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Report to the Chairman, Federal Deposit Insurance Corporation

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FDIC

Loan Sales Jeopardized by Systems and Other Internal Control Problems

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Information Management and
Technology Division

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The Honorable L. William Seidman
Chairman, Federal Deposit
Insurance Corporation

Dear Mr. Seidman:

This past April, a private investor alleged to us that one-third of the $33 million in failed bank loans he purchased in 1990 from the Federal Deposit Insurance Corporation (FDIC) had been inaccurately represented. In order to assess his claim, we requested and he provided, from the total of 818 loans[1] he purchased from FDIC's Denver Consolidated Office, 25 loan cases[2] that he believed best illustrated this inaccuracy. We reviewed these 25 loans to determine whether (1) the automated system used to account for the loans and provide information to investors accurately reflected information stored in the manual loan files, and (2) these manual loan files were accurate.

Because accurate information is critical to the successful disposal of failed banks' assets, we are providing you with the results of our work. Appendix I describes our objective, scope, and methodology.

Results in Brief

The management and sale of assets by FDIC's Denver Consolidated Office appear to be in a state of neglect and disarray. Of the 25 loans reviewed, 23 had serious errors in either the manual loan files or automated system. Basic internal controls were not in place to ensure that the manual and automated records were properly updated to reflect the actual status of loans. Consequently, information on 23 loans was inaccurately represented to investors, and FDIC itself was often unaware of the actual condition of the loans.

Of the 25 loans the Denver office offered for sale, 5 had been fully paid at least 2 years before the sale. Six showed collateral that did not exist. Four showed FDIC as owning the entire loan, when portions were actually owned by other financial institutions. Eight loans involved borrowers either in bankruptcy or having outstanding court judgments

[1]As of July 31, 1991, FDIC repurchased 479 loans with a book value of about $21 million from the investor.

[2]For purposes of this report, we have referred to loan cases as loans. Each case will have only one borrower but could have more than one loan.

against them for nonpayment of the loans—facts not made known to investors. This means that collection was riskier than represented.

These serious errors raise concern as to whether the Denver office can effectively fulfill an important FDIC mission objective: selling assets. Moreover, since FDIC's Inspector General found similar problems at eight other consolidated offices in 1990 and 1991, FDIC's asset-disposal program may be at jeopardy because reliable asset information may not be available for the efficient and effective disposal of assets.

Decisive action is needed immediately. We are making a number of recommendations designed to correct the Denver problems, and determine the extent of these problems throughout FDIC and the action needed to correct them.

Background

FDIC's primary responsibility is to insure deposits of financial institutions. FDIC also acts as a receiver for failed banks and thrift institutions, and is responsible for selling their assets.[3]

FDIC's Division of Liquidation has 18 consolidated offices in four regions to administer the sale of assets. Information on loan values and the status of the assets is maintained in both FDIC's Liquidation Asset Management Information System (LAMIS) and manual loan files. LAMIS is used to maintain computerized financial and loan-servicing information on loan assets, including borrower information, loan values, collateral, and payment history. The manual loan files contain paper copies of this LAMIS data and additional information, such as correspondence with borrowers. FDIC's consolidated offices are responsible for (1) updating LAMIS and ensuring that the information it contains accurately reflects the manual loan files, and (2) maintaining accurate loan-status records in the manual files.

To establish minimum bid prices for the sale of assets, FDIC policies require that loan values and collateral be examined by various offices, depending on the value of the loans packaged for sale. FDIC's Legal Division must also determine whether borrowers are in bankruptcy or whether outstanding court judgments exist against borrowers for nonpayment of loans being packaged for sale.

[3]The Resolution Trust Corporation is responsible for thrifts that fail from January 1, 1989 to August 9, 1992.

The San Francisco Regional Office is responsible for monitoring the performance of the Denver Consolidated Office, which manages about 6,000 assets (with a book value of nearly $1.6 billion). Between April and July 1990, the Denver office planned to sell 3,232 of its loan assets with a book value of about $156 million. Eventually 1,296 loans with a book value of about $60 million were sold.

Loans Were Inaccurately Represented

For 23 of the 25 loans, serious errors in the manual loan files and the automated records were found. As a result, five loans valued at $183,000 were in reality worthless. The remaining 18 loans, valued at about $1.8 million, were worth less than represented because either (1) they were not totally owned by FDIC, (2) they were not backed by collateral as claimed by FDIC, or (3) they were subject to borrowers' judgment or bankruptcy proceedings not disclosed by FDIC. The following summarizes the problems uncovered:

- FDIC represented five loans that had been paid off, and were therefore worthless, to have a total book value of about $183,000. Documentation verified that the loans had been paid off at least 2 years before FDIC sold these same loans. Although manual and automated loan records did not reflect the cash receipts for these payoffs, after we brought this to FDIC's attention, FDIC was able to substantiate the payment of three loans. For one of the two remaining loans, FDIC had used a private company to collect the loan. The company's records indicated that the borrower paid off the loan in December 1987, and a check was forwarded to FDIC in January 1988, but the check had not been cashed by FDIC. However, FDIC had no record of receiving the check and had not followed up on the status of the loan until our review this past May. In addition, even though FDIC records showed these five loans to be outstanding, little contact was made with these borrowers in over 3 years.
- FDIC overstated the value of four loans by about $313,000 because it included portions of the loans owned by other financial institutions. Financial institutions sometimes participate in loans with other institutions, but FDIC failed to reflect this participation on its automated systems or to investors. For example, in one case our review of manual files found that FDIC represented a loan value of about $234,000 on its automated systems and to investors, when FDIC actually owned only $117,000 of the loan.
- FDIC inaccurately represented six loans by listing collateral when none existed. FDIC had released the collateral on these loans before the sale. Although manual loan files correctly showed that collateral did not exist, automated records were not updated to reflect this fact. As a

result, FDIC sold about $608,000 in unsecured loans that FDIC represented as having collateral.

- Although FDIC received bankruptcy notifications for six loans before the sale, it did not show this information on its automated loan records or to investors. Consequently, about $548,000 in loans were sold that may actually be worth considerably less.
- FDIC had records showing that two borrowers had outstanding court judgments against them for nonpayment of the loans. However, its automated loan records did not show this information. The book value of these loans totaled $345,000.

Weaknesses in the Maintenance and Review of Loan Information

Because of the need to immediately bring these problems to your attention, we did not pinpoint the exact cause of the problems found in each of these 23 loans. However, we identified certain key weaknesses that seemed to have contributed to the inaccurate representation of loans. These weaknesses are (1) the use of an unauthorized system that did not accurately track loan amounts, (2) the similar inability of the authorized system—LAMIS—to accurately track loan amounts, and (3) the failure of FDIC managers to ensure that procedures for maintaining manual and automated loan records are followed and that the records are reviewed by supervisors.

According to Division of Liquidation officials, LAMIS' shortcomings resulted in the Denver office's using an unauthorized system to assemble asset information for investors. However, this system—like LAMIS—did not reduce loan values when portions were owned by other financial institutions. This problem resulted in some loan values being overstated. These officials also said that many of the Division's consolidated offices have developed their own automated systems to compensate for LAMIS' inability to support their asset-management needs.

FDIC failed to ensure that its manual and automated loan records were accurately maintained and that errors related to loan values, collateral, or other areas were corrected and changed. Although it has procedures for keeping these records current and accurate, FDIC managers failed to ensure that these procedures were consistently followed at the Denver office. For example, loan records were supposed to be periodically reviewed by supervisors. However, we found little evidence that supervisors did in fact perform periodic reviews of these records.

In preparation for the 1990 loan sale, 21 of the 25 loans were reviewed by supervisory officials. Twelve loans were reviewed by either San

Francisco or Kansas City regional staff, and the other nine loans were reviewed by supervisory personnel at the Denver office.[4] The Division of Liquidation's Associate Director, Credit, eventually reviewed and approved the loan sale. Even with these various levels of review, 19 of these 21 loans had been inaccurately represented. Although we did not evaluate the extent of these reviews, it raises serious questions about the adequacy of FDIC's supervisory review process.

FDIC's Director of the Division of Liquidation attributed these problems to (1) staff not following FDIC procedures for maintaining loan records, (2) the large number of assets in the sale, and (3) inexperienced staff. The Deputy Director of FDIC's San Francisco Regional Office and Denver's Managing Liquidator agreed with this assessment. Denver's Managing Liquidator noted that while a typical FDIC sale contains less than 1,000 loans, this sale contained over 3,000 loans.

Similar Weaknesses Found at Other FDIC Offices

FDIC's Office of Inspector General found, in its audits of other offices, internal control problems similar to those we found at the Denver office. We reviewed its 1990 and 1991 reports for eight consolidated offices. At six offices, the Office of Inspector General found cash-management problems, such as not depositing funds or not applying funds to the proper accounts in a timely manner. Another problem at four offices was inadequate maintenance of manual loan files. For example, files were not adequately maintained to ensure that taxes and insurance premiums were paid on properties. At five offices, loan values were not accurately reflected in LAMIS. At one of these five offices, 27 percent of the commercial loans had no value, while LAMIS records indicated that these loans had a total value of $3.8 million.

Conclusions

The lack of internal controls over maintaining correct and current loan information at the Denver office is disturbing. This almost total breakdown in fundamental controls has resulted in assets that are grossly overvalued, and in FDIC's losing control over cash receipts, loan delinquencies, and account records maintained in manual files and LAMIS. The FDIC's Inspector General findings at eight consolidated offices also raise concerns that such conditions exist beyond the Denver office and may have serious adverse consequences for FDIC's ability to account for and

[4]The Denver Consolidated Office was in FDIC's former Kansas City region until September 1989.

sell failed bank assets. The magnitude of the errors could, if left uncorrected, erode investor confidence over time in FDIC offerings and hinder the agency's loan sales program.

Recommendations

Given the importance of accurate asset information, we recommend that you take immediate action at the Denver Consolidated Office to ensure that

- cash receipts are properly accounted for in the manual and automated loan records;
- the manual and automated loan records are corrected to provide accurate and current information;
- procedures are strengthened to continually maintain accurate and current loan records; and
- loan records are periodically reviewed to verify the status of the loans.

We also recommend you take steps to ensure that the internal control weaknesses discussed in this report do not exist at other FDIC offices.

Agency Comments

Senior officials of FDIC's Division of Liquidation generally agreed with our findings and recommendations. They said that the control and procedural problems identified at the Denver office were an isolated incident, which they were in the process of correcting, and steps have been taken to resolve the problems reported by FDIC's Office of the Inspector General. However, we believe that FDIC, including its Office of the Inspector General, needs to assess whether the steps taken adequately resolved the problems and to determine whether similar problems exist in other consolidated offices.

We are sending copies of this report to interested members of Congress and will make copies available to others upon request. This report was prepared under the direction of Howard G. Rhile, Director, General Government Information Systems, who can be reached at (202) 275-3455. Other major contributors are listed in appendix II.

Sincerely yours,

Ralph V. Carlone
Assistant Comptroller General

Objective, Scope, and Methodology

The objective of our work was to determine whether FDIC's Denver Consolidated Office accurately represented assets to an investor. To assess the investor's allegation that one-third of the loans he purchased in 1990 were misrepresented, we reviewed documents on 25 loans he purchased. He identified these 25 loans as best illustrating the inaccuracies he alleged. We reviewed these 25 loans to determine whether (1) the automated systems used to account for these loans and provide information to investors accurately reflected information stored in the manual loan files, and (2) these manual loan files were accurate. Our work was performed between May and July 1991 at FDIC's headquarters office in Washington, D.C., and at its Denver Consolidated Office in Colorado. It was also performed at an investor's office in Casper, Wyoming.

Our work included reviewing FDIC policies and procedures on managing the sale of assets. We reviewed sale procedures and internal evaluations of the sale held between April and July 1990. In addition, we examined 25 manual loan files to verify loan agreements, collateral, and other information. However, we did not physically verify the existence of collateral. We also met with appropriate personnel responsible for manual loan files, automated records, and the sale. We discussed audit results with key officials from the Division of Liquidation, headquarters, San Francisco Regional Office, and the Denver Consolidated Office. We interviewed asset marketing officials and one section chief responsible for bulk sales and manual loan file maintenance, respectively. Account officers were interviewed to discuss manual loan file procedures and the sale verification process. We also discussed accounting record problems with the field accountant in the Division of Accounting and Corporate Services in Denver. Finally, we discussed all legal matters pertaining to the loans in our review with attorneys in Denver's Legal Division.

We requested and received official oral comments on a draft of this report from senior officials of FDIC's Division of Liquidation. We incorporated their comments as appropriate.

Our work was performed in accordance with generally accepted government accounting standards.

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