Office of Inspector General

January 22, 2004
Report No. 04-004

Observations from FDIC OIG Material Loss Reviews Conducted 1993 through 2003

AUDIT REPORT

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Part I

Transmittal Memorandum to Director,

Division of Supervision and Consumer Protection

Observations from FDIC OIG Material Loss Reviews

Conducted 1993 through 2003

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General

DATE:	January 22, 2004
MEMORANDUM TO:	Michael J. Zamorski, Director Division of Supervision and Consumer Protection
FROM:	Russell A. Rau [Original signed by Stephen M. Beard for Russell Rau] Assistant Inspector General for Audits
SUBJECT:	*Observations from FDIC OIG Material Loss Reviews Conducted 1993 through 2003* (Report No. 04-004)

This report presents summary observations from previously issued Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) material loss review[1] reports. In this report, we address the recurring and root causes for the failure of 10 FDIC-supervised institutions subject to the material loss review provisions of Federal Deposit Insurance Act (FDI Act) section 38(k), *Review Required When Deposit Insurance Fund Incurs Material Loss.* Section 38(k) provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the Inspector General of the appropriate federal banking agency shall prepare a report to the banking agency. The 10 failed banks had combined assets of $3.2 billion at the time they failed. The combined estimated loss to the BIF totaled about $584 million.

In accordance with the Act, our audit objectives for each material loss review were to: (1) review the agency's supervision of the institution, including the agency's implementation of FDI Act section 38, *Prompt Corrective Action*; (2) ascertain why the institution's problems resulted in a material loss to the insurance fund; and (3) make recommendations for preventing future material losses.

The scope of this review included an analysis of the 10 statutorily-required material loss reviews performed by the OIG since 1993. We reviewed each material loss review report to determine the root causes of failure and to ascertain whether there were any indicators of problems before the financial condition of the bank deteriorated. We then aggregated the information to determine whether there were any trends or common characteristics among the failed institutions. Based on the objective of this audit, we did not conduct any new audit procedures related to compliance with laws and regulations, internal control, or performance measures and did not rely on computer-generated data. We performed this audit from May through November 2003 in accordance with generally accepted government auditing standards.

[1] A material loss is generally defined by section 38 of the FDI Act as a loss that exceeds the greater of $25 million or 2 percent of the institution's total assets at the time the FDIC was appointed receiver.

SUMMARY

Our material loss reviews disclosed that the major causes of failure were inadequate corporate governance, poor risk management, and lack of risk diversification. Bank management[2] took risks that were not mitigated by systems to adequately identify, measure, monitor, and most importantly, control the risks. As a result, bank management did not adequately fulfill its responsibility to ensure that the banks operated in a safe and sound manner. Although economic conditions may have contributed to failure and the resulting material loss, the economy was not the sole cause of failure. In fact, the financial condition of the majority of the banks became dependent on the economy as a result of bank management decisions.

The failed banks typically went through four stages:

1. Strategy – the banks typically underwent a change in philosophy and developed aggressive business plans usually in a high-risk lending niche. Characteristics of a bank in this stage included emergence of a dominant person, lack of expertise in the niche area, and high-risk lending with liberal underwriting and weak internal controls.

2. Growth – the banks appeared financially strong due to rapid growth in their niche area. High levels of fee income were reported, but bank portfolios were not sufficiently aged to show losses resulting from poor lending decisions and weak credit administration. Violations of laws and regulations and insider abuse occurred, and examiners' concerns were not fully addressed. Poor risk management and inadequate diversification were evident.

3. Deterioration – the banks' overall financial condition declined. Characteristics of a bank in this stage included resistance to supervisory concerns, overvaluation of assets, plateau or decline in earnings, inadequate allowance for loan and lease losses (ALLL), impaired capital, significant concentrations of credit, and loan problems that were exacerbated when the economy declined.

4. Failing – massive loan losses occurred, ALLL was severely deficient, significant capital depletion occurred, enforcement actions were issued by the FDIC, and key management officials departed. A massive capital infusion was needed for the bank to survive.

[2] Bank management refers to the Board of Directors and executive officers.

OBSERVATIONS

Our analysis led to the following observations that may be of value to Division of Supervision and Consumer Protection management and staff involved in planning and conducting bank examinations:

- Failed banks often exhibit warning signs when they appear financially strong.
- Financial condition is no guarantee of future performance.
- Failed banks frequently assume more risk than bank management is capable of handling.
- An inattentive or passive board of directors is a precursor to problems.
- Banks may reach a point at which problems become intractable and supervisory actions are of limited use.

The observations discussed in this report underscore one of the more difficult challenges facing bank regulators today - limiting risk assumed by banks when their profits and capital ratios make them appear financially strong. A critical aspect of limiting risk is early corrective action by bank regulators in response to bank examinations that identify potential problems and effects on a bank's condition. For example, if a bank is experiencing rapid growth, the effects of poor underwriting in commercial real estate loans may not appear on the bank's financial statements until several months or even years after the loans are made. Left uncorrected, poor underwriting could result in the serious and intractable problems experienced by the banks we reviewed.

The FDIC has taken a number of steps to address these challenges through risk-focused examination programs and risk-based capital requirements. Nevertheless, we recognize that bank failures may never be eliminated and, in a free economy, might even be necessary to cull the industry of marginal performers and excess capacity.

CORPORATION COMMENTS AND OIG EVALUATION

On January 14, 2004, the DSC Director provided a written response to the draft report. Prior to receiving the response, we made some changes to the report to add perspective based on conversations we had with DSC officials. The response is presented in Part III of this report. In its written response, DSC management generally concurred with the report's observations and conclusions. Since the report contains no formal recommendations, no further action is necessary on the part of management.

Part II

Slide Presentation of Audit Results

OBSERVATIONS FROM FDIC OIG MATERIAL LOSS REVIEWS CONDUCTED 1993-2003

Office of Inspector General

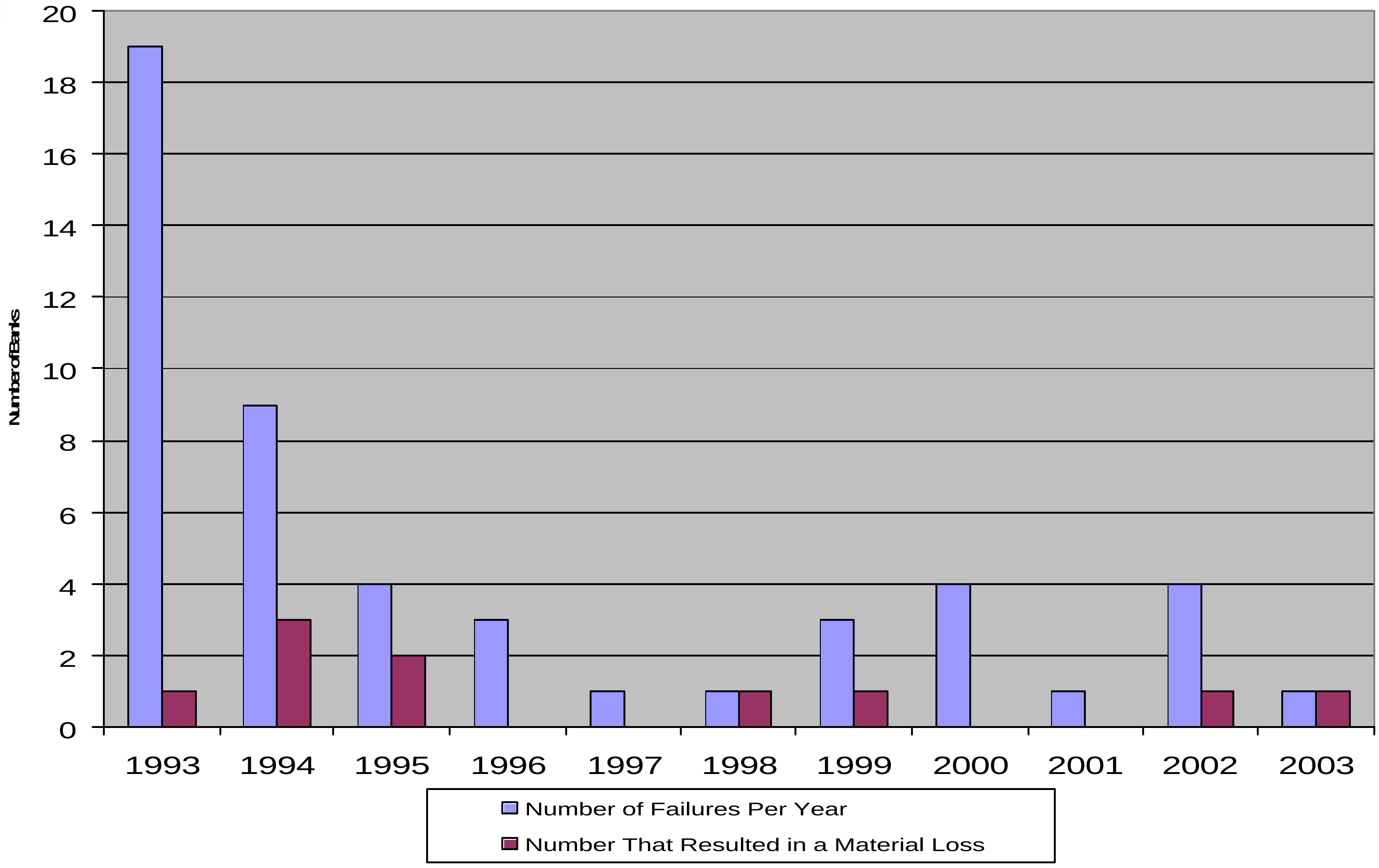
Office of Audits

BACKGROUND

- Material Loss Provisions of Section 38(k) of Federal Deposit Insurance Act effective July 1, 1993
  - Review agency's supervision of institution, including Prompt Corrective Action (PCA)
  - Ascertain why an institution's problems resulted in a material loss to the insurance fund
  - Make recommendations for preventing future losses

BACKGROUND

Failures of FDIC-Supervised Banks 1993 - 2003



BACKGROUND
OIG Material Loss Reviews

Financial Institution	Date Closed	Loss (millions)	Assets (millions)	Location	Charter Year
Bank of San Diego	10/29/93	$39.4	$316.8	San Diego, CA	1978
Bank of Hartford	6/10/94	$31.3	$349.6	Hartford, CT	1919
Bank of San Pedro	7/15/94	$28.8	$123.4	San Pedro, CA	1975
Bank of Newport	8/12/94	$26.6	$174.3	Newport Beach, CA	1972
First Trust Bank	3/3/95	$34.5	$245.6	Ontario, CA	1887
Pacific Heritage Bank	7/28/95	$37.3	$155.6	Torrance, CA	1981
BestBank	7/23/98	$171.6	$ 314.0	Boulder, CO	1982
Pacific Thrift & Loan Co.	11/19/99	$52.0	$117.6	Woodland Hills, CA	1988
Connecticut Bank of Commerce	6/26/02	$63.0	$379.0	Stamford, CT	1964
Southern Pacific Bank	2/7/03	$100.0	$1,000.0	Torrance, CA	1982
Totals		**$584.5**	**$3,175.9**		

RESULTS OF REVIEW
Four Stages of a Bank Failure

Stage I: Strategy

Corporate Governance
- Change in philosophy
- Aggressive business plan
- Inattentive Board of Directors
- Emergence of a dominant person
- High-Risk lending
- Lack of expertise in high-risk(niche) lending area

Risk Management
- Lack of strategic plan
- Weak risk management

Lending Concentration
- Liberal underwriting
- Weak internal controls
- Aggressive growth

Stage II: Growth

Corporate Governance
- Some violations of laws and regulations
- Insider abuse
- Disregard for examiners' concerns

Risk Management
- Poor risk diversification
- Financially strong image

Lending Concentration
- Rapid growth in niche (high-risk) area
- High level of fee income, but portfolio does not show loss rates
- Poor credit administration

Stage III: Deterioration

Corporate Governance
- Increased resistance to supervisory concerns
- Independent public accountant problems
- Memorandum of Agreement/Board of Directors Resolutions

Risk Management
- Earnings plateau/ decline
- Inadequate Allowance for Loan and Lease Losses
- Capital impaired

Lending Concentration
- Significant loan amounts by type
- Growth plateaus
- Emergence of loan problems worsened by a declining economy

Stage IV: Failing

Corporate Governance
- Enforcement actions issued by regulatory agency
- Departure of key officials

Risk Management
- Severely deficient Allowance for Loan and Lease Losses
- Significant depletion of capital
- Need for massive capital infusion for bank to survive

Lending Concentration
- Massive loan losses

RESULTS OF REVIEW
Major Causes of Failure

- Inadequate corporate governance
- Weak risk management
- Lack of risk diversification - lending concentrations

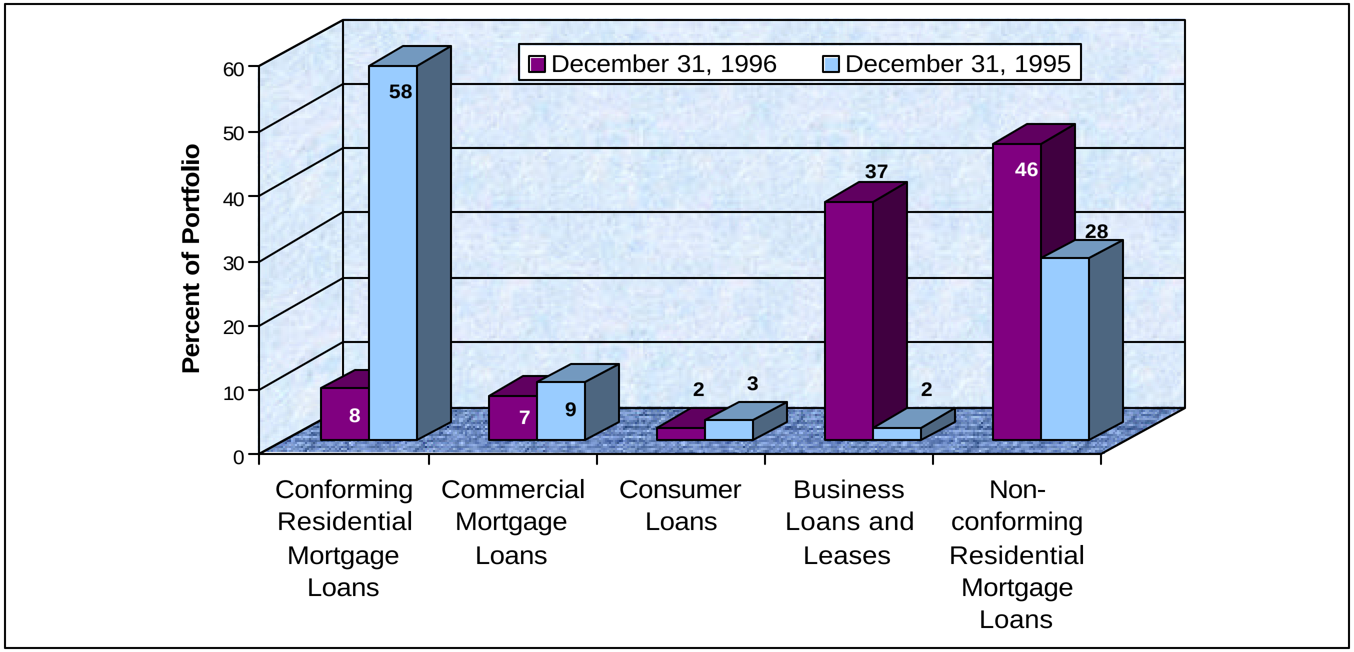
CORPORATE GOVERNANCE

- Deficiencies by Boards of Directors directly led to failures:
  - Change in philosophy/aggressive business plans and rapid growth
  - Emergence of dominant person
  - Lack of expertise in niche lending area
  - Violations of laws and regulations
  - Disregard for examiner’s concerns
  - Internal control and audit deficiencies

CORPORATE GOVERNANCE
Example of a Change in Philosophy

Southern Pacific Bank

Change in Composition of Loan Portfolio



CORPORATE GOVERNANCE
Aggressive Business Plans

- **Pacific Heritage.** Increased assets from $200 to $500 million in 4 years. Pursued high-risk/high-yield lending without following prudent underwriting standards.
- **First Trust.** Generated income through significant construction and development lending. Portfolio grew from $16 million in 1984 to $88 million in 1990, without proper policies and procedures in place.
- **Pacific Thrift & Loan.** Conducted expansionary program of securitizing subprime loans without regard to adequate policies, programs, and controls.
- **BestBank.** Increased credit card portfolio from $42 million to $314 million in about 2 years with little preplanning activities or analysis of the market before investment. Did not adopt or implement appropriate policies or procedures prior to funding new business ventures.
- **Southern Pacific.** Acquired or created 10 commercial and 1 consumer lending divisions from 1993 through 1999 with inadequate loan review program and inferior underwriting and administration practices. Loans were non-traditional, high-yield, high-risk.

CORPORATE GOVERNANCE
Dominant Person

- **Pacific Thrift & Loan** - president was extremely influential and dominated the lending area.

- **Southern Pacific** - chairman of the board also served as president and remained a management figure throughout bank's history.

- **Connecticut Bank of Commerce** - chairman of the board, who was also the majority stockholder, dominated bank management.

CORPORATE GOVERNANCE
Lack of Expertise in Niche Lending Area

- **BestBank**. Management was unfamiliar with many aspects of banking, yet invested heavily in risky type of credit card lending.

- **First Trust**. Management ventured into direct real estate investments without adequate policies and procedures and without fully understanding the consequences of the new initiatives.

- **Bank of Newport.** Management positioned the bank to be dependent on the commercial real estate market but lacked expertise and experience in commercial real estate lending.

- **Bank of San Pedro.** Management displayed poor judgment in traditional banking activities (funds management and subsidiary operations) and lacked expertise to properly monitor the purchase and resale of mortgages.

CORPORATE GOVERNANCE
Violating Laws and Regulations

Examiners cited common violations of laws and regulations:

- Federal Reserve Board Regulation O, which prohibits loans to insiders
- FDIC Rules and Regulations section 323.4, which established appraisal requirements
- Legal lending limits established by states
- Federal Reserve Act sections 23A and 23B, which prohibit improper transactions between affiliates

CORPORATE GOVERNANCE
Disregard for Examiner’s Concerns

Examiners identified problems and made recommendations that were not adequately addressed by the bank.

- **Connecticut Bank of Commerce**: risk diversification, risk management, loan underwriting, and loan administration.
- **Bank of San Diego**: bank management, capital adequacy, classified asset reduction, credit concentration reductions, loan policy revisions, maintenance of sufficient loan loss reserves, and budget and profit plan modifications.
- **Bank of San Pedro**: poor underwriting standards, subsidiary's real estate investment problems, control of overhead and expenses, reliance on volatile liabilities, inadequate Allowance for Loan & Lease Losses and capital levels, and ineffective funds management policy.

CORPORATE GOVERNANCE
Internal Control and Audit Deficiencies

- Banks lacked:
  - adequate interaction between management, internal auditors, and external auditors
  - strong internal audit function

- Management did not:
  - follow established policies
  - implement and maintain a control environment that promoted risk management in operations
  - implement prudent credit and loan administration policies and procedures

WEAK RISK MANAGEMENT
Common Deficiencies

- Cash flow depended primarily on the performance of the real estate market (Pacific Heritage Bank)
- Subprime loans were securitized without regard to adequate policies, programs, and controls (Pacific Thrift and Loan)
- Subprime credit card lending increased without adequate planning or analysis of the market before investing (BestBank)

WEAK RISK MANAGEMENT
Allowance for Loan and Lease Losses

- Insufficient risk rating systems
- Poor loan review processes
- Failure to consider impact on earnings and capital for new and riskier activities (subprime lending)

LACK OF RISK DIVERSIFICATION

FINANCIAL INSTITUTION	CONCENTRATION	GROWTH PERIOD IN YEARS	CONCENTRATION AS A PERCENTAGE OF CAPITAL
Bank of San Diego	Construction and development real estate/commercial real estate	1982 to 1991	From 155% to 1,163%
Bank of Hartford	Multi-family/commercial real estate	1984 to 1991	From 163% to 238%
Bank of San Pedro	Construction and development real estate/commercial real estate	1984 to 1994	From 215% to 808%
Bank of Newport	Construction and development real estate/commercial real estate	1984 to 1993	From 171% to 582%
First Trust Bank	Direct real estate investing	1985 to 1990	From 38% to 120%
Pacific Heritage Bank	Construction and development real estate/commercial real estate	1985 to 1993	From 192% to 709%
BestBank	Unsecured subprime loans for credit cards	1996 to 1998	Total Assets From 650% to 1,160%
Pacific Thrift & Loan .	Interest-only residual receivables	1997 to 1999	From 69% to 776% (increase due mainly to depletion of capital)
Connecticut Bank of Commerce	Commercial real estate and out-of-territory lending	1996 to 2002	Over 400%
Southern Pacific Bank	Subprime residential mortgage loans and commercial and industrial loans (industry concentrations)	Residential: 1991 to 1993 Commercial: 1994 to 2000	Residential not available, commercial over 223%

INDEPENDENT PUBLIC ACCOUNTANT CONCERNS

- Independent Public Accountants (IPA) for Pacific Thrift and Loan, Connecticut Bank of Commerce, and Southern Pacific Bank did not comply with American Institute of Certified Public Accountants Statement on Auditing Standards 58, *Reports on Audited Financial Statements.*
  - Did not fairly, accurately, and promptly identify the actual financial condition of bank.
  - Did not provide a written report of internal control weaknesses to bank's audit committee and examiners.
- IPAs performed both annual financial statement audits and internal audits, a practice that is now prohibited for publicly-traded companies by the Sarbanes-Oxley Act and U.S. Securities and Exchange Commission.

Other Factors in Failures

- Fraud and insider abuse was apparent in two failures
  - BestBank engaged in high-risk credit card program administered by a third-party contractor who made delinquent accounts appear current, which delayed the recognition of $134 million in losses.
  - Connecticut Bank of Commerce's majority shareholder orchestrated a $20 million nominee loan scheme to obtain funds to purchase another bank.

OBSERVATION NO. 1

Banks that fail often exhibit warning signs even though they appear to be financially strong.

OBSERVATION NO. 2

Financial condition is no guarantee of future performance.

OBSERVATION NO. 3

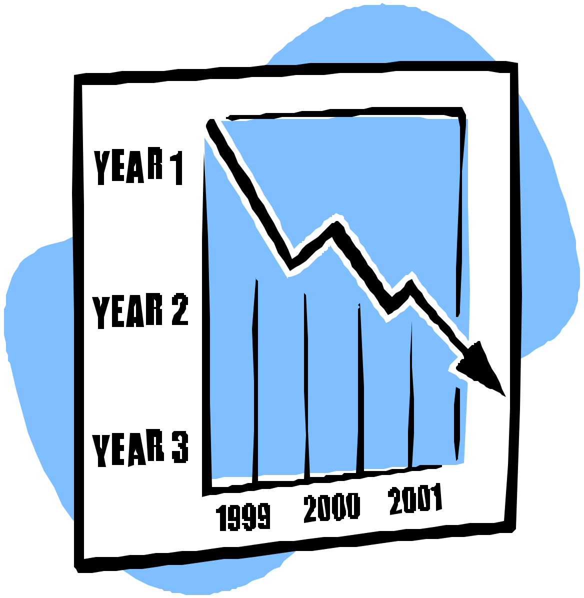
Banks that fail often assume more risk than bank management is capable of handling.

OBSERVATION NO. 4

Inattentive or passive Board of Directors is a precursor to most problems.

OBSERVATION NO. 5

Banks reach a point at which problems become serious and ultimately intractable. Failure is unavoidable absent a significant capital contribution.



Prior OIG Recommendations

The OIG material loss review reports made numerous recommendations implemented by the FDIC to help prevent future material losses. The recommendations pertained to examiner use of enforcement actions and addressed examiner assessment of:

- Corporate governance
- Risk management
- Risk diversification
- Subprime lending
- Securitizations

FDIC Initiatives to Improve Bank Safety and Soundness

FDIC Initiatives

- Risk-focused examinations
- Internal guidance issued on:
  - the impact of the Sarbanes-Oxley Act of 2002
  - internal controls and the detection of fraud
  - subprime lending programs
  - real estate lending standards
- Rule changes for high-risk residual assets
- Risk-based capital requirements
- Outreach programs aimed at bank directors and senior banking officials
- Symposium on “Lessons Learned” from bank failures

CONCLUSIONS

- Bank management ultimately determines how a bank will perform

- Bank failures will likely never go away

- Observations in this report may help the FDIC limit the cost impact of future bank failures on the Bank Insurance Fund

Part III

Corporation Comments

CORPORATION COMMENTS

FDIC

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

Division of Supervision and Consumer Protection

January 14, 2004

TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

[Electronically produced version;
original signed by Michael J. Zamorski]

SUBJECT: Draft Report Entitled, *Observations From FDIC OIG Material Loss Reviews Conducted 1993-2003 (Assignment No. 2003-042)*

The Division of Supervision and Consumer Protection (DSC) appreciates the opportunity to respond to this Draft Report prepared by the FDIC's Office of Inspector General (OIG). We generally concur with your five observations and three conclusions.

Your discussion further confirms FDIC's traditional emphasis upon Corporate Governance as the body of established processes and general practices that characterize an institution's decision-making and oversight. Corporate governance encompasses an institution's strategic mission, processes, relationships, and control structure that significantly influence its overall condition, performance, prospects, and risk profile. It is a culture that permeates the full scope of an institution's activities.

The FDIC has long recognized the importance of corporate governance in maintaining the integrity and stability of the nation's banking system. The FDIC's experience, particularly during the financial crisis of the late 1980s and early 1990s, shows that weak corporate governance policies and practices can result in enormous financial losses not only for individual corporations, but also for the whole society.

DSC continues to evaluate the causes of bank failures and to improve the effectiveness of our supervisory programs. In recent years we have observed increased loss and failure events resulting from complex residual assets, fraud, and higher risk lending programs. FDIC has been a leader in the legislative and supervisory initiatives that responded to these and other challenges. We are proud of FDIC's efforts that resolve the vast majority of troubled institutions without failure and loss to the deposit insurance funds. We remain committed to continuing our strong record of stewardship by minimizing the potential for bank failures and then to efficiently resolve those that occur.