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Briefing Report to the Honorable Henry B. Gonzalez, Chairman, Committee on Banking, Finance, and Urban Affairs House of Representatives

April 1989

TROUBLED THRIFTS

Bank Board Use of Enforcement Actions

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The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance, and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This briefing report responds to your March 31, 1989, request that we provide you with the preliminary results of work we are doing for the Committee on the Federal Home Loan Bank Board's (FHLBB) supervision of near-failing thrifts, focusing on enforcement actions.

We share your concern that inadequate supervisory oversight has contributed to the present problems in the thrift industry. In testimony, we have said that fundamental reforms are needed and that the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than its risk management and insurance function.[1]

We are presently analyzing the supervisory history of near-failing thrifts and reviewing in detail the histories of 47 thrifts in three Federal Home Loan Bank System districts.[2] Our preliminary work on these 47 thrifts indicates that

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[1]See the January 26, 1989, statement of the Comptroller General of the United States before the Committee on the Budget, U.S. House of Representatives, p.8, and his February 2, 1989, statement before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, p.4.

[2]Supervision of thrifts encompasses many different activities undertaken by various organizational units within the Federal Home Loan Bank System. Some activities are intended to identify problems and bring them to the attention of appropriate Bank Board officials. Others are intended to correct problems. This report looks at such supervisory actions taken against near-failing thrifts identified as having problems. Such actions are referred to as enforcement actions.

- for over half of the thrifts in the three districts, no formal enforcement actions were taken, and in one district, 24 of 29 near-failing thrifts had no history of formal actions against them;

- when formal enforcement actions were taken against the near-failing thrifts, many of the available tools, such as civil money penalties, were not used;

- enforcement actions that were taken were often not effective in correcting identified violations and preventing further financial deterioration; and

- the elapsed time between identification of a need for a formal enforcement action and implementation of the action was often unduly lengthy.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the work we are doing for your Committee is to assess the effectiveness of FHLBB's use of enforcement actions against near-failing thrifts. This report provides our preliminary results. We are reviewing the supervisory histories of 424 thrifts that were referred to as "Significant Supervisory Cases" (SSC) in June 1987. The FHLBB considers SSCs to be the severest supervisory cases. According to guidance provided to the Federal Home Loan Banks (FHLBank), thrifts should be considered SSCs if they (1) are in imminent danger of insolvency, (2) have significant problems that would likely require some form of resolution external to the thrift, or (3) have a problem that a FHLBank wants to bring to the attention of FHLBB. We focused on the SSC inventory as of June 1987 to take into account the effects of organizational and resource changes stemming from FHLBB's transfer of the examination function to the FHLBanks in 1985. This transfer was accompanied by increased compensation and staffing levels that should have improved the quality of supervision. The transfer was fully implemented by early 1987.

We are doing detailed analyses of 47 of the 424 SSC cases. These 47 SSCs were among 262 SSC cases supervised by the FHLBanks in the Dallas, San Francisco, and Chicago districts and had combined assets exceeding $85 billion. We selected these districts because they accounted for about 50 percent of the Nation's insolvent thrifts at year-end 1987. Within the districts, we selected the largest 47 cases (after excluding thrifts that were in the Management Consignment Program and those that were already designated FSLIC cases) because asset size is one indication of potential impact on FSLIC.

Our analysis of these cases goes back to the time when a significant problem was first uncovered in an examination and traces the supervisory response through December 31, 1988, or a final resolution, such as a merger or determination that special supervisory efforts were no longer warranted. We reviewed relevant documents, including examination reports and enforcement-related memoranda. We also interviewed involved officials at the FHLBanks and at the Bank Board's Office of Regulatory Affairs and Office of Enforcement.

Because of your need to obtain this report on an expedited basis, we have not obtained agency comments. We began our work in October 1988 and are doing it in accordance with generally accepted government auditing standards.

PRELIMINARY RESULTS

FHLBB policy states that one purpose of prompt supervisory action is to stop the continuation of violations or practices that may result in financial harm to the thrift, its customers, or FSLIC before such harm actually results.

Of the 424 SSCs, at least 75 percent deteriorated, and at least 60 percent became insolvent. In one district, the average regulatory net worth as a percentage of assets for the thrifts entering the SSC caseload had deteriorated to 2.4 percent by the time they entered the program. It deteriorated further to a negative 34.4 percent by the time of our analysis.[3] In another district, net worth of SSCs had declined after entering the SSC caseload from an average

[3]At the time of our analysis, the as-of-date for current financial information provided by the FHLBanks varied. However, most current financial data was as of June 1988 or later.

of 1.4 percent to a negative 12.7 percent. While declining net worth is not by itself proof that the FHLBB's supervisory response was inappropriate or ineffective, we consider it to be a cause for concern, and we plan to address this issue in our detailed analyses of the 47 cases.

Infrequent Use of Formal Enforcement Actions

The FHLBB did not use formal enforcement actions in over 50 percent of the SSCs in the three districts on which we focused.[4] We analyzed the extent to which such actions were taken against the 262 SSCs in the Dallas, Chicago, and San Francisco districts. We found that 142 of these thrifts had no history of formal enforcement actions. And, in those cases where actions were taken, most involved placing an institution into receivership or conservatorship after it was insolvent.

The following table shows the formal actions. More than one action of each type and/or more than one type of action may have been taken against a single thrift.

[4]The enforcement actions listed in table 1 are provided for by statutes and regulations. They require approval by the FHLBB. Informal enforcement actions, also called administrative actions, are generally less severe and are to be used in instances when potential harm to the institution is only slight and it is considered likely that management will correct identified problems.

Table 1:

Use of Formal Enforcement Actions for 262 Thrifts

Type of formal enforcement action	Frequency of use of actions
Cease and desist order	51
Prohibition and removal action	27
Suspension of officials	None
Capital directive	None
Civil money penalty	None
Withdrawal of deposit insurance	None
Receivership/conservatorship	90

In one district, the 29 SSCs that were reported to the FHLBB in June 1987 had been in the SSC caseload an average of about 2.2 years (ranging from 0.2 to 3.0 years). Examination reports noting problems needing urgent and decisive corrective measures could be traced back an average of 4.1 years (ranging from 0.9 to 7.4 years). As of mid-1988, 24 (82 percent) of the 29 SSCs had no history of formal actions against them. Twenty-three of the 29 institutions were insolvent; 18 of the 23 insolvent thrifts had no history of formal enforcement actions.

The limited use of formal enforcement action against the SSC thrifts is of particular concern in light of (1) the marked decline in the SSCs' financial condition, which can ultimately increase FSLIC's final resolution costs; (2) a history of examination reports revealing critical problems; and (3) the length of time thrifts had been in the SSC caseload. We will explore the reasons why more use of such actions was not made in our continuing work.

Ineffective and Untimely Supervisory Actions

In addition to the fact that formal supervisory actions were infrequently used, we are also concerned about the timeliness and adequacy of supervisory actions. For example, one thrift with assets exceeding $100 million had been designated as a SSC in April 1987. Examinations going back to 1984 showed repeated violations of regulations; an aggressive emphasis on high-risk acquisition, development, and construction (ADC) loans; and inadequate lending procedures. After a series of informal supervisory actions, a formal cease and desist order was initiated in May 1986 but was not issued until March 1988, 22 months later.

On the basis of a review of supervisory records and interviews with officials, we found that the delay in issuing the cease and desist order was due to disagreement over the content of the order. The FHLBank that recommended that an order be issued did not believe that the order, as drafted by the Office of Enforcement, would adequately address the thrift's underlying problems. The FHLBank then entered into protracted negotiations with the thrift's management as to the terms of the order. Ultimately, the FHLBank; the Office of Enforcement, whose approval is necessary for issuing a cease and desist order; and the thrift's management reached agreement on the terms of the order. All the while, however, the thrift's financial condition and operations continued to deteriorate. The thrift became insolvent and was placed under receivership 2 months after the cease and desist order was issued. The district FHLBank estimated, as of December 1988, that FSLIC's cost of resolving this institution would be about $18 million.

In another district, one thrift grew rapidly from about $120 million in assets in 1983 to over $3 billion by February 1986. In early 1986, an examiner identified numerous regulatory violations, problem ADC loans, inadequate lending procedures, problems with conflicts of interest, unrecognized losses, and failure to maintain minimum regulatory capital.

In April 1986, the supervisory agent recommended a cease and desist order to, among other things, restrict lending and to prohibit the payment of dividends and bonuses. Shortly thereafter, the examiner also recommended a removal and prohibition action. The FHLBank selected instead an informal supervisory agreement, stating that this would be quicker. This agreement was finally signed in October 1986. The institution paid dividends totaling over $2 million in June and July and bonuses to officers totaling about $650,000 immediately before signing the agreement.

In light of the thrift's weak capital position, the supervisory response was not only untimely but was also ineffective in preventing the institution from dissipating assets. The proposed removal action was never pursued, but the targeted individuals later resigned. By June 1988, the thrift had negative regulatory net worth of almost $2 billion.

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This briefing report conveys our preliminary observations on the use of enforcement actions. The examples cited above on untimely, ineffective, or inadequate actions, while not unique, cannot be assumed to be representative of all cases. During our review, for example, we have examined some supervisory histories in which actions taken seemed appropriate and effective. We also recognize that FHLBB has recently taken steps to improve the supervisory process, such as centralizing policies and procedures on the use of enforcement actions in a regulatory handbook.

We will keep you informed as we proceed with our assessment. As arranged with the Committee, we will make no further distribution of this report for 7 days. At that time, we will send copies to FHLBB and other interested parties. If you have any questions, please call me at 275-8678 or Alison Kern on 898-7196.

Sincerely yours,

Craig A. Simmons
Director, Financial Institutions

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