



Testimony

Before the Committee on Banking,
Housing, and Urban Affairs
United States Senate

Lessons Learned from the Financial Crisis Regarding Community Banks

**Statement of Jon T. Rymer
Inspector General
Federal Deposit Insurance Corporation**

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Chairman Johnson, Ranking Member Crapo, and Members of the Committee:

Thank you for the opportunity to testify in today's hearing on the lessons learned from the financial crisis related to community banks. As you requested, I will focus on the broad and comprehensive study, required by Public Law 112-88, that the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) conducted on the impact of the failure of insured depository institutions during the recent financial crisis. Specifically, I will summarize the study's general observations, findings, conclusions, and recommendations contained in the report, *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (Report No. EVAL-13-002, dated January 3, 2013). In addition, I will highlight some of the work my office has completed over the last 5 years that could contribute to the Committee's "lessons learned" discussion.

The OIG is an independent office within the FDIC, established to conduct audits, investigations, and other reviews to prevent and detect waste, fraud, and abuse relating to the programs and operations of the FDIC, and to improve the efficiency and effectiveness of those programs and operations. I was appointed as the Inspector General of the FDIC by President Bush, and confirmed by the Senate in June 2006.

Through its audits, evaluations, and other reviews, my office provides oversight of FDIC programs and operations. Our work is either required by law or self-initiated based on our assessment of various risks confronting the FDIC. Our audits, evaluations, and other reviews assess such areas as program effectiveness, adequacy of internal controls, and compliance with statutory requirements and corporate policies and procedures. We perform our work using internally available resources, supplemented by contracts with independent public accounting firms when expertise in a particular area is needed or when internal resources are not available. Our work, as well as that of our contractors, is performed in accordance with standards applicable to federal audit, evaluation, and investigative entities.

Before I discuss the study's high-level observations and resulting recommendations, and to provide helpful context, I will briefly describe the regulatory framework and the individual regulator responsibilities for overseeing insured depository institutions and resolving those institutions when they fail.

Regulatory Framework and Regulator Responsibilities

In the wake of the savings and loan and banking crisis of the 1980s, the Congress passed two laws that drove the closure and resolution decisions we witnessed in this most recent crisis. These laws were the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the FDIC Improvement Act of 1991. Taken together, these laws amended the Federal Deposit

Insurance (FDI) Act to require, among other things, that (1) institutions maintain minimum capital levels and the chartering regulator promptly close critically undercapitalized institutions through prompt corrective action provisions, (2) the FDIC resolve banks in the least costly manner, and (3) the FDIC maximize recoveries from failed institutions. The FDI Act also placed requirements on how the regulators examine institutions, including establishing minimum examination frequency requirements, requiring the agencies to establish standards for safety and soundness, and requiring the agencies to establish appraisal standards. In response, the FDIC and the other regulators issued implementing regulations and policy statements pertaining to many of the topics discussed in our report.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the FDIC oversee the nation's insured depository institutions to ensure they operate in a safe and sound manner. The OCC supervises national banks, the FRB supervises state-chartered banks that are members of the Federal Reserve System and bank holding companies, and the FDIC supervises state-chartered banks that are not members of the Federal Reserve System (state nonmember banks). The FDIC has additional responsibilities for insuring deposits, effectively resolving failed institutions, and maximizing the recovery of receivership assets.

In examining insured depository institutions, the regulators assess the condition of institutions through off-site monitoring and on-site examinations, and have longstanding policies for reviewing an institution's lending and loan review functions, assessing capital adequacy, and recommending improvements, if needed. When regulators determine that an institution's condition is less than satisfactory, they may take a variety of supervisory actions, including informal and formal enforcement actions, to address identified deficiencies. Each regulator has somewhat different approaches to enforcement actions.

Should an institution's condition decline to a point that it becomes *Critically Undercapitalized*, the chartering regulator (a state banking authority or the OCC) is generally required by law to promptly close institutions that cannot be recapitalized. The FDIC is required by law to resolve failing institutions in the least costly manner.

Study Results—Observations, Findings, and Conclusions

The financial crisis had devastating impacts on the banking industry, businesses, communities, and consumers. At the time of our review, over 400 institutions had failed and some of the country's largest institutions had required government intervention to remain solvent. Commercial real estate (CRE) collateral values had fallen by more than 42 percent. Construction starts remained partially complete and continued to detract from the quality of neighborhoods and home values. Trillions of dollars of household wealth had vanished, and almost 18 million loans had faced foreclosure since 2007. Unemployment peaked at 10 percent in October 2009 and remained stubbornly high at the time of our study.

Events leading to the financial crisis and subsequent efforts to resolve it involved the dynamic interrelationship of laws passed by the Congress, regulatory rules, and agency-specific policies and practices with the real estate and financial markets in ways that are continuing to play out. In that regard, our study indicated the following:

- The markets drove behaviors that were not always prudent. Banks expanded lending to keep pace with rapid growth in construction and real estate development, rising mortgage demands, and increased competition. Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and controls. For their part, many borrowers who engaged in commercial or residential lending arrangements did not always have the capacity to repay loans and pursued many construction projects without properly considering the risks involved. Ultimately, these loans created significant losses for the institutions involved and often left the FDIC with the challenge of managing and disposing of troubled assets.
- In response to unprecedented circumstances, the regulators generally fulfilled their supervisory and resolution responsibilities as defined by statutes, regulations, accounting standards, and interagency guidance in place at the time. In addition, the regulators reacted to a rapidly changing economic and financial landscape by establishing and revising supervisory policies and procedures to address key risks facing the industry. While not a focus of this study, our report does acknowledge, however, material loss review findings that showed the FRB, OCC, and FDIC could have provided earlier and greater supervisory attention to troubled institutions that ultimately failed. For its part, among other initiatives associated with resolutions, the FDIC reinstated the use of shared loss agreements (SLA) with acquiring institutions and took steps to promote private capital investments in failing institutions.

In our report, we provided a detailed presentation of our findings and conclusions for each of the topics under the law's eight matters. These matters include (1) SLAs, (2) significance of losses at institutions that failed, (3) examiner implementation of appraisal guidelines, (4) examiner assessment of capital adequacy and private capital investment in failing institutions, (5) examiner implementation of loan workout guidance, (6) application and impact of formal enforcement orders, (7) impact of FDIC policies on investments in institutions, and (8) the FDIC's handling of private equity company investments in institutions. In addressing these matters, we also made the following observations:

- The FDIC's resolution methods—including the SLAs that we studied—were market-driven. Often, failing banks with little or no franchise value and poor asset quality did not attract sufficient interest from viable bidders to enable the FDIC to sell the banks without a loss-share guarantee. The FDIC used SLAs to keep failed bank assets in the banking sector, support failed bank asset values, and preserve the solvency of the Deposit Insurance Fund (DIF). The FDIC has established controls over its SLA monitoring program, which help protect the FDIC's interests, promote loan modifications, and require equal treatment of SLA and legacy loans. We did find, however, that the FDIC should place additional emphasis on monitoring commercial loan extension decisions to ensure that acquiring institutions do not inappropriately reject loan modification requests as SLAs approach termination. In addition, we concluded that the FDIC needed to formulate a better strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF so that the FDIC will be prepared to address the potentially significant volume of asset sale requests.

- The majority of community banks failed as a result of aggressive growth, asset concentrations, poor underwriting, and deficient credit administration coupled with declining real estate values. These factors led to write-downs and charge-offs on delinquent and non-performing real estate loans as opposed to examiner-required write-downs or fair value accounting losses.
- The regulators have longstanding policies for classifying problem assets, monitoring appraisal programs, assessing capital adequacy, evaluating CRE loan workouts, and administering enforcement actions, when warranted. The regulators also have processes and controls, training programs, and job aids to help ensure examiner compliance and consistency. We found that examiners generally followed relevant policies and implemented them appropriately. For example, examiners usually did not classify as loss loans that the institution claimed were paying as agreed without justification, nor did they question or reduce the appraised values of assets securing such loans. However, examiners did not always document the procedures and steps that they performed to assess institutions' appraisal and workout programs. We also noted that the regulators had different approaches to enforcement actions, particularly related to non-problem banks.
- The FDIC has investment-related policies in place to protect the DIF and to ensure the character and fitness of potential investors. These policies are largely based in statute. By their nature, such policies are going to have an impact on investments in institutions. The FDIC approved most change-in-control and merger applications, although approval rates were lower for states such as California, Florida, and Nevada that were heavily impacted by the financial crisis. The FDIC has policies and procedures for certain aspects of the review of private capital investors, and the FDIC generally followed those policies. Purchases of failed institutions by private capital investors accounted for 10 percent of total failed bank assets acquired. Finally, we identified instances where the FDIC did not accept proposed open bank investments and instead closed an institution. However, in each case, we found that the FDIC identified concerns with the proposed investment related to safety and soundness issues, proposed management, or proposed business plans, or determined that the proposed transaction would not present the least loss option to the DIF.

Recommendations

While the regulators generally implemented their policies appropriately, our study identified certain areas for improvement and issues warranting management attention. In the interest of strengthening the effectiveness of certain supervisory activities and helping ensure the success of the FDIC's ongoing resolution efforts, we made seven recommendations. Five were addressed specifically to the FDIC and two were directed to the three regulators. These recommendations, which the regulators concurred with and proposed actions that adequately addressed the recommendations' intent, involved the following areas:

- **SLA Program.** We made recommendations related to developing additional controls for monitoring acquiring institutions' commercial loan modification efforts and developing a more formal strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF.

- **Appraisals and Workouts.** We made several recommendations related to clarifying how examiners should review institutions' appraisal programs and strengthening examiner documentation requirements to more clearly define examination methodologies and procedures performed to assess institutions' appraisal and workout programs. These recommendations should help to assure agency management that examiners are consistently applying relevant guidance.
- **Enforcement Orders.** We recommended that the regulators study differences between the types of enforcement actions that are used by the regulators and the timing of such actions to determine whether there are certain approaches that have proven to be more effective in mitigating risk and correcting deficiencies that should be implemented by all three regulators.

Study Approach

Signed into law on January 3, 2012, Public Law 112-88 required my office to conduct this study and submit a report to the Congress not later than 1 year after the date of enactment. The legislation required my office to conduct work at the FDIC, OCC, and FRB, and as required, our scope included open and failed state member, state nonmember, and national banks. Our scope did not include institutions formerly regulated by the Office of Thrift Supervision. Our review timeframes generally covered a 4-year period (i.e., 2008 through 2011).

My office performed work at three FDIC regions, three OCC regions, eight reserve bank districts, and selected state banking agencies. In conducting our work, we

- Interviewed agency officials and bank examiners, representatives at open banks, investment bankers, and compliance contractors;
- Reviewed relevant policies and guidance;
- Reviewed examination reports, working papers, material loss review reports, and documentation supporting loan workouts and enforcements orders;
- Analyzed institution financial data and agency enforcement action statistics; and
- Surveyed borrowers of failed institutions.

We conducted our work from January 2012 through October 2012, in accordance with the Council of the Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation. KPMG LLP assisted us with several areas of review. We also coordinated with the U.S. Government Accountability Office as that office conducted its work pursuant to Public Law 112-88.

Other OIG Work

As the Committee continues the discussion of the financial crisis and possible "lessons learned," I wanted to highlight some of the other work my office has completed. Over the last 5 years, my office was heavily involved in the efforts to explain what happened during the financial crisis. The following is a brief snapshot of this work.

During the financial crisis, my audit and evaluation staff was dedicated to conducting reviews of the FDIC-supervised banks that failed, and providing feedback to the FDIC to assist the Corporation in improving its bank supervision program. As required by section 38(k) of the FDI Act, and amended by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act), my office, along with our fellow financial regulatory OIGs, was required, at some level, to review the 484 institutions that failed during the crisis. To date, we have issued 107 reports that take a comprehensive look at why the failed bank caused a material loss to the DIF and provide an assessment of the FDIC's supervision of that bank. Since the Dodd-Frank Act amended the FDI Act, my office has also performed 166 failed bank reviews, where the failure was below a certain loss threshold and no unusual circumstances existed to warrant a more in-depth review of the loss.

In a separate report, *Follow-up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), issued in December 2010, we examined the supervisory actions the FDIC had taken in response to an internal memorandum we issued in May 2009, which outlined major causes, trends, and common characteristics of the eight banks failures we had reviewed to date, and identified new trends and issues that emerged from our reviews of subsequent failures. Our January 2013 study further supported the existence of these trends and issues, which included concentrated assets in the CRE and acquisition, development, and construction (ADC) loan portfolios, inadequate risk management practices for loan underwriting and credit administration, and reliance on volatile funding sources to support growth.

In October 2012, my office issued a report, *Acquisition, Development, and Construction Loan Concentration Study* (Report No. EVAL-13-001), detailing our evaluation of FDIC-supervised institutions with significant ADC loan concentrations that did not fail during the economic downturn. We studied the characteristics and supervisory approaches for these institutions and identified the factors that helped them mitigate the risks associated with ADC concentrations during periods of economic stress. Our findings were not surprising, in that they confirmed what regulators have been saying are the ingredients for a strong bank—a well-informed Board, strong management, controlled growth, sound credit administration and underwriting, and adequate capital. We also observed that surviving banks were responsive to supervisory actions and guidance and maintained or secured capital needed to absorb losses in response to regulatory demands.

My office also teamed up with the other bank regulatory OIGs and evaluated prompt regulatory action, as described in sections 38 and 39 of the FDI Act. The OIGs from the FDIC, FRB and Department of the Treasury issued a comprehensive joint report in September 2011, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which discussed the use and impact of prompt corrective action (PCA) and the safety and soundness standards during the crisis. We found that PCA occurred too late to rehabilitate most troubled institutions and while critically undercapitalized institutions were closed promptly, failure losses were still significant. We recommended the regulators consider several options for strengthening the prompt regulatory action provisions.

The reports noted above are available on our Web site, www.fdicig.gov.

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This concludes my prepared statement. Thank you for the opportunity to discuss the work of the FDIC OIG. I will be pleased to answer any questions that you may have.