

STATEMENT OF HON. ERIC M. THORSON
INSPECTOR GENERAL
DEPARTMENT OF THE TREASURY
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
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Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee, thank you for the opportunity to appear before you this afternoon on the threshold requirement for the initiation of a material loss review after a financial institution has failed. I appreciate the Subcommittee's interest in this important topic.

I will begin with some background about my office. We provide independent audit and investigative oversight of the Department of the Treasury which includes numerous departmental offices, programs and operations, as well as the 8 non-Internal Revenue Service bureaus. Our oversight includes Treasury's financial institution regulators—the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). In addition to bank and thrift regulation, we provide oversight of Treasury's programs and operations to combat money laundering and terrorist financing, manage federal collections and payments systems, manage and account for the public debt, maintain government-wide financial accounting records, manufacture the Nation's currency and coins, collect revenue on alcohol and tobacco products and regulate those industries, and provide domestic assistance through the Community Development Financial Institutions Fund and international assistance through multilateral financial institutions. Our current on-board staffing level is 104 which breaks down as follows: 64 personnel in our Office of Audit and 21 personnel in our Office of Investigations. The remaining 19 personnel include my deputy, my legal counsel, our administrative support staff, and me. Our fiscal year 2009 budget appropriation is \$26.1 million.

I do want to add that Treasury is unique among federal agencies in that it has two other Inspectors General. The Treasury Inspector General for Tax Administration provides audit and investigative oversight of IRS, and the Special Inspector General provides audit and investigative oversight of the Troubled Asset Relief Program.

Since the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Inspectors General are required to perform material loss reviews, frequently referred to as MLRs, of failed banks. Specifically, when a financial institution fails and causes a material loss to the Deposit Insurance Fund (DIF), the Inspector General for the regulator of that failed institution must

complete within 6 months a review that ascertains the causes of the failure, assesses the regulator's supervision (including the use of the Prompt Corrective Action provisions in FDICIA), and makes recommendations to prevent similar failures in the future. Currently, a material loss is defined as the greater of \$25 million or 2 percent of the institution's assets. That dollar threshold has not changed since 1991.

Material loss reviews are some of the most resource-intensive audits performed by our office. Among other things, the work entails looking at the regulator's examination reports and exam documentation going back to at least 1 exam cycle before problems at the failed institution began. In some cases this has required that we go back as far as 10 years. We also interview the examiners and their supervisors in the field office, regional or district office, and headquarters about the supervision exercised over the institution. Additionally, we interview officials and staff at the Federal Deposit Insurance Corporation (FDIC) as to the causes of the failure and we look at pertinent bank records in the possession of the FDIC. This is a thumbnail sketch of the kind of work performed on all MLRs. That said, where necessary, we expand certain areas of work given the unique circumstances of each failure. For example, one recent failure, IndyMac Bank, FSB, required that we review a number of loan files to get a better understanding of the issues related to the nature of loan products offered by the thrift as well as underwriting and appraisal practices.

Beginning with the failure of NetBank in September 2007, 20 Treasury-regulated (OCC or OTS) banks and thrifts have failed during the current economic crisis as of May 1, 2009. Sixteen (16) of those failed institutions met the material loss review threshold. The estimated loss for those 16 failures totals approximately \$16.8 billion. To date, we have completed 6 reviews and have 10 others in progress. Additionally, while it does not meet the criteria for an MLR, we have also initiated a joint project with FDIC's Office of Inspector General to review the federal supervision of Washington Mutual Bank. Specifically, in September 2008, FDIC facilitated the sale of Washington Mutual Bank to JP Morgan Chase in an open bank transaction that resulted in no loss to the DIF. Given Washington Mutual's size (combined assets of \$307 billion), circumstances leading up to the FDIC-facilitated transaction, and non-DIF losses, Inspector General Rymer and I believe that a review of OTS and FDIC supervision is warranted.

To provide perspective to our current workload, for the first 16 years after FDICIA was enacted, our office was tasked with 5 required MLRs. Furthermore, before NetBank's demise in September 2007, it had been 5 years since we had last been required to perform an MLR. And, until now, there was only one time, in 2001 and 2002, where we were required to perform concurrent MLRs. By all measures, the current number of institutions requiring MLRs by our office is unprecedented. The size of the losses -- \$10.7 billion for IndyMac and \$1.4 billion for Downey -- are

unprecedented as well. Furthermore, we are concerned that this unfortunate trend could continue.

To meet our material loss review requirements, we have shifted practically all of our discretionary audit resources to this work. That means that we have either shut down or indefinitely deferred nearly all critical audits in other Treasury high-risk programs. I will discuss a few exceptions to that statement before discussing the work we have had to stop and defer.

The first exception deals with a situation that came to our attention during our recent material loss review of IndyMac. Specifically, in its review of IndyMac, the Securities and Exchange Commission came across a workpaper prepared by IndyMac's independent auditor which indicated that a senior OTS official approved a capital contribution to be backdated to a previous quarter so that the thrift would maintain its well-capitalized position for that quarter. Less than 4 months later, IndyMac failed. Because of its potential significance to our material loss review, the workpaper was provided to our office through FDIC Inspector General Rymer. Our auditors and investigators followed-up and confirmed the events happened as described in the workpaper. Through this work, we also learned that OTS permitted, and in one case directed, other thrifts to backdate capital contributions. As a result of our inquiry into this matter, OTS removed the senior official involved with the IndyMac backdated capital contribution. That individual has since retired from federal service. As a result of another backdating, the one directed by OTS, the Acting Director of OTS was placed on administrative leave pending a Departmental review. We are currently wrapping up the results of the broader audit of OTS's involvement with the backdated capital contributions. So far, including the two backdated capital contributions already discussed, OTS has identified to us six institutions where backdating occurred.

Another exception deals with the enormous spending authorized by the American Recovery and Reinvestment Act of 2009 and the need to ensure accountability and transparency in the use of those funds to achieve their intended purpose. As you know, the Inspector General community has been called upon to provide vigorous oversight over the Recovery Act funds, with my office being no exception. In fact, I am one of 10 Inspectors General who serve on the Recovery Accountability and Transparency Board. The Board, established under the Recovery Act, coordinates and conducts oversight of funds distributed under the act in order to prevent fraud, waste, and abuse. Toward this end, I have dedicated a small cadre of auditors to work in conjunction with the Treasury Inspector General for Tax Administration to advise the Department on setting up proper controls and safeguards for more than \$4 billion in new grant programs for low-income housing and energy property that are in lieu of tax credits. I see this as one of the highest priorities of my office. However, it is a delicate balancing act to properly resource our mandated work related to failed banks while providing appropriate coverage to Recovery Act oversight at the same time.

Examples of work that we shut down include the following audits in Treasury's anti-money laundering and terrorist financing mission:

- an assessment of the quality of suspicious activity reports filed by financial institutions with the Financial Crimes Enforcement Network
- the events that led to the failed FinCEN effort to develop the BSA Direct system
- OCC's Bank Secrecy Act examination program for private banking services operated by national banks (a prior audit in 2001 identified weaknesses in the examination coverage of this high risk area for money laundering)
- a review of the Treasury Executive Office for Asset Forfeiture's national seized property contract, which had been requested by Treasury management.

An example of work we have deferred in this mission area is an assessment of the effectiveness of FinCEN's memoranda of understanding with financial institution regulators to share information—these memoranda are critical to FinCEN's Bank Secrecy Act administration responsibilities as it does not have direct line authority over these regulators.

In addition to work we have had to shut down or deferred in the area of anti-money laundering, chronic resource challenges have made it difficult for us to provide adequate oversight coverage of several other Treasury high-risk areas for a number of years. For example, we have not conducted any recent performance audits of public debt programs or Treasury payments systems. These programs and systems involve trillions of dollars. This gives us serious concern because with the current financial crisis facing our nation, other recently enacted legislation also demands our vigorous oversight. An example of such recently enacted legislation, in addition to the new \$4 billion Recovery Act programs that were discussed above, is the Housing and Economic Recovery Act of 2008. Through that legislation Treasury has taken on an important role to complement the Federal Housing Finance Agency's September 2008 decision to place Fannie Mae and Freddie Mac in conservatorship. Specifically, Treasury did three things. First, Treasury agreed to purchase senior preferred stock in the companies as necessary to ensure each company maintains a positive net worth. Second, it established a new secured lending credit facility that will be available to the two companies, as well as the Federal Home Loan Banks, for short-term loans. And third, to further support the availability of mortgage financing, Treasury initiated a temporary program to purchase new mortgage backed securities issued by the companies. The financial commitment to Fannie and Freddie is significant and involves hundreds of billions of dollars.

We are also mindful that the wave of bank failures that started in 2007 underscore the need for increased prospective reviews in the area of banking regulation. A

material loss review is a backward look at the quality of supervision as it relates to a failed institution under review. There is no question that this work provides important information to the Department, OCC and OTS, and the Congress about supervisory processes and where they need to be strengthened. That said, we believe that it is also important, if not more so, for regulators to address emerging risks in financial markets and products. The subprime mortgage crisis is a costly lesson that serves to remind us that regulators need to anticipate, recognize, and control business practices that create unreasonable risk. That brings to mind another area that we would like to look at but cannot at this time is OTS's supervisory role with respect to American International Group (AIG) and other large, complex global financial institutions. My office needs to be positioned to inform and assist the regulatory process through independent and forward looking reviews.

Having discussed the challenges of our office in meeting our oversight responsibilities, I also want to take this opportunity to bring to the Subcommittee's attention that our fiscal year 2009 appropriations enacted in March of this year provided us with an additional \$6.8 million for material loss reviews and other important work. We appreciate the support and confidence of the Congress in providing us with that additional funding to help meet our mandated workload. In that regard, we are aggressively recruiting staff to stand up two new audit divisions that will be dedicated to MLR and as resources permit, other banking and Recovery Act work. We expect to have all positions filled in early fiscal year 2010 and when done we should be in a much better position to address our mandated work and other oversight challenges discussed above. However, I do want to add the caveat that the numbers and complexities of expected bank failures still to come are not known. So, in the short term, we may find it difficult, if not impossible, to complete all MLRs within the mandated timeframe if several more concurrent MLRs come due in a short period of time.

Before I comment on Chairman's Moore's proposed amendment to S. 383, I would like to finish my discussion of our resource challenges by recognizing the hard work done by my staff to complete timely MLRs, and concurrently meet our financial audit mandates under the Chief Financial Officers Act and Government Management Reform Act as well as our review requirements under the Federal Information Systems Management Act. These achievements were possible only through the dedication of a fine group of people and their willingness to put in long hours and make other sacrifices to get the job done. I am truly proud of our office in this regard.

With respect to the Chairman's proposal, I endorse increasing the threshold for material loss to between \$300 million and \$500 million, which is in line with the threshold of \$400 million in S. 383. In January 2009, Inspectors General Coleman and Rymer and I signed joint letters to the Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs suggesting that

Congress consider increasing the thresholds for conducting MLRs and that doing so would better serve our offices and the Congress, and still meet the intent of FDICIA. We recommended in our letter modifying the threshold for a material loss to increase from \$25 million to somewhere between \$300 and \$500 million. We also recommended language that would allow the OIG to undertake an MLR of an institution with a projected loss below the increased threshold, should circumstances (e.g., new, non-conventional financial products or indications of fraud) warrant.

Looking at our current inventory of in-progress MLRs, had the threshold of material loss been somewhere from \$300 million to \$500 million, it would have had the effect of reducing the number of required MLRs drastically. This change would allow our office to free up resources to re-focus efforts on other risky programs and initiatives that Treasury and its bureaus are now dealing with.

I am providing the following table showing the numbers of MLRs that would be required by our office for the total universe of failed banks and thrifts since January 1, 2007, through April 30, 2009, at various thresholds, ranging from the current threshold of \$25 million up to \$500 million.

Table: Threshold Analysis of Treasury-Regulated Failed Institutions Requiring an MLR

| Threshold Amount | Treasury Regulator | | |
|--------------------------|--------------------|-----|-------|
| | OCC | OTS | Total |
| \$25 million (Current) | 8 | 8 | 16 |
| \$100 million | 4 | 6 | 10 |
| \$200 million | 4 | 3 | 7 |
| \$300 million | 3 | 3 | 6 |
| \$400 million (Proposed) | 3 | 3 | 6 |
| \$500 million | 3 | 3 | 6 |

Note: The threshold analysis is based on the latest available loss estimates by FDIC as of May 1, 2009.

Furthermore, under the proposed amendment, we would also be required every 6 months to review all losses incurred by the DIF from bank failures and determine, for losses that are under the \$400 million threshold, whether there might be unusual circumstances about the failure that would warrant an in-depth review. I think this is a very prudent measure given the threshold increase under consideration.

In closing, I again want to express my appreciation for the Subcommittee's interest in this topic. Our office fully supports the effort to increase the MLR threshold and I believe the amendment represents a practical solution. I would also like to point out the excellent relationship I have with Inspectors General Rymer and Coleman. Over

the years, our respective offices have forged strong bonds in addressing numerous matters of mutual interest. For example, soon after FDICIA was enacted, we developed a common methodology for conducting MLRs and implemented through a memorandum of understanding a mechanism for coordinating MLR work in our respective agencies as necessary. As I mentioned above, FDIC OIG and my office are working together on a joint review of the Washington Mutual failure. We were also assisted on our material loss review of IndyMac by two FDIC OIG personnel. Also, just last February, our offices co-hosted a week long MLR training conference for our auditors and investigations at FDIC. These are just a few examples of what I consider one of the best professional working relationships between agencies in the federal government.

This concludes my testimony; I would be pleased to answer any questions the Subcommittee may have.