing securitizations. As a result, DOS pursued a second extension of time that the OTS denied.

6. In conducting follow-up work related to this OTS statement, FDIC officials informed us that the FDIC and the OTS EICs discussed the CAMELS component and composite ratings in advance of the examination exit meeting with bank management, and that during the last week of the examination, it was clear that the two regulators had differences in opinion regarding several component ratings and the composite rating.

7. In conducting follow-up work related to this OTS statement, FDIC officials informed us that they agreed that the "allocated reserve" should not be included in capital but did not necessarily agree with the OTS on the appropriate manner to remove the "reserves" from capital.

8. In conducting follow-up work related to this OTS statement, FDIC officials informed us that the FDIC EIC believed that because the bank had used an inappropriate accounting treatment, the bank's well-capitalized status was in question and that until the issues impacting capital could be resolved, holding the exit meeting with bank management would be premature.

9. In our February 2002 report, our statement that the OTS ultimately agreed with DOS that the bank's composite rating should be lowered from a 3 to a 4 referred only to a difference in opinion concerning the results of the July 2000 examination, not the composite rating of the previous examination. In conducting follow-up work related to this OTS statement, FDIC officials informed us that although the FDIC EIC did not concur with several of the CAMELS component ratings, this was not considered a significant issue once agreement was achieved on the composite rating.

10. After completing our fieldwork with the OTS and the FDIC, we sought OTS's input on several issues raised during our review in a letter dated November 26, 2001. We incorporated the OTS's response, received in December 2001, throughout our report. We provided DOS with a preliminary and incomplete draft of the report in mid-January 2002. We provided the OTS with copies of the complete draft report on January 29, 2002, the same day that we provided the complete report to DOS. Because of time constraints imposed by the Senate Committee on Banking, Housing, and Urban Affairs, the draft report was provided for informational purposes only. Additionally, the report was submitted to, reviewed, and accepted by the FDIC's Audit Committee, of which the Director of OTS is a member.