SUMMARY REPORT ON MATERIAL LOSS REVIEWS

AMERICAN ASSOCIATION OF BANK DIRECTORS

January 29, 2013

David Baris
Executive Director
American Association of Bank Directors
1250 24th Street, NW
Suite 700
Washington, DC 20037
(202) 463-4888
(202) 349-8080 (fax)
dbaris@aabd.org
www.aabd.org

Material Loss Reviews of failed banks by the Office of Inspectors General of the FDIC, Federal Reserve Board and U.S. Treasury

Are bank failures really always the fault of bank directors?

A Summary Report of the American Association of Bank Directors

David Baris
Executive Director

In reviewing a representative sample of Material Loss Reviews of failed banks conducted by the Office of Inspectors General of the FDIC, Federal Reserve Board, and the Department of Treasury ("MLRs"), the American Association of Bank Directors ("AABD") has concluded that there is at least one constant – the bank failure was **always** the fault of the board of directors of the failed bank.

Can that really be true? AABD is not in a position to make that judgment. But a reading of the sampled MLRs suggests that they are a flawed record of what actually happened and, therefore, should not be relied on to conclude that a bank failed because of its board of directors.

It is very important that MLRs produce an accurate and complete record of why a bank failed. That is what Congress has directed the Inspectors General to do. See Section 38(k) of the Federal Deposit Insurance Act. Section 38(k) requires the appropriate Inspector General ("IG") to "ascertain why the institution's problems resulted in material loss in the Deposit Insurance Fund" and requires every MLR to be made public and reported to Congress and others. The Government Accountability Office ("GAO") is charged with the responsibility of recommending improvements in supervision of insured depository institutions based on its review of MLRs.

There is reliance on the veracity of MLRs by Congress, its committees, the FDIC as receiver when it decides whether to sue a director or officer of a failed bank, and by others in in the federal banking agencies and other government agencies. For example, the FDIC's Office of Inspector General's January 2013 Report to the Congress entitled "Comprehensive Study on the Impact of the Failure of Insured Depository Institutions" acknowledged Material Loss Review findings. The GAO's January 2013 Report to Congressional Committees on "Causes of Consequences of Recent Bank Failures" based its report in part on its review of Material Loss Reviews. Representatives of the federal banking agencies have based their testimony before congressional committees on Material Loss Review findings. See, for example, the Statement of Marc Steckel, Associate Director, Division of Insurance and Research, FDIC, on Executive Compensation Oversight, before the House Committee on Financial Services, September 24, 2010. Findings from MLRs have been referenced in prefatory material to proposed and final regulations of the federal banking agencies, clearly indicating that MLRs were relied on in proposing or adopting regulations.

The performance audits performed by the IG offices in preparing MLRs are conducted in accordance with generally accepted government auditing standards. Those standards require that the IG office plan and perform the audit "to obtain sufficient, appropriate evidence to provide a reasonable basis for its findings and conclusions based on its audit objectives."

It is also important to directors and officers of failed banks not to be unjustly and unfairly accused in public of having caused a bank to fail.

AABD has the following concerns with the MLRs that it reviewed:

- **No input from former directors and officers of the failed bank.** The MLRs state that the staff of each IG interviewed the staff of the agency or agencies that conducted the examinations of the failed bank but never state that they interviewed any of the former directors and officers of the failed bank. The MLRs do not state that the IG staff made any effort to invite the former directors and officers to be interviewed. The lack of input from former directors and officers of the failed bank raise the question whether the IG obtained "sufficient, appropriate evidence to provide a reasonable basis for its findings and conclusions…"
- **No comments on the draft MLRs from former directors and officers of the failed bank.** The MLRs state that the agencies having responsibility over the examinations of the failed bank had an opportunity to review the draft report. The MLRs attach the letters from those agencies. The MLRs do not state whether directors and senior management of the failed bank had an opportunity to comment on the draft report or were even allowed to review the draft report, and the MLRs reflect no such comments or comments received in connection with the MLR.
- **Little apparent attention paid to bank responses to reports of examination.** The MLRs state that the IG staff reviewed the reports of examination of the agencies that conducted the examinations of the failed bank and the correspondence file of the agencies, but only rarely acknowledge a review of responses by the bank's board of directors and management to the reports of examination or bank disagreements with the findings in the reports of examination.
- **Whenever there was disagreement between the bank and the examiners, the examiners were right.** In those few instances where the MLRs reflect disagreement by the board or management of the bank with the findings in the reports of examination, the MLRs always assume that the agencies were right and the board and management were wrong.
- **Disagreements by the board or management with the findings in the reports of examination were sometimes characterized negatively.** In some cases, the MLRs use the disagreement of the board or management of the bank with the findings in the reports of examination as evidence of lack of cooperation and unwillingness to take corrective action rather than a good faith statement that they believed that certain findings of the reports of examination were not correct.

- **“High-risk” strategies were often not viewed as such by contemporaneous examinations.** The MLRs repeatedly refer to the strategies adopted by the board of directors and management as “high-risk” with the implication that the board and management knew that the strategies were high-risk at the time they were adopted and implemented. Yet during the early and mid- 2000s when the strategies were being adopted and implemented, bank examiners themselves did not typically identify the strategies as high-risk and instead rated the banks as CAMELS composite “2”s and even”1”s. It was not until late 2007, 2008 or even later, when residential real estate values started to decline precipitously and substantial losses began to be realized by banks did the bank examiners begin to lower CAMELS composite and component ratings and criticize boards and management substantially for lax credit underwriting and credit administration practices. A December 2012 report by Cornerstone Research based on a review of 36 MLRs (out of 40) of banks whose boards or management had been sued by the FDIC concluded that 86% of the failed banks had CAMELS “2” or “1” composite ratings and 75% of them had management component ratings of “2” or “1” two years prior to closing.
- **The worsening economy was viewed as a condition, not a cause of the bank failure.** The worsening economy and plummeting residential real estate values are mentioned in many of the MLRs, but more as an afterthought or condition and not typically as a cause of the bank failure.
- **The failed bank’s local economy is often mentioned but is not often described in detail to reflect the severity of the downturn and its effect on the bank.** The MLRs seldom reflect the dramatic impact that the unanticipated rapidly declining local, regional and national economy and residential real estate prices had on the community banks that failed. Some local markets experienced precipitous residential real estate price declines of 60-70%. From the height of residential real estate prices in mid-2006 through the third quarter of 2011, the average national decline was about one-third. The prices in some markets fell even more precipitously. From the third quarter of 2007 through the third quarter of 2010, many of the areas hardest hit by the real estate crash saw a substantial number of bank failures: Orlando experienced a 46.7% decline in real estate values, Sacramento, a 38.0% decline, and Tucson, a 33.0% decline.
- **The findings in the reports of examination prepared after the losses mounted were always assumed to be right.** Many of the MLRs point out that as the banks’ losses began to mount in 2007 and successive years, the reports of examination became more critical and identified purported credit administration and underwriting deficiencies and violations of law and regulation that had not been previously identified or were identified in passing. AABD found in every MLR reviewed that the MLR assumed that the later findings were correct and the earlier findings were incorrect or were somehow deficient.

This AABD Report makes the following recommendations to the IG's Office of the FDIC, Federal Reserve Board and Treasury:

- **Interview former directors and senior management of the closed bank.** Prior to drafting an MLR, provide each board members and member of senior management of the failed bank an opportunity to review all relevant bank and banking agency documents thoroughly, and then be interviewed.
- **Let former directors and senior management of the closed bank review and comment on the draft MLR report.** Provide an opportunity to each member of the board and member of senior management of the failed bank to review and comment on the draft MLR report.
- **The MLRs should reflect the views of former board and management.** Reflect the views of each member of the board and member of senior management in the final MLR, including any letters of comment.
- **Post comments from former directors and senior management on issued MLRs.** Offer the opportunity to each member of the board and senior management of failed banks which have been the subject of a final MLR to comment publicly on the MLR, and publish and post the comments on each of the IG websites.
- **Reflect the full effects of the local economy on the losses suffered by failed bank.** Future MLRs should reflect the dominant role that the economy played in the failures of many community banks.
- **Don't assume that the examiners were wrong in 2004-2008 and right beginning in 2007 or 2008.** Future MLRs should not assume that the later criticisms of the board and management starting in late 2007 and 2008 were correct and that the earlier assessments of the bank, board and management were incorrect. Loan losses do not always connote management or board deficiencies.
- **Maybe boards of directors of all failed banks didn't cause their bank to fail.** Future MLRs should not assume that boards of directors and senior management always caused their banks to fail.

Founded in 1989, the non-profit American Association of Bank Directors is the only trade group in the United States solely devoted to bank directors and their information, education, and advocacy needs. AABD recently established the Bank Director Liability Resource Center, which acts as a clearinghouse for developments in bank director liability, including lawsuits by FDIC against directors of failed banks and savings institutions. The Institute for Bank Director Education, established in 1993 as the educational arm of AABD, acts as a clearinghouse for education programs designed for bank and savings institution directors that support the nationally recognized Director Certification Program. Visit AABD online at: http://www.aabd.org.

Copyright © American Association of Bank Directors 2013