Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226 Office of Inspector General

February 12, 2013

David Baris, Executive Director
American Association of Bank Directors
1250 24th Street, NW, Suite 700
Washington, D.C. 20037

Dear Mr. Baris:

The January 23, 2013 Summary Report of the American Association of Bank Directors regarding Material Loss Reviews of Failed Banks by the Offices of Inspector General (OIG) of the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, and Department of the Treasury reflects a significant misunderstanding of both the nature of our work and the standards to which we are held, and oversimplifies the results of the FDIC OIG's work.

The Nature of Our Work and Compliance with Auditing Standards

From 2007 through 2012, we performed 92 Material Loss Reviews (MLR).[1] As stated in each of our reports, we conducted the MLRs in accordance with Generally Accepted Government Auditing Standards (GAGAS) promulgated by the U.S. Government Accountability Office. Generally speaking, we plan and conduct the MLRs as performance audits, and in so doing, obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on the audit objectives defined by Section 38(k) of the Federal Deposit Insurance Act (FDI Act). An independent peer review conducted during this period confirmed our compliance with those standards. We received a peer review rating of "pass" for the system of quality control in effect for the year ended March 31, 2010. Five of the eight audit reports selected for review during that peer review were MLRs. Since that time, our reports, including several MLRs, have been subject to internal quality assurance reviews—a process validated by the peer review itself—to ensure that adequate controls over audit quality were maintained.

The principal basis for your conclusion regarding our MLRs appears to be that our evidence does not include direct input from former directors and officers of the failed institution, and that our reports do not reflect the directors' or banks' responses to examiner concerns. In our opinion, these concerns are unfounded. Specifically, GAGAS requires that auditors obtain and report the views of responsible officials of the *audited entity* concerning the findings, conclusions, and recommendations included in the audit report, as well as any planned corrective actions. Section 38(k) of the FDI Act requires that we report on the FDIC's supervision of the failed institution, including implementation of the prompt corrective action provisions of the Act, and why the institution's problems caused a material loss to the Deposit Insurance Fund (DIF). The statute

[1] We also performed 12 in-depth reviews of bank failures for which the loss to the Deposit Insurance Fund was lower than the threshold requiring an MLR, consistent with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

clearly establishes the FDIC as the audited entity, and, therefore, we obtain and report the views of FDIC officials in our MLR reports.

Nevertheless, consistent with GAGAS, to ensure that our findings are reported in the proper context, we generally perform the following steps to obtain an understanding of the views and actions of former directors and officers of a failed bank in each MLR:

- We read and consider correspondence from the bank's senior management and board describing their concerns and reactions to the FDIC's supervisory findings and activities.
- We review contemporaneous notes from examination exit conferences and meetings with senior management and board members.
- We interview federal and state examiners about disagreements with bank management and the board, their responsiveness to examination findings and results, and determine how such disagreements were addressed.
- We review the bank's strategic and operating plans, press releases, Securities and Exchange Commission filings, and other documentary evidence obtained directly from the records of the institution, such as minutes of board of directors and committee meetings, to gain an understanding of the business goals and objectives of the board and senior management.

In our professional judgment, the evidence we obtain through this methodology is appropriate and sufficient for the purposes of our work, and is the most reliable evidence available to us, consistent with our objectives. In that regard, GAGAS indicates that evidence obtained through direct physical examination, observation, computation, and inspection is ordinarily more reliable than evidence obtained indirectly—such as through a third party who has a direct interest in the matter being reviewed.

GAGAS also suggests that, when investigations or legal proceedings are initiated or in process, auditors should evaluate whether their work may interfere with those investigations or proceedings, or conversely whether those matters have an effect on the audit. The statutory 6-month time frame for completion of an MLR often is coincident with the commencement of investigations by a variety of authorities following the failure of a financial institution, and this timing also plays a role in our decision not to interview directors or former officers of failed institutions.

Characterization of Our MLR Findings

The "one constant" of our reports that your report identifies – that "bank failure was always the fault of the board of directors of the failed bank" – oversimplifies our findings related to the causes of failure. We found that concentrations in commercial real estate and acquisition, development, and construction loans, coupled with inadequate risk management practices, played a role in the vast majority of failures that were the subject of an MLR. In most instances, we found that bank management generally failed to implement an adequate risk management framework appropriate for the asset level and nature of the asset concentrations. The MLRs often found that failed institutions were overly reliant on non-core funding sources, particularly

brokered deposits, to achieve rapid asset growth, and that the extent of this funding often significantly and consistently exceeded the bank's peer group. We also found that in many instances, failed institutions had developed large borrowing relationships or individual concentrations that resulted in substantial losses to the DIF, without implementing adequate risk management controls to mitigate those risks, and had frequently exceeded legal lending limits. We noted significant losses associated with purchased participation loans and security investments.

Further, our MLRs often found situations in which the FDIC's reports of examination indicated high-risk activities on the part of the failed institution without adequate corresponding controls and oversight, and we concluded that earlier and more aggressive action by the supervisor was warranted. We criticized reports of examination that did not adequately acknowledge the severity of deficiencies and violations. In response to these findings, the FDIC has taken or planned to take numerous actions to address issues identified in our MLRs to enhance its supervisory program. Specifically, the FDIC has

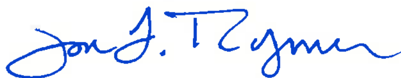
- Emphasized a forward-looking supervisory approach, embodied in a comprehensive training program and various guidance.
- Implemented a post-MLR assessment process to identify lessons learned from bank failures and conclusions included in our MLR final reports and solicit input from FDIC examination staff regarding suggested changes to policies and procedures.
- Identified best practices relating to the FDIC's examination program.
- Enhanced offsite monitoring activities.
- Enhanced coordination between its risk management and compliance examination functions.
- Improved coordination for charter conversions.
- Worked with the other federal regulatory agencies to implement a new agreement associated with the FDIC's backup examination authority.

Our MLRs thus paint a portrait of the complex economic, business, and supervisory environment in which failed institutions operated, often for many years prior to their failure. The simple fact, however, is that the boards of directors of these institutions ultimately were responsible for the strategies that the institutions pursued. The FDIC takes the position that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and making business decisions on the basis of fully informed and meaningful deliberation. Where sufficient and appropriate evidence led us to conclude that the board of a failed institution did not discharge one or more of these responsibilities, and that the action or inaction of the board contributed to the eventual loss to the DIF resulting from the institution's failure, we would be remiss in not noting this in our reports. Our reports also describe cases in which the board diligently tried to rectify the operations of a problem bank, including bringing in new management, although those efforts ultimately proved unsuccessful in saving the institution.

To provide a different perspective than MLRs, we also conducted a study that addressed the factors that enabled financial institutions with very large ADC concentrations to survive during the financial crisis. Our resulting report is entitled *Acquisition, Development, and Construction Loan Concentration Study*, (Report No. Eval-13-001). We found that boards and management with conservative or moderate risk appetites that implemented key elements of the risk management framework that regulators said were needed to manage ADC concentrations were more successful during the crisis. We also studied institutions that received very low CAMELS ratings due to their portfolios, but that did not ultimately fail during the crisis. We found that the supervisory approach and level of supervisory attention for these "turn-around banks" were generally consistent with the FDIC's supervisory practices and policies and similar to the approach for banks that ultimately failed. That is, as economic conditions declined and banks' financial condition began to weaken, the FDIC's supervisory attention increased and supervisory actions were pursued. However, we observed that the approach yielded a better outcome – stable or improved examination ratings – because turn-around banks were responsive to supervisory actions and guidance, and maintained or secured capital needed to absorb losses in response to regulatory demands.

We are confident that the procedures we employ in conducting our MLRs fully comply with GAGAS and, by extension, address the themes emanating from your recommendations. We will continue to implement a system of quality control to ensure that MLR findings and conclusions remain accurate, objective and complete.

Sincerely,



Jon T. Rymer
Inspector General