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FAILED THRIFTS

**Internal Control Weaknesses Create
an Environment Conducive to Fraud,
Insider Abuse, and Related Unsafe
Practices**

Statement of
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Before the
Subcommittee on Criminal Justice
Committee on the Judiciary
House of Representatives



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Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss our observations on the operating characteristics, management practices, and the extent of fraudulent activities at savings and loan institutions which failed in recent years. As you know, the financial condition of the savings and loan industry and its insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), is critical and presents a problem of unprecedented magnitude. We have previously testified and reported extensively on the magnitude, causes, and proposed solutions to the problem. In February 1989, the Administration introduced a comprehensive proposal to deal with this problem and to restructure the thrift industry. This proposal included a \$50 million increase in the Department of the Justice's budget to help investigate and prosecute crimes against thrifts.

My testimony today will focus on the kinds of activities, including fraud and insider abuse, which we believe helped to bring about these massive thrift problems, problems which in our view could have been largely prevented. In this regard, I would emphasize our conclusions that the huge losses which will ultimately be passed to the nation's taxpayers did not come about primarily because of such factors as economic conditions or deregulation. Instead, the bulk of the losses are directly attributable to the failure by management of a minority of the

industry to follow basic, prudent business practices, including the establishment of effective systems of internal control.

INDUSTRY CONDITION

First, I would like to briefly review the extent and size of the problem. Currently, there are four distinct segments of the savings and loan industry:

- insolvent institutions;
- barely solvent institutions (institutions at risk);
- FSLIC-assisted, open institutions; and
- solvent, healthy institutions.

As of September 30, 1988, the date for which most recent information was available, there were 434 insolvent institutions according to generally accepted accounting principles (GAAP). These institutions had assets of \$138.0 billion and GAAP capital of negative \$18.1 billion. During the first 9 months of 1988, these thrifts incurred net loses of over \$7 billion. Between October 1, 1988, and December 31, 1988, FSLIC acted on 94 of the 434 thrifts, leaving 340 insolvent institutions on which action had not been taken.

As of September 30, 1988, 216 thrifts had GAAP capital between 0 and 2 percent of assets, and are at risk of becoming insolvent. These thrifts had assets of \$164.2 billion and GAAP capital of only \$1.6 billion.

The third segment of the industry consists of thrifts created by FSLIC's 1988 merger and assistance transactions. During 1988, FSLIC provided assistance to or merged almost 200 institutions with assets of \$104 billion. These thrifts are now protected from losses by the government and are largely shielded from regulatory sanctions. Therefore, they enjoy a distinct competitive advantage over the healthy, unassisted portion of the industry.

The fourth segment of the industry consists of unassisted, relatively healthy thrifts. As of September 30, 1988, the 2,374 thrifts with GAAP capital in excess of 2 percent had assets of \$1.0 trillion and GAAP capital of \$55.7 billion, for a GAAP capital-to-assets ratio of 5.45 percent. These thrifts are providing a substantial amount of mortgages and other necessary services to the public. Moreover, it is important to remember that traditional residential mortgage financing, the core business for which the thrift industry was created, did not cause the losses we are facing today.¹

¹See Bank and Savings and Loan Insurance Funds: Financial Condition and Proposed Reforms (GAO/T-AFMD-89-3, March 10, 1989).

FSLIC's Financial Condition

Our audit of FSLIC's 1988 financial statements is currently ongoing and, in fact, FSLIC has not yet closed its books for the year, nor has FSLIC provided us with financial statements or an estimate of its liabilities for resolving the problems of troubled thrifts. Nonetheless, we are able to provide some very preliminary observations on its financial condition. Specifically, due to its 1988 resolution actions, which, according to FSLIC's records, cost about \$37 billion and to its continuing liability for insolvent thrifts, we believe FSLIC's deficit has at least quadrupled from its 1987 deficit of \$14 billion.

During 1988, FSLIC acted on over 220 problem thrifts at a reported cost of \$37.1 billion on a net present value basis. It is important to recognize that this amount is a present value figure; cash outlays over the next 10 years will likely be in excess of \$60 billion plus as much as \$7 to \$8 billion in tax benefits accruing to the acquirers.

A precise estimate of the eventual cost to resolve the industry's problems still cannot be made because the cost depends upon various uncertainties, such as the quality of each institution's assets, future interest rates, the economic

outlook for certain sectors of the economy in which many of the troubled institutions operate, and whether the troubled thrifts are liquidated or acted on through mergers and acquisitions. Nonetheless, various knowledgeable parties have estimated these costs to be in the \$100 billion and upward range; based upon our experience, we believe such estimates are reasonable and do not overstate the problem.

REVIEW OF FAILED THRIFTS

In developing a solution to the current thrift crisis and in determining how to prevent it from recurring, we believe it is instructive to contrast the attributes of failed thrifts with those of solvent ones. Therefore, we have undertaken a number of assignments evaluating various aspects of the financial institutions industry and its insurance and regulatory functions.

Today, I will discuss one of our reviews which focused on determining how so many thrifts got into this difficulty in the first place. For this review, we analyzed examination reports and related supervisory documentation for a sample of failed thrifts to determine whether such institutions are characterized by conditions or operating practices that distinguish them from solvent institutions. In addition, we interviewed numerous regulatory and industry officials, attorneys, and others

knowledgeable about the thrifts. We also considered the role insider abuse and fraud as well as environmental factors, primarily economic conditions, played in these failures. Characterizations of the institutions' conditions and the operating practices we discuss were recorded by examiners and regulators in documents we reviewed.

We selected a sample of 26 institutions which FSLIC either began assisting between January 1, 1985, and September 30, 1987, or anticipated assisting as of September 30, 1987. This sample of thrifts represented almost 60 percent of the combined actual and estimated loss to FSLIC attributable to the 284 thrifts merged, liquidated, or in FSLIC's problem list caseload as of September 30, 1987. We compared this sample to a group of 26 similar, but solvent, thrifts to determine which characteristics distinguished the two groups. Attachment I shows the geographic location of the failed institutions.

The names of failed thrifts are made public at the time FSLIC takes action. However, some of the institutions included in our review are still open. We are prohibited by law from disclosing the names of open banks we review, and as a matter of long-standing policy, we treat thrifts in the same manner. Further, we have not identified the names of either institutions or individuals in our draft report or in this testimony because we are sensitive to the effect such disclosure could have on the

government's efforts to seek recoveries in civil suits or to prosecute alleged criminal acts.

Our draft report on thrift failures, which describes at length the numerous weaknesses noted, is currently with the Federal Home Loan Bank Board for comment. Today, I will review only a sample of the more pervasive of those problems. (See attachment II for lists of the weaknesses that examiners and regulators found at thrifts and the number of institutions in our sample where weaknesses were noted.)

FRAUD AND INSIDER ABUSE

The recent publicity surrounding thrift failures has focused a great deal of attention on insider abuse and suspected fraud.² Insider abuse and fraud pose a threat to the safety and soundness of thrift operations, and the presence of such actions indicates a weakness in or the absence of an effective internal control structure.

In a March 1988 report to the Congress, the Federal Home Loan Bank Board (FHLBB) cited fraud and insider abuse as the most pernicious of all factors leading to the insolvency of thrift

²Fraud generally involves an action which violates a fraud-related criminal statute of the United States or of a state.

institutions. It defined fraud and insider abuse in this manner:³

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

The presence of insider abuse and insider involvement in fraud can create an environment conducive to further abusive practices and indicates the need for stronger internal controls in financial institutions. Under the broad definition cited above, insider abuse and fraud, although not necessarily criminal offenses, were identified at each and every one of the 26 failed thrifts in our review.

³For the purposes of our review of failed thrifts, we used the Bank Board's definition of fraud and insider abuse.

Criminal Referrals and Prosecutions
Involving Our Sample of Failed Thrifts

Through the Bank Board's Office of Enforcement (OE), we obtained and reviewed referrals made to the Department of Justice of alleged criminal activity which Bank Board officials believe contributed to the demise of the 26 failed thrifts and those referrals which involved insiders such as an officer, director, or majority shareholder. A total of 85 such referrals were made in regard to 19 of the 26 failed thrifts in our sample. These referrals, which were made primarily by Bank System personnel and filed with the district banks, cite suspected violations of criminal statutes such as false entries, conspiracy, theft, embezzlement, willful misapplication of funds, and fraud.⁴ Other allegations include falsifying information on loan applications, kickbacks, and bribes.

In the 85 referrals, allegations of criminal violations were made against 182 persons. The majority of individuals referred (62 percent) were former officers, directors, or shareholders of the failed thrifts. The remaining 38 percent included employees, customers, borrowers, agents, brokers, and others. In 13 of the

⁴Other criminal referrals may have been made directly to the Federal Bureau of Investigation (FBI) or a U.S. Attorney. In addition, Bank Board officials said referrals may have been warranted but not filed by Bank Board personnel when investigations by the FBI or U.S. Attorneys were already ongoing. Thus, the 85 referrals we received from the Bank Board may understate the total amount of suspected criminal violations filed.

referrals, the suspect was affiliated with another federally insured institution.

As of March 1989, the Bank System had received information regarding criminal indictments, convictions, or acquittals associated with 13 of the failed thrifts in our sample which had referrals. According to this information, 23 persons had been convicted, 19 individuals were under indictment, and 2 people had been tried and acquitted. At least 11 of the 23 convicted pleaded guilty. The persons convicted were officers, stockholders, or borrowers in 16 of the 23 cases. Others convicted included real estate brokers, an attorney, and a consultant. Those convicted were sentenced to prison in 15 of the 23 cases. However, the prison sentences were generally suspended with probation.

Of the 19 individuals currently remaining under indictment, 9 are borrowers and 7 are officers, directors, or stockholders. Generally, the charges are bank fraud, false statements, misapplication of funds, or conspiracy.

Bank Board Comments on Fraud and Negligence

Statements by officials at the Bank Board indicate that fraudulent and abusive practices are by no means confined to the 26 thrifts in our sample. In March 1, 1989, hearings before the

Senate Committee on Banking, Housing, and Urban Affairs, the Bank Board Chairman discussed Bank Board efforts to combat fraud:

"The Bank Board has also attacked fraud by increasing the number of criminal referrals that it has made to the Justice Department in recent years. In 1987, 6,205 cases were referred for prosecution, and another 5,114 cases were referred during 1988. These totals are significantly above the number of referrals in 1985 and 1986--434 and 1,979, respectively. The Bank Board's stepped-up activity has resulted in more criminal prosecutions, and increasing dollar amounts have been recovered through restitution. Over \$46 million in restitution was granted to the FSLIC during 1987 and 1988; an additional \$23 million was awarded in the first week of 1989."

At the same hearing, the Bank Board Chairman also described a recent study of the 1988 resolution actions by his organization. With regard to the presence of negligence and fraud, the Chairman cited results of the study:

"In virtually all cases, the Boards of Directors of resolved institutions were found to not have acted prudently. It is too early to identify more specific incidence of negligence and of fraud for many of the resolved thrifts. However, based on the count to date, loans-to-one borrower violations were present in at least 34 percent of the 205 cases. For the 50 costliest resolutions, such activity was found in 50 percent of the cases. The same proportions hold for the presence of self-dealing. Moreover, in 27 percent of all the 1988 resolutions (and 42 percent of the costliest cases), other forms of fraud were present. Other fraud may be categorized as that perpetrated by outsiders, such as borrowers or by futures and options traders with whom the thrift dealt."

Management's Responsibility for Establishing Adequate Systems of Internal Control

In this regard, it is important to note that thrift management is responsible for creating an environment which encourages safe and sound operations and reduces the potential for insider abuse and fraud. Management is also responsible for developing policies and procedures, including a system of internal controls, designed to foster sound practices, to comply with laws and regulations, and to protect the institution against insider abuse, fraud, and other crimes. Further, directors should ensure that management is aware of applicable laws and regulations and develops a system to implement and monitor compliance. Managers are also under a duty to avoid behaving in a manner which places their own personal interests above the interests of the bank. When management does not foster an environment conducive to safe and sound practices and compliance with laws and regulations, the thrift becomes vulnerable not only to fraud and insider abuse, but also to other unsafe practices, as discussed below.

CONDITIONS NOTED BY EXAMINERS AND SUPERVISORS AT FAILED THRIFTS

The following are some of the more pervasive internal control weaknesses and other characteristics examiners found at the 26 failed thrifts in our sample. Many of these weaknesses

permitted practices to occur that the Bank Board defines as fraud and insider abuse.

Inadequate Board Supervision and
Dominance by One or More Individuals

Poor board supervision or the presence of a dominant figure occurred at 73 percent of the 26 failed thrifts in our review. For our purposes, a dominant figure is defined as a high-level individual who exerts a strong personal influence on important aspects of an institution's operations. While the presence of a dominant figure may not always have a negative effect on an institution, it can, and often does, result in a lack of separation of duties or accountability for actions, circumvention of policies or internal controls (if they exist), or other unsafe and unsound practices to the detriment of the institution's operations. This situation is exacerbated when inadequate supervision by the board of directors is also present.

For example, the dominant individual may, and sometimes did, initiate a large number of poor-quality loans (which may ultimately result in losses) before the board is aware of risks assumed, may commit the institution to unsound courses of action, or may undertake abusive practices. In these circumstances, the board of directors does not question or control such an individual's decisions, nor does it hold the individual

accountable for actions having a negative effect on the institution.

Examiners' records showed that a dominant individual at one thrift, who was chairman of the board of directors, made an offer to acquire a company before obtaining approval of the board. The acquisition was subsequently approved by the board during a telephone conference call in which the chairman portrayed the company as a good investment. Pros and cons of the acquisition were not discussed; the board effectively rubber-stamped the deal with its unanimous approval. The company was acquired in 1983; thrift examiners classified the thrift's equity investment in the company as substandard in both 1983 and 1984. By 1985, examiners said fully 70 percent of the failed thrift's losses were attributable to the acquisition.

Members of the board at another failed thrift said they did not question the business decisions of the former chairman because he owned the federally insured thrift--they thought he could run his business as he pleased. However, when that thrift failed, it was FSLIC which incurred the loss, estimated to be \$1.3 billion.

Transactions Not Made in
the Thrifts' Best Interest

A thrift's board of directors and officers have a fiduciary duty not to compromise the thrift's best interests in favor of their own or others' personal interest. However, almost all of the 26 failed thrifts made transactions that were not in the thrift's best interest. Rather, the transactions often personally benefited directors, officers, and other related parties. To protect a thrift's interest, several regulations limit or prohibit certain kinds of transactions. For example, one regulation governs transactions with affiliates, another deals with conflicts of interest. A third limits the amount of loans made to one borrower.

"Affiliates" of a thrift are generally defined by a business relationship which, due to common ownership, directors, or influence, ties people or business entities closely to a thrift. For example, an affiliated person includes directors and officers, and their immediate families. It also includes an individual who controls a thrift either directly or indirectly--for example, by controlling the appointment of a majority of the board of directors. An affiliate could be a corporation that a thrift owns, or in which it controls a majority of stock.

Certain transactions with affiliates are prohibited, while others are limited. For example, a thrift cannot buy property

from a director or officer unless the Bank Board approves the transaction in advance. Examiners found that 81 percent (21 of 26) of the failed thrifts violated the transaction with affiliates regulation or engaged in related unsafe practices.

Another Bank Board regulation addresses the need to prevent and eliminate practices and conditions that represent conflicts between the interests of a thrift and the personal financial interests of directors, officers, and other affiliated persons. According to the Bank Board, it is impossible to define every practice or condition which falls within the broad concept of conflict of interest. Nevertheless, the Bank Board has issued regulations that prohibit or limit certain activities deemed conflicts of interest. For example, a director or officer cannot receive any fee or "kickback" on a loan made by a thrift.

Examiners found that 77 percent (20 of 26) of the failed thrifts violated the conflicts of interest regulation or engaged in related unsafe practices. Examiners often cited both improper transactions with affiliates and conflicts of interest in the same business deals, as the following examples illustrate.

The president of a thrift formed a separate corporation to receive loan referral fees for identifying borrowers to the thrift. In March 1984, the Bank Board informed the thrift that its president was an affiliated person who could not properly

accept loan fees. However, even after this admonition, the president received almost \$1 million in fees. Aside from the fees, losses are expected on some of the loans. Although Bank Board officials have not determined the full extent of such losses, they estimate them to be a minimum of \$5.1 million.

Examiners noted a case of a similar conflict of interest which was made extraordinary by the fact that, in April 1984, a thrift's chairman attested to the Bank Board in writing that he had no interest in, and would receive no direct or indirect benefit from a proposed transaction which required prior Bank Board approval. However, the Bank Board subsequently determined that he received a \$1 million fee.

The transaction regulators approved was for the thrift to buy a 50 percent interest in a real estate development firm for \$2 million. Instead, the thrift bought the 50 percent interest for \$1 million, and paid a \$1 million fee to another firm--a mortgage company. The mortgage company was 100 percent owned by the thrift chairman who signed the affidavit saying neither he nor his entities held any ownership interest, legal or beneficial, that would directly or indirectly benefit from the transaction.

Conflict of interest violations at the failed thrifts were not confined to just officers and directors. At one thrift, the

law firm that acted as the thrift's general counsel engaged in activities constituting conflicts of interest. At the same time the law firm represented the thrift, it referred borrowers to the thrift, represented both parties in the resulting transactions, received fees from both parties, allowed loans to close under terms materially different from those approved by the thrift, and failed to obtain documentation required by the loan commitments issued by the thrift.

Inadequate Underwriting or Loan Administration

Regulators cited weaknesses related to poor loan documentation at almost all of the 26 failed thrifts. Loan documentation, consisting of complete and accurate data for making credit decisions, is an important aspect of granting credit and administering loans. Lending errors frequently result from management failing to obtain and properly evaluate information about the borrower and the project or property involved. For example, 92 percent of the 26 failed thrifts performed inadequate credit analysis of a borrower's ability to repay a loan. Among other weaknesses in loan underwriting and administration, regulators frequently found appraisal deficiencies and noncompliance with loan terms.

Appraisal Deficiencies

Federal regulations requiring thrifts to obtain appraisals for loans secured by real estate were violated by 88 percent of the failed thrifts in our sample. For such loans, Bank Board regulations require thrifts to obtain written appraisal reports, which should be prepared specifically for the thrift by an appraiser appointed by the board of directors and be signed by the appraiser prior to loan approval. In addition, the reports should disclose the market value of the collateral and contain sufficient information to substantiate that value.

Examiners found that some appraisal reports accepted by thrifts were not adequately or accurately substantiated, as required. Other times, examiners noted that thrifts did not obtain appraisals at all, or obtained one after they already made a loan. Examiners also often noted that thrifts accepted appraisals prepared at the borrower's request rather than at the thrift's request. Under such circumstances, the appraiser may not have been previously approved by the thrift's directors, as required. Bank Board officials stated, and examination reports confirmed, that appraisals often reflected only the "best case" scenario for the property or project--sometimes, unfavorable information would be overlooked, or high occupancy rates at top dollar would be used.

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

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

Noncompliance with Loan Terms

According to examiners' records, half of the 26 failed thrifts violated a federal regulation which requires proper documentation of loan terms or engaged in unsafe practices such as deviating from loan terms which the thrifts themselves set. For example, in December 1982, a thrift's loan committee approved a \$5 million loan for a borrower to acquire and develop a ski resort. The approval required that (1) the thrift seek other lenders to finance the construction phase, (2) the thrift receive 25 percent of the total profits generated by the project, (3) a 2-year maturity term, and (4) an interest rate of prime plus 2.5 percent. However, the commitment actually issued to the borrower did not conform to those terms--the loan was for 5 years and had an interest rate ceiling of 16 percent. Although \$2 million of the loan proceeds were to be used for land acquisition, the

borrower used \$1.8 million for other purposes and only \$200,000 to purchase the land. Moreover, the borrower did not invest any funds in the project. The thrift expects to incur a loss in excess of \$3.5 million on this loan.

In similar loans, examiners noted that borrowers not only had no funds of their own invested in the projects which thrifts funded, but these borrowers also personally received funds when the loans were made. In the thrift industry, such arrangements are referred to as "drag loans" because the borrower "drags away" part of the proceeds.

Excessive Compensation and Expenditures

Among the cases of excessive compensation, examiners cited one thrift that paid the chairman of its board of directors a bonus of \$500,000 in the same year that the thrift lost almost \$23 million. Regulators told another thrift that a bonus of over \$800,000 (one third of the thrift's earnings) paid to one officer/director was excessive and a waste of assets. In response, management paid the individual \$350,000 to relinquish his right to future bonuses and increased his salary from \$100,000 to \$250,000.

Extravagant expenditures included trips abroad for thrift officers and their families, ownership of private planes and

employment of pilots to operate them, and parties costing tens of thousands of dollars. One thrift majority stockholder used \$2 million of the institution's funds to buy a beach house for his use and another \$500,000 for related expenses while he lived there. Thrift examiners noted these and other expenditures were not business-related.

High-Risk ADC Transactions

Perhaps the most critical problem unique to the failed thrifts was their extensive and imprudent participation in acquisition, development, and construction (ADC) transactions, often, but not always, with related parties. Thrifts usually provided most or all of the funds on ADC transactions, thereby assuming a high degree of risk. To compensate for the risk, the thrifts were often to receive a part of the profits from the project. Generally, the thrifts relieved developers from any personal liability to repay the funds. If the developer defaulted, the thrift had only the property for recourse. Essentially, the thrifts' return of principal depended on the project being completed and achieving profitability, which was often dependent upon continued inflation.

Deregulation in the early 1980s gave thrifts the legal authority to pursue these new activities. However, some thrifts pursued these transactions in an unsafe manner. A combination of

factors--poor underwriting, large amounts of funds, and excessive geographic concentration--coupled with other violations of Bank Board regulations such as those related to insider transactions or ignoring guidance proved to be a formula for losses.

One thrift in California lent \$40 million to one borrower principally to build condominiums and a shopping center. No feasibility studies were done. Examiners stated that adequate feasibility studies would have shown that the area was already heavily overbuilt with condominiums and shopping facilities before the loans were made. This thrift expects to lose over \$10 million on this project.

Failed thrifts in Texas concentrated this business in the Dallas and Houston areas. Failed thrifts in other states also invested in Texas projects. This concentration, in part, led to excess supply when projects were completed and made the thrifts more vulnerable to economic downturns in that region.

Loans to Borrowers Exceeded Legal Limits

Although a federal regulation limits the amount of money a thrift can lend to one borrower, examiners noted that about 88 percent of failed thrifts in our sample violated the regulation. Huge sums of money were often involved. One thrift continued to make loans to one borrower after promising federal examiners it

would stop doing so. The loans totaled \$88 million; the thrift expects to lose at least \$23 million of the \$88 million it lent to that borrower.

Recordkeeping Was Inadequate

The problems of insider abuse and high-risk deals were compounded by poor financial and other records which examiners noted at all 26 of the failed thrifts. In some instances, the records were so poor that examiners could not tell the true financial condition of the thrifts.

Examiners described the records one thrift used to prepare quarterly financial reports to submit to the Bank Board, as "from no more than approximately correct to completely inaccurate." The report was filled "with a multitude of unexplained figures apparently stored" in the controller's memory, they said.

Transactions Recorded in a Deceptive Manner

Thrifts are required to maintain specified levels of regulatory capital; if regulatory capital falls below these levels, the Bank Board can initiate administrative or enforcement actions. Some of the failed thrifts recorded elaborate transactions that examiners concluded were designed to present a

better financial picture than actually existed, thereby forestalling supervisory action.

For example, one type of transaction is designed to circumvent supervisory action by giving the appearance of adequate capital by having a thrift indirectly purchase of its own stock. In one such transaction noted by examiners, joint venture partners contributed undeveloped land to a venture, while the thrift contributed cash equal to the purported fair value of the land. This fair value was unsupported by appraisals. The cash the thrift contributed was distributed to the joint venture partners who had provided the land, and they used part of it to buy stock in the thrift. Subsequent appraisals on the land revealed that it had been overvalued. Regulators term such arrangements as "dirt for stock" transactions because they mask the fact that thrifts fund the purchase of their own stock, in violation of regulations. Even though the thrift had indirectly provided the financing, the stock purchase increased its reported net worth. This deceptive transaction not only provided the appearance of adequate net worth to meet regulatory requirements, it was also used to justify bonuses paid by management.

FEWER PROBLEMS NOTED AT SOLVENT INSTITUTIONS

We also reviewed examination reports and other documentation pertaining to solvent thrifts. Our review of such institutions indicate that solvent institutions had significantly fewer internal control weaknesses than failed institutions. When such weaknesses did occur, they were generally less severe--more often technical violations than fundamental problems. Moreover, management of solvent institutions generally initiated corrective actions in a timely manner and was responsive to problems regulators identified during the examination process. The specific characteristics which generally distinguished solvent institutions from failed ones in our comparisons included

- competent, well-qualified management;
- good board supervision;
- few or minor weaknesses in policies and procedures;
- effective internal controls;
- better underwriting practices;
- compliance with laws and regulations;
- few supervisory enforcement actions;
- few instances of insider abuse or fraud; and
- significantly less reliance on ADC transactions.

Some within the financial institutions industry have expressed the view that the unprecedented problems and resultant failures are largely due to economic downturns in certain

regions. However, our review leads us to a different conclusion. Well-managed, prudent institutions with strong internal controls for the most part appeared able to remain viable despite downturns in local economies. Conversely, existing problems at poorly run institutions were exacerbated by adverse economic conditions, often leading to failure.

Federal regulators have often cited management-related problems as the leading cause of thrift failures. For virtually all the institutions included in our review, regulatory documents identified serious internal control weaknesses which jeopardized the safety and soundness of the institutions' operations. The broad objectives of internal controls are to (1) safeguard assets, (2) ensure the accuracy and reliability of data and compliance with policies, applicable laws, and regulations, and (3) promote management efficiency. Failure to establish and maintain adequate internal controls may result in management's breaching its duty to operate a financial institution in a safe and sound manner.

Many identified weaknesses at the failed institutions remained uncorrected despite regulators' efforts, primarily through the examination process and related supervisory enforcement actions, to encourage management to remedy these internal control weaknesses. This disregard for safe and sound operating policies and practices is alarming since such

weaknesses are related to operations directly within the control of the boards of directors or management of these institutions.

THE FHLB SYSTEM OF
SUPERVISION AND OVERSIGHT

This assignment was not intended to assess the adequacy of oversight or enforcement activity. Nonetheless, Bank Board examination reports and related documentation noted that the supervision and oversight measures were often ineffective in either preventing, or sometimes even stopping, unsafe or illegal practices once they were detected. We asked Bank Board officials to comment on what we saw as a pattern of regulatory violations and unsafe practices documented in examination reports that often persisted for years. Bank Board officials cited several reasons for what appear to be untimely actions and provided information on specific steps that the Bank System has taken to improve supervision and regulation as a result of the unprecedented number of thrift failures.

With regard to the timeliness and frequency of enforcement actions taken by the Bank Board, several officials cited the onerous burdens of proof and the necessarily long "due process" required by the law, as well as "regulatory breakdowns" due to the fact that the Bank Board was unaccustomed to handling such a large volume of problem thrifts. Before the 1980s, officials

said, there was little need for enforcement actions against thrifts. The Bank Board established the Office of Enforcement in 1986 to help speed the process of taking legally enforceable action.

Doubts About Authority to Regulate State-Chartered Thrifts

Bank Board officials also told us that before 1985 they viewed their authority to issue regulations to restrain state-chartered thrifts from engaging in high-risk activities as "questionable." The officials said that Bank Board officials at that time were hesitant to act in certain instances, especially where state law gave thrifts specific powers which federal laws did not address.

Twenty of the 26 failed thrifts we reviewed were state-chartered. While the Bank Board limited federally chartered thrifts from making certain "direct investments" (such as equity securities, real estate, service corporations, and operating subsidiaries, etc.), state-chartered thrifts often were authorized to make such direct investments under state law. Moreover, FSLIC did not have regulations which placed limitations on the type and amount of direct investments insured thrifts could make.

In 1985, after many thrift failures, the Bank Board issued the first regulation to restrain the use of direct investment authority by all insured thrifts. In addressing its authority to issue the regulation, the Bank Board cited its

"longstanding position, supported by legislative history and prior administrative practice, that the NHA [National Housing Act] authorizes the Board to regulate state-chartered institutions..."

In a court case challenging the Bank Board's authority to issue a regulation limiting the activities of state-chartered thrifts, the court ruled that under the provisions of the National Housing Act and the Federal Home Loan Bank Act, the Bank Board had the authority to issue the regulation for all federally insured thrifts, notwithstanding the fact that state law provided for unrestricted direct investment activities for the state-chartered institutions.⁵ The court's decision clearly confirmed FSLIC's supervisory and regulatory authority over all federally insured thrifts. Thus, while the Bank Board told us that at times it viewed its authority to regulate state-chartered thrifts as "questionable," we believe there should have been little doubt that the Bank Board had the necessary legal authority to promulgate regulations needed to ensure that all federally insured

⁵Lincoln Savings and Loan Association vs. Federal Home Loan Bank Board, 670 F. Supp. 449 (D.D.C. 1987) aff'd, 856 F. 2d, 1558 (D.C. Cir. 1988).

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

FHLB System's Actions to Increase
Regulatory Staff and Improved Guidance

According to officials of the Office of Regulatory Activities (ORA), the "quantity and quality" of examiners and supervisors has increased and improved. Because of Office of Management and Budget (OMB) and Office of Personnel Management (OPM) restrictions on the number of examiners the Bank Board could hire, as well as salary and other benefits they could receive, the Bank Board reassigned the examination function to its district banks in 1985. As employees of district banks, the examination force is not subject to the OMB and OPM restrictions. As a result, the number of examiners and supervisors increased from 1,063 in June 1985 to 2,068 in June 1988.

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

A major philosophical change, as described by the director of ORA, involves emphasizing an overall concept of safety and

soundness as opposed to specific, detailed regulations with which thrifts must comply. The ORA director stated that this change was called for in the Competitive Equality Banking Act of 1987⁶ and that bank regulators already operate in this type of framework. Accordingly, ORA made changes in the reference materials used by the examiners and supervisors. A new series of regulatory handbooks, which embody this philosophical change, provides specific procedures that should be performed when examiners evaluate a thrift.

SPECIFIC INITIATIVES TO COMBAT FRAUD
AND INSIDER ABUSE IN FINANCIAL INSTITUTIONS

A number of federal agencies have undertaken initiatives to address the problem of fraud and insider abuse in financial institutions, including thrifts. We have not specifically evaluated the details of most of these actions; nonetheless, in our view, they represent positive steps.

⁶Section 407 (a) of the act provides that the Bank Board "shall issue guidelines which provide greater flexibility for supervisory agents, examiners, and other employees and agents of the Board, the Federal Savings and Loan Insurance Corporation, and the [district] banks in applying regulations, standards, and other requirements of the Board [and FSLIC] with regard to particular situations or particular thrift institutions" (12 U.S.C. 1437 note).

Interagency Cooperation

In December 1984, federal bank and thrift regulators and Department of Justice officials responded to public and congressional concern over bank fraud and insider abuse by forming the Attorney General's Interagency Bank Fraud Enforcement Working Group to improve communication and coordination among its members.⁷ The working group's goal is to improve the detection, investigation, and prosecution of bank fraud cases. Actions to accomplish this objective have included increasing training in bank fraud investigation for both thrift and bank examiners as well as Federal Bureau of Investigation (FBI) agents and encouraging its members to establish tracking systems to monitor criminal referrals. In addition, individual regulators have taken measures to combat insider abuse and fraud. For example, the Federal Deposit Insurance Corporation (FDIC) issued a list of "red flags," to serve as warning signs of possible insider abuse and fraud, to aid its examiners and the financial institutions' internal and independent auditors.

⁷In addition to the bank and thrift regulators (the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Home Loan Bank Board) and Justice, the other members of the working group include the National Credit Union Administration, the Farm Credit Administration, and the Federal Bureau of Investigation.

FDIC Fraud Detection Group

In February 1989, the Bank Board contracted with FDIC to conduct and manage the receiverships or conservatorships resulting from the insolvency of approximately 220 thrifts. As part of this new responsibility, FDIC announced the formation of a "fraud squad." This unit, comprised of specially trained FDIC examiners, will investigate evidence of fraud detected by federal regulators placed in the insolvent thrifts. This unit's mission, according to the FDIC Chairman, will be to "get back misappropriated thrift assets and help send those responsible to jail, when appropriate." However, it is still too early to determine how effectively the fraud squad will be able to fulfill its mission.

Local Bank Fraud Working Groups

The Department of Justice has established local working groups in at least 16 areas. These working groups, comprised of representatives of the FBI, Justice, and state and federal regulators, attempt to pool the resources of the agencies involved in the investigation and prosecution process to deal in the most efficient manner with crimes committed at financial institutions. One example of such a working group is the Dallas Bank Fraud Task Force, which was established in late 1987. Through January 1989, the task force has brought criminal charges against 33 individuals, 20 of whom have been convicted. Of those convicted,

12 have been sentenced to terms ranging from probation to 35 years in prison. Restitution of approximately \$2.8 million has been ordered by the courts, although this full amount may not be ultimately collected.

IMPEDIMENTS TO SUCCESSFUL PROSECUTION
OF CRIMES AGAINST FINANCIAL INSTITUTIONS

With respect to these efforts to investigate and prosecute suspected criminal actions involving the thrift industry, there are a number of obstacles to successfully concluding such cases. White-collar crime is inherently difficult both to investigate and to successfully prosecute in the courts. This difficulty is exacerbated by the circumstances involving many of the failed thrifts, including

- Complexity of transactions. The kinds of white-collar crimes involving financial institutions are often massive and complex, and committed by relatively sophisticated individuals with specialized industry knowledge, often in concert with others. To the extent that investigators do not possess detailed industry knowledge--which can take years to acquire--the effectiveness of their efforts is reduced.
- Poor or nonexistent records. Inaccurate, misleading, or missing records can make it extremely difficult to determine the nature and specifics of transactions which have occurred.
- Delayed discovery. Because the effect of white-collar crimes is usually not immediately apparent, and those who commit them often attempt to conceal their acts, substantial delays can occur between the time an illegal transaction occurs and its discovery. Accordingly,

potential witnesses and others familiar with the transactions can be difficult to locate or unavailable. In addition, the time required to adequately investigate such cases can add further delays, bringing into effect the various statutes of limitations.

Moreover, the rapid buildup of special units to focus on crime in specific areas means that investigators often do not have local knowledge, nor have they had the time to cultivate informants, both of which are often needed to successfully prosecute this kind of crime.

It should also be noted that the court-ordered restitutions resulting from prosecutions do not necessarily mean the government will collect the entire amounts ordered. The illegal gains of fraudulent operators often disappear or are otherwise dissipated after the crimes are discovered.

CURRENT STRUCTURE OF THE FEDERAL HOME LOAN BANK SYSTEM
NOT CONDUCIVE TO EFFECTIVE OVERSIGHT

The Bank System has taken a number of steps to strengthen supervision and oversight of the thrift industry, as have other government organizations such as the Department of Justice and, more recently, FDIC. However, these actions do not address a fundamental conflict created by the Bank Board's and the district banks' roles to both promote and regulate the industry.

This review, as well as our other work related to the thrift industry, recognized a basic structural flaw in the current Bank System organization, namely its conflicting responsibilities for promoting the thrift industry while at the same time supervising, regulating, and insuring it. We believe that such conflicting responsibilities at times may hamper the Bank System's ability to satisfactorily fulfill any of these roles.

The current structure of the Bank System includes several entities that have roles in overseeing thrift activity: the district banks, the Office of Regulatory Activities, and offices within the Bank Board itself, such as the Office of Enforcement. In 1985, the Bank Board delegated its responsibility to examine and supervise thrifts to the 12 district banks. Thus, the district banks, like the Bank Board itself, now have a dual role of both promoting and regulating the thrift industry. However, under the current structure, FSLIC, as the insurer of the thrift industry, does not have the independent ability to monitor, supervise, or exercise its legal authority against any thrifts; these activities and its legal powers can be exercised only through the Bank Board.

The involvement of so many different entities has created a complex federal regulatory and enforcement framework. It also creates the appearance of conflict for both the Bank Board (which charters, promotes and provides regulatory oversight) and

especially the district banks (which provide banking services, examine and supervise the thrifts, and a majority of whose board of directors are thrift industry executives).

Our previous work pointed to the need to establish an independent structure for oversight and regulation. Accordingly, we recommended that FSLIC be disengaged from the Bank Board and given independent status.⁸ Implicit in this independent status would be both the authority and resources to regulate and supervise the industry. Such an independent status, along with the necessary resources, would allow the insurer to establish stringent controls over improperly operated and undercapitalized thrifts and to protect the interests of the insurance fund.

ADMINISTRATION PROPOSES CHANGES TO THE THRIFT INDUSTRY

In February 1989, the President sent to the Congress a major reform and financing initiative to resolve the nation's savings

⁸See Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47, February 21, 1989) and Statement of Frederick D. Wolf, Assistant Comptroller General for Accounting and Financial Management, before the House Committee on Banking, Finance and Urban Affairs--Bank and Savings and Loan Insurance Funds: Financial Condition and Proposed Reforms (GAO/T-AFMD-89-3, March 10, 1989).

and loan industry problems.⁹ Among other things, the proposal creates a single, independent insurer (FDIC) with the overriding mission of providing insurance to depositors and maintaining the security of the deposit insurance fund. While we agree that under the proposal the considerable expertise of the consolidated FDIC will be available to deal with case resolution issues, we believe additional measures will be required for the agency to deal with examination and supervisory issues. We agree with the President's proposal to administratively consolidate FSLIC's insurance function with that of FDIC. However, the multiple roles played by the Federal Home Loan Bank System as promoter, charterer, banker, and primary regulator of the thrift industry would continue under the President's proposal. Accordingly, we believe that legislation to restructure the thrift industry should provide for transferring the examination and supervision functions from the Bank System to the insurer.

As discussed previously, to increase the "quantity and quality" of examiners and supervisors, these activities were transferred to the district banks, thus overcoming the personnel and salary restrictions which applied to FSLIC. In order for an

⁹While we are not yet in a position to comment on all aspects of the proposal, we believe that the results of our review address specific issues which the Congress should consider in developing legislation to reform the thrift industry. Specifically, we believe that our review provides insights related to restructuring regulatory and insurance activities. Other GAO work will address a more comprehensive review of the President's proposal and associated legislation.

independent regulator to deal effectively with the problems in the thrift industry, it is important that such a restructuring not result in any impairment to its ability to attract and retain sufficient numbers of qualified regulatory, supervisory, and examination staff. If the proposed legislation is amended to transfer this function to the insurer, FDIC will need to establish compensation levels, consistent with its authority, to attract and retain sufficient numbers of qualified and experienced personnel.

Need to Affix Greater Accountability to
Thrift Management for Safe and Sound Operations

In addition to establishing an independent insurer that would examine and supervise the thrift industry, we believe that the Congress should also consider adding provisions to the proposed legislation which would help ensure that federally insured financial institutions operate in a prudent and responsible manner. More specifically, we believe legislation is necessary to strengthen controls at federally insured financial institutions.

Adherence to sound internal controls, management practices, and financial reporting practices is essential to ensure the safety and soundness of the nation's financial institutions. As previously mentioned, management is responsible for developing policies and procedures which include a system of internal

controls designed to foster sound practices, to promote compliance with laws and regulations, and to protect the institution against crimes and internal fraud and abuse. However, the pervasive nature of internal control weaknesses, along with related violations of laws and regulations, cited for failed thrifts indicates that management of these institutions did not implement adequate internal controls. This points to the need for an increased awareness of this responsibility and for greater management accountability.

To accomplish this, we believe that management of federally insured financial institutions should be required to prepare annual reports (1) acknowledging their responsibility for maintaining effective systems of control and complying with laws and regulations, (2) providing their assessment of the adequacy of their internal control systems and their compliance with laws and regulations, and (3) explaining any existing weaknesses along with plans for their correction. Such reports should be examined by the institutions' auditors, who would issue reports to the regulator on the validity of management's assertions. We believe such reporting would go a long way toward establishing top management's accountability for operating insured institutions in a safe and sound manner.

Proposal to Increase the Department of Justice Budget
for Combatting Crime in Financial Institutions

The subcommittee has asked our views on the Administration's proposal to increase the budget of the Department of Justice by \$50 million to help strengthen enforcement of laws related to the financial institutions industry. We have not assessed law enforcement activity related to the thrift industry and, therefore, cannot specifically comment on the effectiveness with which existing investigative and prosecutorial resources are being used or on the benefits that a \$50 million increase in resources would achieve. However, a report issued by the House Committee on Government Operations, entitled Combating Fraud, Abuse and Misconduct in the Nation's Financial Institutions: Current Federal Efforts Are Inadequate (House Report 100-1088, October 13, 1988), specifically addresses such law enforcement issues.

Nevertheless, we believe that the maximum practical amount of investigative and prosecutorial resources should be focused on the problem for two reasons. First, it would be patently unfair to the nation's taxpayers and to the prudent operators in the industry (whom we believe constitute the significant majority) to allow those who attempted to profit by flaunting laws and regulations to go unpunished. Second, in order to deter such actions in the future, the government should make it clear that it has both the will and the resources to stringently enforce its

laws. We view it as vitally important that all possible steps be taken to prevent the current crisis in the thrift industry from occurring again. The vigorous pursuit of all legal remedies against those who illegally benefited is certainly one of those steps.

Mr. Chairman, this concludes my formal statement. At this time, I would be pleased to answer any questions you may have.

GEOGRAPHIC DISTRIBUTION OF FAILED THRIFTS

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

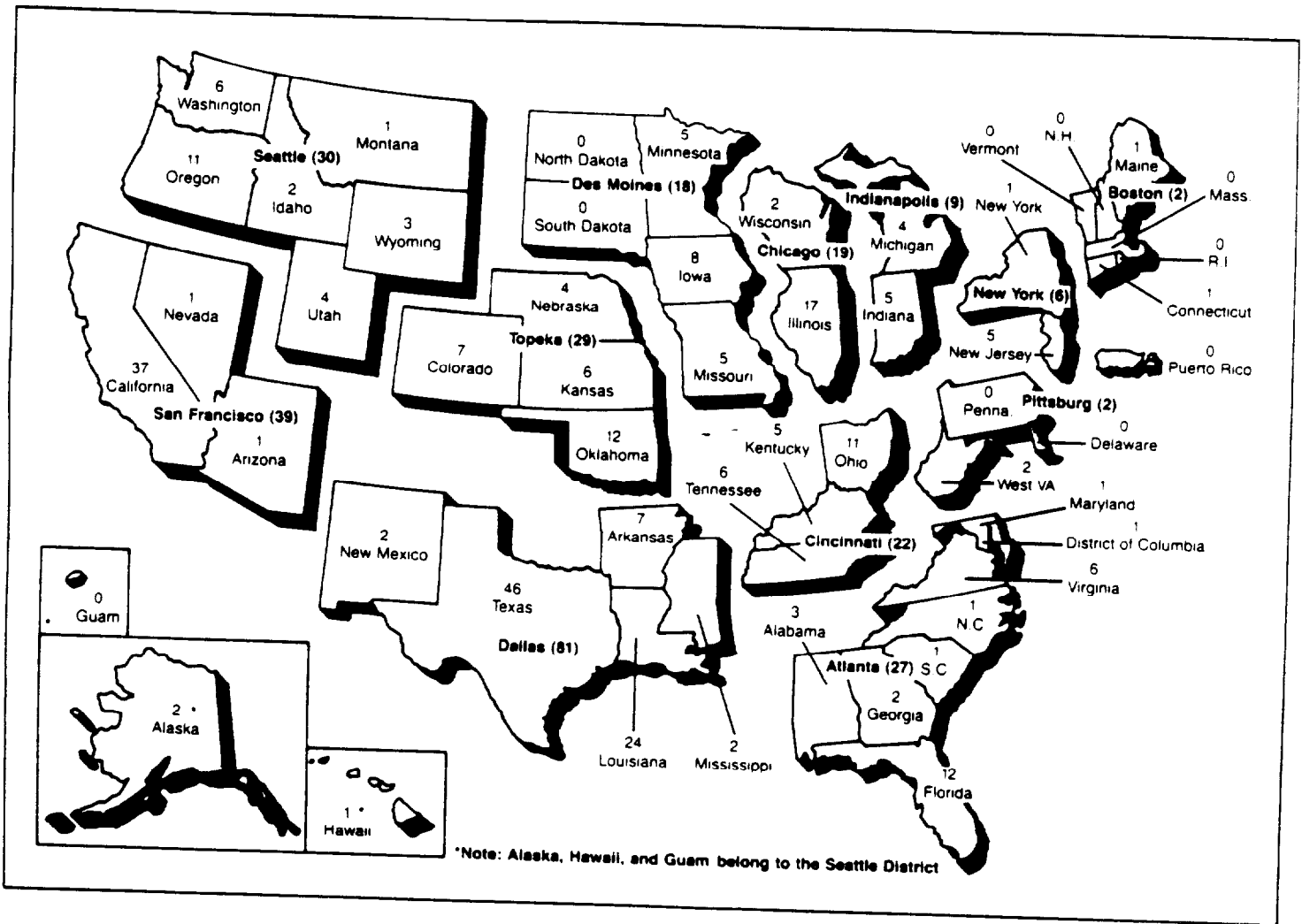


Table I.1: Insolvent and Solvent Thrifts in Our Sample

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

CHARACTERISTICS OF 26 FAILED THRIFTS IN OUR SAMPLE

<u>Characteristic</u>	<u>Number</u>	<u>Percent</u>
Inaccurate recordkeeping or inadequate controls	26	100
Change from traditional to high-risk activity	26	100
Inadequate credit analysis	24	92
Inadequate appraisals	23	88
Excessive loans to one borrower	23	88
Overreliance on volatile funding sources	21	81
Transactions with affiliates	21	81
Conflicts of interest	20	77
ADC lending	19	73
Passive board of directors or dominant individual	19	73
Excessive compensation	17	65
Inadequate project analysis	17	65
Change in control	16	62
Faulty loan disbursements	14	54
Thriffs with supervisory agreement signed with district bank	22	85
Thriffs with enforcement action taken by Bank Board	10	38
Thriffs with criminal referrals	19	73
Thriffs with civil suits filed by Bank Board	14	54