

In Reports on Failures, Regulators Also Fail

Inspectors general consistently find agencies slow to act

American Banker | Wednesday, April 15, 2009

By Joe Adler

WASHINGTON — While policymakers are focused on giving regulators more power to oversee financial institutions, a growing list of government watchdog reports suggest the banking agencies have failed to effectively use the powers they already have.

The inspectors general at the Treasury Department and the Federal Deposit Insurance Corp. have issued nine reports on recent failures since April 2008 — and all of them say pretty much the same thing. Though bank examiners saw clear warnings that lenders were taking dangerous risks during the real estate boom, they were not aggressive enough in forcing changes at institutions.

The reports, which cut across the banking and thrift regulators, said institutions routinely kept high supervisory ratings long after examiners first expressed concerns, and that the agencies issued formal enforcement actions too late to be effective.

"Overall, the regulators were slow to react," Marla Freedman, an assistant Treasury inspector general, said in an interview. "They saw these issues, but didn't take aggressive action to deter or prevent them."

The reports, which are required whenever a failure is estimated to cost the Deposit Insurance Fund at least \$25 million, have proliferated as bank collapses have multiplied.

The Treasury's inspector general, which issues reports for thrifts and national banks, has released four reports to date, and has seven more in process. The FDIC inspector general has completed five reports and is working on 19 more, while the inspector general for the Federal Reserve Board, which has not released any reports in the past year, is working on two.

Some former regulators criticize the reports, saying hindsight always makes it easier to pinpoint what went wrong. They argue that the IGs favor formal actions over informal enforcement measures, which they claim are often more effective. "What the IGs are

doing is ... somewhat simplistic, saying as soon as you see anything, take a formal enforcement action or lower their rating. That can be detrimental to a bank that's working its way out of its problems," said Nicholas Ketcha Jr., a former director of supervision at the FDIC and now a bank consultant at FinPro Inc.

But many observers also view the IG reports as a critical guide to what went wrong — and as a way to alert examiners to problems.

Alan White, an assistant law professor at Valparaiso University, said the Treasury IG report on Superior Bank of Hinsdale, Ill., which failed in 2001 amid heavy subprime losses, should have signaled examiners about the crisis ahead. "That had all kinds of warning flags about relying heavily on subprime lending," White said. "It should have been used to train examiners in the 2005-to-2007 era."

Recent reports underline a mind-set during the real estate boom that profits would continue unabated, removing an immediate need to fix visible loan deterioration, White said.

"When things are good, and you're getting to the end of a cycle where things are going to get really bad, there's a tendency to believe that they'll just remain good, and regulation gets lax when it should get tough," he said.

Overall, the reports paint a picture of weak supervision at banks and thrifts of all sizes. Though most of the blame is usually pointed at the institution itself, in every report the inspectors general said examiners identified red flags about the risks institutions were taking as early as 2005 or 2006. Those concerns did not result in aggressive action until 2007 or 2008.

The most high-profile failure captured by a report so far was that of the \$30 billion-asset IndyMac Bank of California in July of last year. The Treasury IG report, issued in February of this year, found that Office of Thrift Supervision identified numerous problems at the thrift, including the "quantity and poor quality of nontraditional mortgage products," but did nothing to stop those practices.

The agency did not take any enforcement action until June — a month before the thrift's failure — and did not downgrade IndyMac's rating until early last year, only after the thrift recorded substantial losses.

Though an extreme case, other reports found similar problems with institutions overseen by the Office of the Comptroller of the Currency and the FDIC.

In a report last month, the Treasury IG criticized the OCC after it uncovered problems at two subsidiaries of First National Bank Holding Co. of Scottsdale, Ariz., in 2002 but did not take enforcement actions until last year. Exams from 2004 to 2006 cited chronic problems, but the OCC maintained Camels ratings at 2.

Similarly, several FDIC inspector general reports have criticized the regulator for failing to take action sooner. The most recent, on the failure of Silver State Bank in Henderson, Nev., said the FDIC raised concerns about the bank's risky strategies as early as 2005, but it did not lower its supervisory rating until July 2008.

(The largest failure in American history, that of the \$307 billion-asset Washington Mutual Inc. last year, is not the subject of a report because it is not expected to cost the DIF any money.)

In most cases the regulators do not dispute the IG's finding, acknowledging they should have moved faster. Commenting on a February report about the August failure of the \$241 million-asset First Priority Bank in Florida, Sandra Thompson, the head of the FDIC's supervision division, wrote in response to the inspector general: "We agree, in hindsight, with the OIG's assessment that credit administration deficiencies identified by examiners should have warranted supervisory action at the 2006 examination."

But some former regulators argue that the reports do more harm than good, by second-guessing the subjective judgements of regulators, and emphasizing formal actions no matter what the condition of the bank.

E. Wayne Rushton, formerly the OCC's chief national bank examiner, said the reports do not reflect the regulators' successes using a more subjective approach.

"A public order requiring a bank to raise new capital or do other things that the public thinks they are incapable of doing can thrust the bank into a vortex from which it can't pull out," said Rushton, a managing director at Promontory Financial Group. "The agencies naturally are reluctant to pull that trigger."

But Freedman, of the Treasury IG, does not buy that argument. While acknowledging the need for discretion, she said the reports are clear evidence regulators have not moved aggressively enough.

"With a lot of these, they were staring them right in the face, and they didn't do a thing about it," she said. "In most of our reports, there were things that we saw in" examiners' work papers "that did not get elevated to the" final report of examination.

"Action was not taken when it was suggested by the examiners," she said.

And though some agency supporters said the regulators should not overreact to the reports, White said if the reports prove anything it is this: the status quo should not stand. "If you think the solution to the crisis is: Keep doing what we did and continue bad underwriting because we need to make credit available, that's not a solution either," he said.