Report To The Chairman Of The Federal Home Loan Bank Board

Formal Supervisory Process For Savings And Loan Associations Should Be Strengthened.

Supervisory agreements and cease and desist orders are two formal enforcement tools used by the Federal Home Loan Bank Board to supervise savings and loan institutions with federally insured deposits.

This report discusses the reluctance of supervisory personnel to fully use these formal enforcement tools because of their long processing times. Instead, supervisory personnel place greater reliance on informal actions that may not be sufficient to achieve corrective action.

In addition, the Federal Home Loan Bank Board has spent State examiner training program funds to train examiners from States which do not contribute to the program objective of reducing the Federal examination burden. For instance, examiners were trained from States which refuse to share in the examinations of federally insured, State-chartered savings and loan associations. GAO recommends action to improve the administration of the State examiner training program and the processing of formal supervisory actions.
Dear Mr. Pratt:

This report summarizes the results of our review of the operations of the Office of Examinations and Supervision and recommends specific actions which we believe will enhance that Office's ability to examine and supervise savings and loan associations.

This report contains recommendations to you on pages 26, 27, and 35. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We are providing copies of this report to the Director, Office of Examinations and Supervision, and the Director, Internal Evaluation and Compliance Office. In addition, we will provide copies to the House and Senate Committees on Appropriations, the House Committee on Government Operations, the House Committee on Banking, Finance and Urban Affairs, the Senate Committee on Governmental Affairs, and the Senate Committee on Banking, Housing and Urban Affairs.

Sincerely yours,

William J. Anderson
Director
Despite an increase in the number of savings and loan associations that are of supervisory concern to the Federal Home Loan Bank Board, the use of formal supervisory actions has declined. Reasons for this decline include the ambiguity of Board policy, untimely processing of formal actions, and the indecisiveness of supervisory personnel. (See ch. 2.)

The State examiner training program is not adequately controlled and administered by the Federal Home Loan Bank Board. The program is not linked to the Board's goals and is not fulfilling the intent of the Congress. (See ch. 3.)

The Federal Home Loan Bank Board's principal objectives are to increase the availability of financial resources for home ownership and to protect depositors who are the main source of these resources. To meet these objectives, the Federal Home Loan Bank Board examines and supervises the 4,105 savings and loan associations that have deposits insured by the Federal Savings and Loan Insurance Corporation. (See ch. 1.)

The Federal Home Loan Bank system consists of 12 District banks and their member institutions. The banks are owned by, and serve as central credit banks for, the member institutions. In addition to savings and loan associations, member institutions include 142 savings banks and 2 insurance companies. (See p. 2.)

The Office of Examinations and Supervision conducts periodic examinations of the member institutions and is principally responsible for the supervision of the members. (See p. 4.) In addition, this Office provides
training to State examiners with the con-
gressional goal of using State examination
reports in lieu of Federal reports for
State-chartered, federally insured asso-
ciations. (See p. 28.)

Although primarily responsible for the super-
vision of member institutions, the Office of
Examinations and Supervision does not super-
vide the members directly. Officers of the
12 Federal Home Loan Banks, who are desig-
nated supervisory agents, represent the
Federal Home Loan Bank Board to their mem-
ber institutions and act on behalf of the
Board. (See p. 4.)

GAO undertook this review to assess the
ability of the Federal Home Loan Bank Board
to examine and supervise members of the sav-
ings and loan industry. The effectiveness
of the Federal Home Loan Bank Board's super-
vision of savings and loan associations is
extremely critical at this time since many
industry members are experiencing financial
difficulties. (See p. 5.)

ABILITY TO USE FORMAL
SUPERVISORY ACTIONS
NEEDS STRENGTHENING

The supervision of savings and loan asso-
ciations is an art rather than a science.
Because it is an art, considerable judgment
must be exercised by the supervisory personnel
as to when and what type of actions should be
taken against noncomplying or troubled associ-
tions.

Informal supervisory actions, such as letters
and meetings, are the preferred means of
getting associations to correct their prob-
lems. However, in those cases where informal
actions are ineffective, stronger formal
actions may be necessary to prompt corrective
action. Formal actions include cease and
desist orders and supervisory agreements.
(See pp. 8 and 9.)
The supervisory agreement is used to enforce a specific provision of the insurance regulations, which currently requires savings and loan associations to maintain a 4 percent level of net worth. Net worth can be simply defined as assets minus liabilities. In the supervisory agreement, the Federal Home Loan Bank Board and the association agree to a plan to eliminate the net worth deficiency, as well as to correct the problems that led to the deficiency. (See p. 9.)

The cease and desist order is a stronger formal tool. It can be issued at the consent of the parties or after a hearing before an administrative law judge. Violation of the order can result in assessment of substantial civil penalties. (See p. 9.)

Despite an increasing number of associations that are of supervisory concern to the Federal Home Loan Bank Board, the use of formal enforcement actions has declined. The issuance of cease and desist orders, which ranged from 7 to 13 a year during the 5-year period 1975 to 1979, decreased to 2 in 1980. Likewise, the number of supervisory agreements executed dropped from a 1976 high of 41 to 0 in 1980. (See p. 10.)

The reluctance of supervisory personnel to fully use available legal enforcement powers is attributed to the cumulative effect of several factors:

--the ambiguity of Board policy regarding the use of formal powers;
--the inability of parties involved to process formal actions in a timely manner; and
--the indecisiveness of supervisory personnel. (See ch. 2.)

Because of these policy and process problems, supervisory agreements and cease and desist orders—two important formal supervisory actions—are not readily available for use. Consequently, supervisory personnel, out of necessity, place greater reliance on informal actions. These informal actions
alone may not be sufficient to achieve
the correction of problems. As a result,
GAO believes the Federal Home Loan Bank
Board's ability to supervise its members
is reduced. (See p. 25.)

RECOMMENDATIONS TO THE
CHAIRMAN OF THE FEDERAL
HOME LOAN BANK BOARD

GAO recommends the Federal Home Loan Bank
Board:

-- Clarify its position on the extent to
which formal enforcement actions should
be pursued in supervising the savings
and loan industry.

-- Delegate to supervisory agents the author-
ity to use supervisory agreements for
problems other than net worth failure.

-- Direct the Office of Examinations and Super-
vision to prescribe uniform principles
and standards for supervisory agents and
other personnel as to how and when formal
supervisory tools, including an expanded
supervisory agreement, should be used.

-- Accept the recommendations of the Office
of General Counsel's Compliance Division
to eliminate prior Board approval for
formal investigations and negotiation
of consent cease and desist orders. (See
pp. 26 and 27.)

IMPROVED ADMINISTRATION OF THE
STATE EXAMINER TRAINING PROGRAM
WILL LEAD TO MORE EFFECTIVE RESULTS

Before discussing the training program prob-
lems observed, it should be noted that the
Congress, in directing the Federal Home Loan
Bank Board to provide training to State sav-
ings and loan association examiners, envi-
visioned a program which would prepare the
States to assume greater responsibility for
the examination of federally insured, State-
chartered associations. Specifically, the
Congress intended for the Federal Home Loan
Bank Board to reduce its examination burden
by relying on State examination reports for federally insured, State-chartered associations. (See p. 31.)

Despite this intent, the Federal Home Loan Bank Board does not rely solely on State examination reports from any State. The Federal Home Loan Bank Board does not rely on State examination reports because it believes it must be directly involved in the examination and supervision of all institutions insured by the Federal Savings and Loan Insurance Corporation. (See p. 32.)

In lieu of relying on State reports, the Federal Home Loan Bank Board conducts joint examinations with thirty-seven States whereby the examination workload is shared. Although joint examinations obviously reduce the examination burden somewhat, they will not lead to the reduction envisioned by the Congress. (See p. 32.)

Relying on State examinations and reports is an issue GAO addressed in its January 6, 1981, report, "Federal Examinations of Financial Institutions: Issues That Need To Be Resolved," (GGD-81-12). In this report GAO took the position that the Federal financial institutions regulators, including the Federal Home Loan Bank Board, should rely more on State examinations and reports. To accomplish this, GAO made recommendations to the Federal Financial Institutions Examination Council which was established to promote uniformity in the examination and supervision of financial institutions. Specifically, GAO recommended that the Council:

-- Develop criteria for Federal regulators to assess the quality of examinations performed by State agencies, and to monitor the States' examination programs to assess changes which may affect the acceptability of the States' programs for Federal needs.

-- Develop a Federal Government-wide policy under which Federal regulators, using the above criteria, would assess and monitor the quality of State examinations and accept
examinations that are competently performed by State agencies in lieu of their own. (See p. 34.)

GAO continues to believe the Federal Home Loan Bank Board should make the maximum use possible of State examinations and reports.

Regarding the training that the Congress desired for the States, the Federal Home Loan Bank Board has given major program responsibility to the National Association of State Savings and Loan Supervisors. This dual administration of the training program has led to the Federal Home Loan Bank Board not having the control necessary to properly administer and manage the program. GAO found training provided to State examiners

--from a State which has no State-chartered, federally insured associations,

--from States which refuse to work with the Federal Home Loan Bank Board to reduce Federal and State examination duplication, and

--without consideration of their State's overall level of examiner training, experience, and needs. (See pp. 30 and 31.)

RECOMMENDATIONS TO THE CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD

GAO recommends the Federal Home Loan Bank Board:

--Assume greater control over the selection of the States from which examiners are trained.

--Select the States on the basis of criteria which will give priority to examiners needing training from those States participating in or offering the greatest potential for participation in joint examination or shared reporting programs. (See p. 35.)
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ABBREVIATIONS

FDIC  Federal Deposit Insurance Corporation
FHLB  Federal Home Loan Bank
FHLBB  Federal Home Loan Bank Board
FSLIC  Federal Savings and Loan Insurance Corporation
GAO  General Accounting Office
NASS&LS  National Association of State Savings and Loan Supervisors
OES  Office of Examinations and Supervision
OGC  Office of the General Counsel
CHAPTER 1
INTRODUCTION

The Federal Home Loan Bank Board (FHLBB) furthers the American dream of home ownership through its 12 Federal Home Loan Banks (FHLB) and, ultimately, through the 4,249 members of the thrift or savings and loan industry. In the last few years, the American dream has become a nightmare as escalating interest rates have decreased savings and long-term funds available for home mortgages. The savings and loan industry in general and many savings and loan associations in particular have had and are continuing to have financial difficulties. As more and more savings and loans experience difficulties, it becomes increasingly important for the FHLBB as the industry's regulator to provide swift and effective supervision. This report discusses the supervision the FHLBB has provided to its members and recommends actions to improve the FHLBB's effectiveness.

Congress created the FHLBB during the early 1930s contemporaneously with the agencies that were organized to achieve reforms in the securities and banking industries. Those legislative milestones were implemented in response to the financial crisis that occurred with and contributed to the Great Depression. The objective of the FHLBB is to increase the availability of financial resources for home ownership and to protect depositors who are the principal source of these financial resources.

The legislation which established the FHLBB and its constituent agencies was the:

--Federal Home Loan Bank Act (12 U.S.C. 1421), enacted in 1932. This act established the FHLBB and through it the FHLB system, including the 12 FHLBs, to provide a permanent credit reservoir for thrift and home financing institutions.

--Home Owners' Loan Act of 1933 (12 U.S.C. 1464). This act authorized the FHLBB to charter Federal savings and loan associations.

--The National Housing Act (12 U.S.C. 1725), enacted in 1934. This act created the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits in savings and loan associations.

The FHLBB is an independent agency of the Federal Government. It is governed by a bipartisan Board of three members who are appointed by the President and confirmed by the Senate to serve 4 years or to complete unexpired terms. Control over the operational functions of the agency is vested in the Office of the Chairman.

The agency's principal functions are to direct the activities of its constituent agencies and to examine and supervise the savings and loan association members of the FHLB system that have deposits insured by the FSLIC.

The FHLBB's operating and capital expenditures are financed through assessments made on the FSLIC and the FHLBs and through fees charged to institutions which are examined by the FHLBB. Thus, no funds are received from the Federal Government's general revenues, although the FHLBB must restrict its expenditures to within budget limits approved by Congress.

THE FEDERAL HOME LOAN BANK SYSTEM

The FHLB system consists of 12 district FHLBs and their member institutions. They are owned by and serve as central credit banks for member institutions. The FHLBs provide members with services such as advances, purchase and sale of securities, economic analysis and reports, and checking accounts. The principal sources of funds for the FHLBs are sales to the public of debt instruments, known as consolidated obligations, which are the joint and several obligations of all FHLBs. The FHLBs also have supervision departments to monitor members' performance and compliance with FHLBB regulations.

Membership in the system is limited to those institutions whose business activities are heavily concentrated in residential lending, who receive public funds, are chartered by State or Federal authorities, and are subject to periodic examination. As of December 31, 1980, membership consisted of 4,105 savings and loans, 142 savings banks, and 2 insurance companies.

THE SAVINGS AND LOAN INDUSTRY

Savings and loan associations, sometimes called building and loans, homestead associations, or cooperative banks, are the most important members of the thrift industry which also includes
Important characteristics of the thrift industry are that its principal customers for both deposits and loans are private individuals and that its ownership is commonly mutual or cooperative. Savings and loan associations are distinguished from commercial banks by their commitment to residential mortgage lending. On December 31, 1980, total assets of all savings and loan associations were $629.8 billion of which 79.8 percent was invested in mortgage loans.

The savings and loan industry - troubled after a bad year

Industry profits during 1980 were the lowest since 1940. The industry's net income after taxes as a percentage of average assets declined from 0.65 percent in 1979 to 0.13 percent for 1980. Many individual institutions suffered moderate to severe losses.

This poor performance was a function of the nation's economy during 1980. Economic activity during the year was characterized by: (1) a recession that, while short-lived, recorded the steepest one-quarter decline in gross national product since World War II; (2) a continued rise in price level; and (3) high average interest rates which experienced volatile fluctuations. Each of these characteristics adversely affected the American consumer, and the effects on the consumer in turn affected the savings and loan industry which serves the consumer both for deposits and mortgage loans.

The number of savings and loans that were driven out of existence during 1980 because of these difficult economic conditions is unknown. Nevertheless, inferences can be made from the increased number of merger applications processed by the FHLBB during 1980 when the FHLBB authorized 108 mergers and was reviewing applications for 63 more at year's end. This level of activity was three times higher than the level recorded in 1979 and a sharp reversal of a 5-year declining trend in merger activity.

FHLBB'S PROBLEM BOOK INDICATES INDUSTRY'S DECLINING POSITION

Each quarter the FHLBB prepares, for internal use, a problem book that contains information on associations requiring extensive supervisory attention. These associations may ultimately require financial outlays by the FSLIC.
In line with current economic conditions, the problem book shows a substantial increase in the number of associations of concern to the FHLBB. The December 31, 1979, problem book listed 79 associations with assets of $13.3 billion. On March 31, 1981, it listed 244 associations with assets of $41.7 billion.

SUPERVISION OF SAVINGS AND LOAN ASSOCIATIONS

The primary objectives of the FHLBB supervisory process are to ensure the financial safety and soundness of the FSLIC-insured associations and their compliance with Federal statutes and FHLBB regulations. Meeting these objectives can involve a number of the FHLBB offices including:

-- The Board which controls all formal enforcement powers granted by Congress and approves or delegates approval of their use.

-- The FHLBB's Office of Examinations and Supervision (OES) which conducts examinations and represents the Board to the supervisory agents in the FHLBs. The Board has designated OES as being principally responsible for supervision.

-- FHLB officers who have been designated agents of the FHLBB. Known as supervisory agents, they represent the FHLBB to their member institutions and act on behalf of the FHLBB.

-- The FHLBB's Office of General Counsel (OGC) which is responsible for preparing all formal enforcement actions.

-- FSLIC which is responsible for handling cases where resolution will involve insurance funds.

OES and the supervisory agents are the FHLBB's principal contacts with the savings and loan industry.

FSLIC, OGC, and the Board members do not become involved in the supervisory process except in problem cases where OES and the supervisory agents find that use of the FHLBB's legal powers is a potential solution.

Working through a field staff of approximately 900 examiners and support personnel, OES examines all Federal- and State-chartered FSLIC-insured savings and loan associations to determine their financial soundness and compliance with applicable statutes and regulations.
OES's examiners are organized into 12 autonomous districts corresponding to the District banks. The 12 District Directors are responsible for all examinations and report to the OES Deputy Director-Examinations/Field Operations in Washington who provides them guidance, administrative training, and other services. The District Directors work closely with the supervisory agents of the banks.

The supervisory agents are officers and employees of the District banks and are appointed subject to the approval of the FHLBB. In most cases, they are able to achieve their supervisory objectives without formal enforcement powers. The examination process itself and persuasion--telephone contacts, correspondence, and meetings with association directors and personnel--are usually adequate to secure compliance with FHLBB policy and regulations.

In those cases where informal action is not sufficient, the supervisory agent may recommend a plan of corrective action to one of four Regional Directors in Washington, D.C. The Regional Directors report to the OES Deputy Director for Supervision and are each responsible for OHS interface with 3 of the 12 District banks.

OES's Washington-based supervision staff provides oversight of the savings and loan industry for the FHLBB. It monitors the condition of the industry as a whole. In coordination with the supervisory agents, it reviews the progress of savings and loan associations requiring close supervisory attention. As necessary, OES works with FSLIC, OGC, and, in the case of State-chartered institutions, the counterpart State regulatory agencies.

**OBJECTIVES, SCOPE, AND METHODOLOGY**

We initiated this review to assess the efficiency and effectiveness of savings and loan association examination and supervision. Our initial efforts were in both the examination and supervision functions of FHLBB's Office of Examinations and Supervision, but our later efforts focused primarily on the supervision function because we identified areas needing improvement. Areas identified and reviewed in detail include the lack of FHLBB guidance over supervisory actions, the timing of those actions, and the State examiner training program.
We conducted the majority of our work at FHLBB headquarters in Washington, D.C., and at the FHLBB's OES district offices in Little Rock, Arkansas, and Boston, Massachusetts. We selected the Little Rock Bank because it was representative of all the banks in the Federal Home Loan Bank System and supervised most types of institutions for which the FHLBB is responsible. We selected the Boston Bank because it oversees the New England thrift industry, which is complex relative to the other sectors of the country. The New England thrift industry includes savings and loan associations, mutual savings banks, and cooperative banks. To the extent necessary, we interviewed officials from FSLIC and FHLBB officials in the Office of District Banks.

We reviewed examination reports and correspondence files for 23 savings and loan associations which were under special supervisory surveillance due to problems identified by the FHLBB and the District banks. We selected 19 cases from the FHLBB's September 30, 1980, problem list of 118 associations and 4 cases from the Boston Bank's local problem list of 24 associations. We selected cases primarily with financially critical problems located in five different FHLB districts. The associations selected ranged in asset size from $5 million to $700 million. We reviewed examination reports and correspondence files beginning 2 years prior to the identification of the problem and ending with the most current available, usually 1979 or 1980. We interviewed supervisory agents, and other officials concerning specific savings and loan associations and their problems, and reviewed selected examination workpapers.

We compiled, reviewed, and analyzed data on 10 of the 18 cases where the FHLBB used cease and desist orders between 1978 and 1980. In order to review the actions at several FHLBs, we selected cases involving savings and loan associations from 9 of 12 FHLB Districts. In addition, we reviewed one case where a cease and desist order was not issued, but the issuance of two separate cease and desist orders was considered by the FHLBB. We also reviewed data on all 24 cases where supervisory agreements were reviewed by the FHLBB's OGC in 1977 and 1978. OGC did not prepare or review any supervisory agreements after 1978.

The FHLBB has been requested by the Congress to establish a training program for State examiners. The purpose of the training is to (1) reduce the increasing cost of examinations conducted by the FHLBB, and (2) enable the State examining agency personnel to conduct adequate examinations of financial institutions within their States. Our objectives in this portion of our review were to assess the administration of the State examiner training program, and the extent to which this program has enabled the FHLBB to meet the congressional intent.
The review of the State examiner training program was performed by examining records at the FHLBB's Office of Examinations and Supervision. We reviewed OES's training records, the procedures for the selection of State examiners and training site locations, and budget and cost workpapers. We also reviewed the legislative history and the authorizing legislation which established the State examiner training program. We evaluated actions taken to implement the program according to the intent of Congress. This was accomplished by assessing surveys on State examiner capabilities prepared by the FHLBB and the National Association of State Savings and Loan Supervisors (NASS&LS) and minutes of meetings held by the Joint Committee on Examinations.

We interviewed FHLBB OES officials in Washington, D.C., Boston, Little Rock, Atlanta, Chicago, New York, and Cincinnati concerning the State examiner training program. In addition, we interviewed officials of NASS&LS with regard to the program. We also discussed the results of our work with OES officials and considered their views in preparing the report.
CHAPTER 2

FHLBB'S ABILITY TO USE FORMAL SUPERVISORY ACTIONS NEEDS STRENGTHENING

Despite the fact that more and more savings and loan associations are categorized as supervisory problems, the FHLBB does not use formal enforcement actions as frequently as in prior years. The FHLBB now relies more on the use of informal actions. Moreover, although the main objective of the FHLBB supervision process is to ensure the safety and soundness of member institutions, the majority of the formal actions taken address issues other than safety and soundness.

The reluctance of FHLBB supervisory personnel to use fully the legal enforcement powers available cannot be conclusively attributed to any one factor but rather to the cumulative effect of several factors including:

-- the ambiguity of Board policy regarding the use of formal powers;

-- the inability of the parties involved to process formal enforcement actions in a timely manner; and

-- the indecisiveness of supervisory agents and OES personnel.

Because of these factors, the supervisory agents and the FHLBB do not have a full complement of efficient and effective formal actions at their disposal.

FHLBB ENFORCEMENT POWERS

The FHLBB has a variety of formal supervisory tools available if informal actions, such as oral and written persuasion, are not successful. The Home Owners' Loan Act of 1933, the National Housing Act, and the Financial Institutions Supervisory Act of 1966 (68 U.S.C. 634) provided the FHLBB with the authority to take various investigative and enforcement actions against associations that have violated or are about to violate a law, rule, or regulation, or are engaging in unsafe or unsound practices. These powers were expanded and strengthened by the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (12 U.S.C. 226).

These authorities provide a wide range of supervisory tools, such as cease and desist authority over individual officers and directors, civil money penalties for violation of outstanding cease and desist orders, the removal of officers, and termination
of insurance. Also, the FHLBB has delegated to supervisory agents the authority to enter into formal agreements with associations that have failed net worth requirements.

The two most frequently used formal actions have been the supervisory agreement and the cease and desist order. The supervisory agreement is used by the FHLBB only to enforce the provisions of section 563.13 of the insurance regulations, which requires savings and loan associations to maintain specific levels of net worth. 1/ In the supervisory agreement the FHLBB and association agree to a plan to eliminate the net worth deficiency as well as to correct the problems that led to the deficiency. The agreements usually remain in effect until the associations meet the net worth requirement. The Board has delegated authority to OES to execute agreements without Board approval. Violation of a supervisory agreement can provide the basis for a cease and desist order.

The cease and desist order is a stronger formal tool. It can be issued at the consent of the parties or after a hearing before an administrative law judge. The process provides for appeal to the FHLBB, the U.S. Court of Appeals, and, if necessary, the U.S. Supreme Court. Violation of the order can result in assessment of substantial civil penalties. These and other formal tools are discussed in appendix I.

FHLBB SUPERVISORY APPROACH

Selection of an appropriate course of supervisory action is based on the unique circumstances of the specific problem as well as on the professional judgment of the supervisory agents. Although no specific written guide to supervision currently exists, a supervisory philosophy of progression-of-action has evolved. This leads to an approach which employs steps that increase in formality and severity if problems continue uncorrected.

Most OES staff and supervisory agents stated that a preferred and logical approach to a problem case would be to exhaust all informal actions prior to initiating formal actions. Informal actions include conversations with officials of the association, a supervisory letter, and meeting with the association's board of directors.

1/Net worth can be defined simply as assets minus liabilities. Associations are required to maintain a level of net worth equal to 4 percent of their liabilities. Prior to November 30, 1980, the net worth requirement was 5 percent of liabilities.
Although the use of the supervisory agreement is limited to net worth failure, supervisory agents have preferred to use this tool as the first formal action. The agreement process is quicker and less formal than a cease and desist order. If this does not correct the problem, a cease and desist order can be obtained. If further action is required, officers could be removed, or a recommendation could be made for termination of insurance. The use and timing of these actions would depend on the nature, severity, and potential of the problem.

**FORMAL ACTIONS TAKEN BY FHLBB HAVE DECREASED**

The number of occasions when the FHLBB has used formal supervisory enforcement actions, especially supervisory agreements and cease and desist orders, has dropped drastically in recent years. The number of supervisory agreements executed by the FHLBB dropped from a high of 41 in 1976 to 0 in 1980. The issuance of cease and desist orders, which ranged from 7 to 13 a year during the period 1975 to 1979, decreased to 2 in 1980. The following graph illustrates the rise in the number of problem institutions and the decline in the use of formal enforcement actions.

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>Number of institutions on the FHLBB's problem list</th>
<th>Formal actions (note a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>150</td>
<td>15</td>
</tr>
<tr>
<td>1976</td>
<td>135</td>
<td>13</td>
</tr>
<tr>
<td>1977</td>
<td>120</td>
<td>45</td>
</tr>
<tr>
<td>1978</td>
<td>105</td>
<td>45</td>
</tr>
<tr>
<td>1979</td>
<td>90</td>
<td>45</td>
</tr>
<tr>
<td>1980</td>
<td>75</td>
<td>15</td>
</tr>
</tbody>
</table>

*Includes supervisory agreements and cease and desist orders.*
Although not all institutions on the FHLBB's problem list have problems which can be corrected by initiating formal action, our analysis on page 24 shows that most institutions on the January 31, 1981, list had problems which can be corrected by formal supervisory action. More recently, many associations have been placed on the problem list due to financial difficulties directly relating to the general economic conditions of inflation and high interest rates. Although the increase in the number of associations on the problem list increased the disparity in the number of problem associations and formal actions, the downward trend in the initiation of formal actions preceded the increase in the number of problem associations.

Supervisory agents and OES personnel cited several reasons for the decrease in the use of formal enforcement actions. OES's Deputy Director of Supervision stated that many of the associations that have violated insurance regulations and would be subject to supervisory agreements are repeaters and are already under supervisory agreements. The same official also stated that many associations are failing net worth requirements because of the rise in interest rates and that this type of problem does not lend itself to correction by a supervisory agreement or a cease and desist order.

While we do not argue that these are contributing factors, they do not appear to account for all of the decrease in the use of formal actions. With overwhelming consistency, supervisory agents and other OES personnel cited time delays in processing enforcement actions as the driving force in the movement away from the use of these actions. Delays were attributed primarily to the OGC Compliance Division.

Supervisory officials claimed their credibility with the industry can be damaged because of their inability to quickly use enforcement tools. This is particularly true if these tools are used as a threat to achieve corrective action and then cannot be implemented in a timely manner. As a result, supervisory agents are avoiding formal enforcement action as a preventive supervisory tool, and such action is initiated as a last resort.

Supervisory agents, as well as OGC personnel themselves, are concerned that time delays have rendered formal enforcement actions ineffective and, as a result, there is a breakdown in the progression-of-action approach to supervision.
BOARD POLICY ON USE OF INFORMAL AND FORMAL ACTIONS UNCLEAR

Although so doing is not mandated by regulation, the Board has required its approval before cease and desist consent agreements are negotiated or investigations leading to other enforcement actions are commenced. Because there are no precise written guidelines for initiating formal actions, the Board in effect sets its policy toward such actions through the approval/disapproval of action on a case-by-case basis.

Officials from both OES and OGC stated that the Board has discouraged formal enforcement activity by either refusing or modifying requests for formal action. As a result, OES is reluctant to recommend formal action for certain types of cases. The following case illustrates the effect of Board policy.

OES had recommended a cease and desist order for an association that had been delinquent in filing reports continually over a 3-year period. After attempting unsuccessfully to obtain voluntary compliance through informal actions, the supervisory agent recommended issuance of a cease and desist order. The Regional Director, Deputy Director, and Director, OES all concurred. The Board, however, rejected the request because it did not believe this type of violation warranted a cease and desist order.

According to an OES official, this and similar cases have resulted in OES officials being reluctant to recommend formal actions in areas such as recordkeeping and loan documentation. Such problems can seriously affect the safety and soundness of the institution.

LITTLE WRITTEN GUIDANCE IS AVAILABLE IN MAKING ENFORCEMENT ACTION DECISIONS

Supervisory agents and OES personnel have very few written guidelines to assist them in deciding how and when formal enforcement action should be taken. As a result, the professional judgment of each individual in the process weighs heavily in enforcement action decisions.

The OES has prepared some written guidelines concerning formal actions. OES's memorandum #SP-2, for example, describes the internal procedures for when supervisory agreements should be used, i.e., net worth failure. The document does not, however, provide guidance as to how agreements should address the association's problems which led to the deficiency.
The OES has also prepared a document which lists some of the practices and violations that could be the basis for cease and desist orders. The document does not provide assistance in determining when the action should be taken.

The Director of OES stated during discussions with GAO early in the review that the need for a comprehensive supervisory manual for OES personnel and supervisory agents had been recognized. The manual would address the procedures to be followed by supervisory personnel in taking formal action. As of August 11, 1981, OES had prepared a draft table of contents for the manual.

**SUPERVISORY AGREEMENT PROCESSING REQUIREMENTS ARE NOT BEING MET**

Supervisory agreements were seldom prepared and executed in a timely fashion. Delays in the preparation and execution of supervisory agreements are attributed to indecisiveness and confusion over their use on the part of supervisory agents and OES personnel. Although there were gaps in the records available, our analysis showed that processing delays were incurred by all parties involved.

OES memoranda outline the procedures to be followed in entering into a supervisory agreement with an association which failed the net worth requirement. Specific requirements regarding the timeliness of supervisory agreement processing are:

---Within 60 days after an association has a net worth deficiency, the supervisory agent will notify OES with a specific plan for corrective action.

---Within 30 days of notification, OES will notify the supervisory agent as to the acceptability of the proposed corrective action.

---Without delay the supervisory agent will negotiate an agreement with the association.

---OES will advise the supervisory agent as to the acceptability of the negotiated agreement which will then be executed.

The following table illustrates that these requirements were often not achieved.
# Time Required to Process 24 Supervisory Agreements

Reviewed by OGC Between 1977 and 1978

<table>
<thead>
<tr>
<th>Time between net worth failure and supervisory agent's recommendation to OES for a supervisory agreement.</th>
<th>60 days</th>
<th>1</th>
<th>a/5</th>
<th>3</th>
<th>5</th>
<th>4</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time OES considered use of supervisory agreement before requesting OGC to draft document.</td>
<td>N/A</td>
<td>2</td>
<td>8</td>
<td>-</td>
<td>-</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Time required by OGC to review draft agreement.</td>
<td>N/A</td>
<td>9</td>
<td>5</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>10</td>
</tr>
<tr>
<td>Time between completion of OGC work and transmittal of agreement to agent.</td>
<td>N/A</td>
<td>13</td>
<td>2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>9</td>
</tr>
<tr>
<td>Time between receipt of approved agreement and execution by agent and association.</td>
<td>Immediately</td>
<td>5</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>-</td>
<td>b/13</td>
</tr>
</tbody>
</table>

a/Three exceeded the 60-day period.
b/Nine of these were never executed.
Total processing time from the date of the association's net worth failure to execution of the agreement ranged from 5 to 29 months for the 15 agreements which were executed. The average time was 12.5 months.

As shown in the table, in 15 of the 18 cases where documentation was available, the supervisory agent exceeded the 60-day period before notifying the Regional Director. In 9 of 18 cases, or 50 percent, the supervisory agent's decision took 5 months or longer.

The length of time between when OES received the request for a supervisory agreement and requested OGC to prepare the agreement ranged from less than 1 month to more than 8 months for the 13 documented cases. Eight of the 13 cases, or 62 percent, took 1 to 3 months.

At the OGC, 9 of 14 cases, or 64 percent, of the documented supervisory agreements were reviewed within a 1-month period. The average processing time for agreements was 4 weeks. Although OGC processing time is not a large portion of total processing time, the statistics must be considered in the context of what is required in OGC reviews. According to an OGC official, most supervisory agreements can be processed in a week.

**Indecisiveness contributes to time delays**

Memorandum #SP-2 requires that supervisory agreements include provisions which will (1) eliminate the cause of the net worth failure and (2) stabilize the association's financial condition. However, our review of cases where supervisory agreements were considered or issued indicated supervisory agents and OES personnel were confused over the provisions of the supervisory agreement. This lack of understanding contributes not only to a delay in executing the agreement but also to a delay in correcting associations' problems. The following case illustrates the confusion and resulting indecisiveness found in the preparation of supervisory agreements.

**March 1976**

Supervisory agent notifies Regional Director of association's 12/31/75 net worth failure of over $3,000,000. The association had become involved several years earlier in excessive development lending and lending to housing projects with more than four units. This lending resulted in numerous troubled loans.
April 1976

Regional Director notifies supervisory agent that the supervisory agreement must address how the specific condition which led to the net worth deficiency will be corrected.

April 1976 to February 1977

Supervisory agent negotiates provisions of supervisory agreement with association regarding limits on expenses and troubled loans.

February 1977

Supervisory agent sends association supervisory letter regarding September 1976 examination and encloses draft supervisory agreement. September 1976 examination notes severe problems in lending policies and net worth position.

March 1977

Regional Director receives and recommends changes to supervisory agreement.

July 1977

Supervisory agent notifies Regional Director of net worth failure at 12/31/76 of over $4,000,000 and provides specific provisions for supervisory agreement for 12/31/75 net worth failure.

August 1977

Regional Director writes Deputy Director, OES, regarding analyses of association's net worth failure and recommends changes to proposed agreements to include specific action by association for underlying causes of problems, specifically loan underwriting weaknesses, lax collection procedures, and rapid growth, which were not addressed in supervisory agreement.

Regional Director requests OGC to formalize revised agreement.

September 1977

Regional Director receives formalized agreement from OGC and advises supervisory agent to negotiate supervisory agreement with association.
November 1977

Association's board of directors signs supervisory agreement.

Our comments

This association had been cited for lending problems several years before the net worth failure. When net worth failure resulted, the supervisory agent attempted to negotiate an agreement addressing elimination of the net worth failure and not the underlying cause of the problems—lending. Although the negotiation process itself may be beneficial as a corrective action, the process continued for well over a year. The time between net worth failure and execution of the agreement was over 1-1/2 years. During that time, the association's net worth failure became more severe. If the supervisory agreement is to be the first step in a progression of formal actions to eliminate problems, then the agreement must be executed in a more timely fashion.

This case also demonstrates the length of time necessary to process a supervisory agreement and obtain OES and OGC approval. In 1979, the Executive Vice President of the Boston Bank requested OES to delegate authority to the supervisory agents to execute supervisory agreements without prior approval by OES and OGC. The Boston official cited the cumbersome delays experienced by the agents as a result of the review process. The Boston official added that an agreement would often be reviewed at OES and OGC for as long as 6 months and result in recommendations to change the agreement after the provisions had been negotiated with the association. Although this recommendation could act to expedite action, the case demonstrates a need for further guidance and a consistent approach in the timely preparation of supervisory agreements.

CEASE AND DESIST ORDERS - HESITANCY AND OGC DELAYS COMPOUND AN ALREADY LENGTHY PROCESS

Cease and desist orders are more complicated than supervisory agreements. Issuance of such orders, for example, requires due process of law. Also, the process involves OES, OGC, and the Board.
We identified factors that prolong the decision process for
issuing cease and desist orders. These factors include lack of
prompt service by OGC, as well as indecisiveness as to when
cease and desist orders should be used. The lack of timely
issuance and indecisiveness are demonstrated in the following
cases.

CASE 1

March 1978

Memo from OES Regional Director to OGC Compliance Divi-
sion recommending issuance of a cease and desist order
against an association for initiating a merger without
FSLIC approval.

March 1978 to August 1978

OGC agrees to prepare cease and desist order without
investigation. Time is spent preparing documents and
obtaining preliminary approval of OES, OGC, and the
Board.

August 1978

FHLBB officials requested a meeting with association’s
board of directors to discuss issuance of a consent
cease and desist order.

September 1978

Association's board of directors approves consent
cease and desist order.

November 1978

The Board approves consent cease and desist order.

Our comments

This case was straightforward in that there was
complete agreement to issue a cease and desist order
and no investigation was necessary. According to an
OGC attorney, the 5-month period between the OES
recommendation and Board approval to negotiate with
the association should have been 2 months. The
delay was attributed principally to a lack of
resources within OGC.
CASE 2

June 1979

Supervisory agent makes a recommendation to Regional Director for cease and desist order for an association's violations of loan documentation compliance. Violations have been cited in supervisory letters of September 1977 and June 1976.

April 1980

Supervisory agent asks Regional Director for response to June 1979 recommendation for cease and desist action. There were no extenuating circumstances to explain this inaction.

May 1980

Regional Director response to June 1979 recommendation by agent cites that time and resources could be better spent on obtaining cease and desist orders on cases with greater significance. Recommends no further action at this time with matter to be reviewed at next examination.

Regional Director states that the last meeting with the association's board of directors was held June 1976 and that, in recommending cease and desist action to the Board, it is incumbent to show that all normal supervisory efforts have been expended. Since the agent had not met with the association's board of directors for over 3 years, it would be difficult to convince the Board that all normal efforts have been expended.

July 1980

Supervisory agent recommends to Regional Director that cease and desist order be prepared for violation of liquidity requirements. Examination report indicates the association failed to maintain the minimum liquidity during 7 months of 1979. Association had also experienced liquidity deficiencies in 42 of the 75 months since January 1974.

October 1980

Regional Director notifies OGC that normal supervisory action regarding liquidity failures has been unsuccessful and cease and desist action is necessary.
January 1981

Regional Director informs Director, OES, that the proposed cease and desist order has been removed from the Board's agenda for want of additional information. Regional Director cites a new examination in progress that indicates no violations of liquidity since the last examination.

Our comments

One could infer from this case that informal action, or possibly the threat of formal action, may have been successful. However, this case does demonstrate the processing delays which have occurred as well as indecisiveness on the part of OES personnel. We are concerned about the effect such delays and indecisiveness might have in a situation where problems are not corrected and timely formal actions are necessary.

The 11-month period required to respond to the original recommendation appears to be excessive since there were no extenuating circumstances. The time required to process the second recommendation was not as long. However, with over 5 years of history, it appears reasonable that a recommendation to OGC could have been made more quickly.

The supervisory agent cited this case as an example of delays that arise in trying to get formal actions processed. The agent stated that the association had a long history of incurring liquidity penalties and believes the problem will recur. If action had been initiated immediately after the July 1980 recommendation, the cease and desist order could have been issued on the basis of current information. The possibility also exists that the association would have complied with the liquidity requirements sooner had prompt action been taken by the FHLBB.

OGC COMPLIANCE DIVISION RECOGNIZES INABILITY TO PROVIDE TIMELY SERVICES

The Director of the Compliance Division agreed that the time required by OGC to process enforcement actions was a driving force in reducing the use of such actions. The Director attributed the lack of timely services to a substantial reduction in staff and the cumbersome process currently used by the FHLBB for certain enforcement actions.
The Director cited supervisory agreements as a prime example of an enforcement action that suffered from OGC processing. According to OGC officials, the review of an average supervisory agreement by the Compliance Division should not take more than an hour, and, if any problems arose, turnaround time should be no more than a week. However, due to emphasis on higher priority actions, such as formal investigations, the Director estimated that actual processing time of a supervisory agreement could take a month or longer.

Streamlining of enforcement action procedures could improve OGC performance

In conjunction with a recent Board-commissioned study on reduction in paperwork, the Compliance Division Director made several recommendations that could relieve the burden on the Compliance Division and substantially improve its ability to provide more timely support to OES in enforcement actions. The recommendations included elimination of the requirement:

---for Board approval to initiate a formal investigation as well as the extensive review process required for the final report regarding the investigation. This tool would become a part of the examination process to be used expeditiously at the discretion of the Director, OES, with concurrence of the General Counsel. This function would be performed by an attorney, designated by the Board.

---for Compliance Division review and referral of possible criminal violations to the Department of Justice from examiners. Referrals would be made directly by the District Director in accordance with strict guidelines prepared by OGC.

---for Board review and approval of proposed cease and desist consent orders prior to negotiation with the association in an effort to substantially expedite OGC effort. Similar to the bank regulatory agencies, the Board would review fully the notice of charges, stipulation, and consent order after it is negotiated.

\[\text{Under Section 407(m)(2) of the National Housing Act, FHLBB officials can take testimony, administer oaths, and subpoena witnesses and documents when the information needed cannot be obtained otherwise.}\]
The Compliance Division Director stated that acceptance of these recommendations would reduce the time required for formal enforcement action in terms of both a quicker process and better utilization of OGC staff.

Regional Counsel concept is an available option to overcoming timeliness problems

Several District bank, OES, and OGC officials have stated that, in their opinion, a Regional Counsel organization could be effective in providing expeditious processing of enforcement actions. An OES official stated that this idea has been considered by the Board before but never accepted because of concern over whether there is sufficient work to justify a lawyer at each District bank location. District bank officials and the Director of the Compliance Division stated the attorney could be fully used. Specifically, attorneys could participate in investigations and enforcement proceedings; participate in supervisory agreement and cease and desist negotiations with associations; perform legal review of supervisory agreements; furnish legal advice to District bank staff and examiners; and provide legal opinions to member savings and loan associations.

Also cited as an advantage of the concept would be the early involvement of OGC in the supervisory process leading to enforcement actions. This involvement could lead to consistency in the nature and severity of cases referred for action.

WIDENING GAP IN SUPERVISORY TOOLS

Although the progression-of-action approach is preferred by supervisory agents and OES personnel, the limited use of supervisory agreements has resulted in the creation of a gap between the final informal maneuver and subsequent formal actions—a gap that could be difficult to overcome. The time required to process both supervisory agreements and cease and desist orders has made supervisory agents reluctant to use them. Also, because supervisory agreements are only employed for net worth failures—the symptom of a problem or problems—they are not very useful for the early correction of problems.

Officials from the District banks, OES, and OGC stated that supervisory agents prefer to use the supervisory agreement as the first formal supervisory tool. The agreement provides a gradual transition from the persuasion of informal actions to the formal actions, such as cease and desist orders. The agreement also provides a written contract between the association and the FHLBB that could address specific corrective actions without any legal consequences other than forming the basis for possible further action. Also, the agreement does not require Board approval.
Supervisory agents, however, are reluctant to use the agreement for two reasons. First, the supervisory agreement is not used until an association has failed its net worth requirement, and, with the recent reduction in the net worth requirement, there is less time between net worth failure and when the association can be insolvent. The agreement is not strong enough to use when time is critical. Second, given the current time to process an agreement, there may not be a chance to use the agreement and then use a cease and desist order if the problems worsen.

Not using the supervisory agreement breaks the progression-of-action chain and can make the use of other tools such as cease and desist orders more time-consuming. Consequently, according to supervisory agents and OES officials, the cease and desist process may not be useful for a safety and soundness problem where the survival of the association is at stake and immediate action is necessary.

**Expanded supervisory agreement could bridge the gap**

The three bank regulatory agencies use formal written agreements to document a bank's plan to correct problems. The agency and the bank both sign the agreement. A violation of the agreement can be the basis for issuing a cease and desist order.

These agreements are similar to the FHLBB's supervisory agreement except that they are not limited to net worth failures. Several FHLB and OES officials stated that expansion of the authority to use the supervisory agreement for other than net worth failures would allow the supervisory agent to enter the formal enforcement process much earlier for all types of problems. The expanded use of the agreement would provide a more gradual progression to supervisory action and would not preclude further action.

**FHLBB's ENFORCEMENT ACTIVITY DOES NOT EMPHASIZE SAFETY AND SOUNDNESS**

The principal objective of the FHLBB supervisory process is to ensure the financial safety and soundness of the industry and protect the insurance fund. Congress has provided the financial regulatory agencies with increased enforcement powers in recent years to meet this objective. The emphasis of the Board's formal enforcement activity, however, is not on financial safety and soundness issues.
Problems in the savings and loan industry that concern the FHLBB can be divided into two general categories. The first category involves the violation of laws or FHLBB regulations which were written to implement national policy regarding certain business practices. These activities, such as conflict of interest and discriminatory practices, can damage the association; however, financial damage is not implicit in these problems. The second type of problem may also be subject to regulation but directly involves the financial safety and soundness of the association. These problems can lead to consequences that threaten loss to the insurance fund and require timeliness in taking corrective action. Safety and soundness problems include poor loan underwriting, excessive operating expenses, and ineffective or incompetent management.

FHLBB's problem book reflects safety and soundness issues as principal problem

The FHLBB's problem book is the principal source of information on associations OES believes require aggressive supervisory action or will ultimately involve FSLIC financial outlays. The majority of associations in the December 31, 1979, and January 31, 1981, problem books had safety and soundness problems.

The 1979 problem book contained 79 problem cases. In addition, we reviewed four cases which were added to the problem book in early January 1980. Of the 83 total cases, 55, or 66 percent, were concerned solely with safety and soundness issues, and 25 of the remaining 28 cases involved both safety and soundness issues and regulatory violations.

The January 1981 problem book included 122 associations. Of the 122 associations, 70 were new additions. All 70 problem cases involved safety and soundness issues, and 59, or 84 percent, concerned safety and soundness problems only.

OGC Compliance Division emphasis on nonfinancial regulatory violations

Of the 85 cases handled by the Compliance Division between March 1978 and July 1980, 55 (65 percent) involved regulatory violations not concerning financial issues. Twenty cases involved such regulatory violations and financial safety and soundness issues. The remaining 10 cases involved solely safety and soundness issues.

OES and OGC officials agreed that most of their formal supervisory actions are initiated in response to regulatory violations concerning issues other than safety and soundness.
The Director of OGC’s Compliance Division stated that few cases involving safety and soundness issues are referred to the Compliance Division because, in great part, OES tends to wait until the effects of the practices appear. According to the same official, often it is too late for supervisory action and the FSLIC must become involved.

An OES official stated that because enforcement responsibility is divided among supervisory agents, OES, OGC, and the Board and because concurrence is needed at all levels, the decision process is time-consuming and cumbersome. In cases that do not involve regulatory violations, the agent may often avoid this process and strive to bring about corrections using informal actions.

CONCLUSIONS

The use of informal supervisory actions is the preferred means of getting savings and loan associations to correct their problems. However, this does not mean that the formal means for obtaining corrective action should not be readily available for use when circumstances and professional judgment establish their necessity. Because of processing problems associated with such actions and the absence of policy guidelines, supervisory agreements and cease and desist orders—two important formal supervisory actions—are not readily available for the FHLBB to use.

We recognize that the use of formal actions may not always be necessary or effective and that the decision for such action involves professional judgment. However, the full exercise of that judgment is being circumscribed because of confusion over when and how such actions are to be used, time delays encountered in getting formal actions through the process, and limits on the use of supervisory agreements.

The confusion over when and how to use formal actions results from two basic causes. First, the Board has not clearly delineated its policy as to when informal actions should stop and formal ones begin. Nor has it indicated what problems or circumstances will or will not warrant formal action. The policy on corrective action using formal tools is being made on a case-by-case basis. FHLBB supervisory personnel are thus uncertain as to when formal actions are to be undertaken and may be reluctant to act. Second, the supervisory agents have not been given specific guidance on determining what circumstances would call for a cease and desist order, nor have they been given guidance on how supervisory agreements are to be written to be most effective.
It sometimes takes the system too long to move a formal action from inception to implementation. The process is delayed by the uncertainty of supervisory agents and OES personnel, the delays inherent in having to negotiate with the subject savings and loan associations, and processing delays within OGC. The length of the process creates two problems: (1) the formal action may be accomplished too late to prevent further deterioration, and (2) the supervisory staff is reluctant to pursue formal action because it takes too long.

Supervisory agreements are the first of the formal actions. Yet the FHLBB only uses them when an association has experienced a net worth failure. Many times the net worth failure is a symptom of long-standing problems—problems that may have been corrected earlier through more forceful supervisory action. Also, waiting to negotiate a supervisory agreement for a net worth failure could reduce the time the FHLBB has to obtain corrective action before FSLIC intervention becomes a necessity.

We cannot point to cases where the use of supervisory agreements or cease and desist orders would have saved a savings and loan association from failure. However, the FHLBB's use of these actions has decreased dramatically during a period when the number of problem associations has increased. The use of formal actions has not decreased because informal methods have become more effective. Rather, the supervisory personnel no longer view them as viable supervisory approaches and are reluctant to use them. In effect, the lack of clear guidance and processing delays in the use of supervisory agreements and cease and desist orders, as well as overly restrictive limits with regard to supervisory agreements, have removed these options from the FHLBB's supervisory approach. Thus, the FHLBB's ability to effectively supervise its members is reduced.

We believe that to be fully effective, the FHLBB needs to be able, when necessary, to employ expeditiously every available supervisory option. Therefore, the existing barriers to the timely and effective use of supervisory agreements and cease and desist orders should be eliminated.

**RECOMMENDATIONS TO THE CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD**

We recommend that the FHLBB:

--- Clarify its position on the extent to which formal enforcement actions should be pursued in supervising the savings and loan industry.
---Delegate to supervisory agents the authority to use supervisory agreements for problems other than net worth failure.

---Direct OES to prescribe uniform principles and standards for supervisory agents and OES personnel as to how and when formal supervisory tools, including an expanded supervisory agreement, should be used.

---Accept the recommendations of the OGC Compliance Division to eliminate prior Board approval for formal investigations and the negotiation of consent cease and desist orders.

AGENCY COMMENTS

FHLBB officials from OES and OGC were in agreement with our conclusions and recommendations. They believe the report will result in changes to the FHLBB's procedures in the use of supervisory agreements and cease and desist orders. The FHLBB expressed two specific concerns as follows. First, not all associations on the problem list have problems that can be resolved through formal actions, and many of their problems are directly related to the present economic condition. Secondly, the FHLBB was not satisfied that our analysis of the types of association problems for which formal supervisory actions were initiated clearly delineated the problems we categorized as safety and soundness problems and regulatory violations.

In view of the FHLBB's first concern, we expanded our report on page 11 to state that not all financial institutions on the FHLBB's problem list have problems that can be resolved through the use of such formal actions as supervisory agreements and cease and desist orders. As a result of the second comment, we expanded the explanation on page 24 to include specific examples of association problems we categorized as financial safety and soundness and nonfinancial regulatory violations.
CHAPTER 3

IMPROVED ADMINISTRATION OF THE STATE EXAMINER TRAINING PROGRAM WILL LEAD TO MORE EFFECTIVE RESULTS

The Congress has directed the FHLBB to train State examiners to assume a greater responsibility for the examination of federally insured, State-chartered savings and loan associations. To meet this end, the FHLBB programmed $1.2 million in training funds for State examiners for fiscal years 1979-1981.

In establishing the State examiner training program, the FHLBB has given major responsibility to the National Association of State Savings and Loan Supervisors (NASS&LS). This dual administration of the training program has led to the FHLBB not having the control necessary to properly administer the program. As a result:

— Training is provided at FHLBB expense to examiners from a State which has no State-chartered, federally insured associations.

— State examiners receive FHLBB training even though their respective States refuse to participate in joint examination programs, continue to conduct separate examinations, and continue to issue separate examination reports.

— State examiners are selected for training without regard to their State's overall level of examiner training and experience and overall examiner training needs.

The FHLBB has also taken the position that it cannot withdraw from direct participation in the examination of all savings and loan associations and allow the States to independently examine federally insured, State-chartered associations. Even with greater control over the State examiner training program, the FHLBB will not fully meet the congressional intent of the program until greater reliance is placed on State examination reports.

ESTABLISHMENT OF THE STATE EXAMINER TRAINING PROGRAM

In 1978, the Congress authorized the FHLBB to spend $395,000 in fiscal year 1979 to establish a State examiner training program. The Congress had previously rejected the FHLBB's request for $790,000 to fund 33 new Federal examiner positions in fiscal year
1979. The Congress' intent in creating the State examiner training program was to reduce the FHLBB's examination burden. Specifically, the Congress envisioned that, as a result of the program, the States would be able to independently examine many State-chartered, federally insured associations and that the FHLBB would rely on the States' examination reports.

Congress recommended the training funds be spent on training approved by the FHLBB and the Institute for Continuing Regulatory Education, the educational arm of NASS&LS. In addition, the Congress recommended that State examiner training include the following courses which are given by the FHLBB to Federal examiners:

--New Examiner Training School,
--District Training Programs,
--Special Courses,
--Professional Examiner Development, and
--Electronic Data Processing Training.

The FHLBB, as directed by Congress, programmed $395,000 for training of State examiners in fiscal year 1979, $400,000 in fiscal year 1980, and $400,000 in fiscal year 1981. In 1979 and 1980, the FHLBB provided 660 slots for State examiners from 40 States and the territory of Guam.

FHLBB NEEDS TO ASSERT CONTROL OVER THE STATE EXAMINER TRAINING PROGRAM

The FHLBB's OES does not exert enough control over the State examiner training program to ensure its effectiveness. The OES has given authority for selection of State examiners to NASS&LS without adequate guidelines or controls. As a result, the selection process has been haphazard and resulted in training being provided to State examiners with no benefit to the goal of the program.

FHLBB has no role in selection of State examiners being trained

OES does not participate in the selection of State examiners for FHLBB-sponsored training. This decision is made by NASS&LS and the States. OES furnishes the number of slots available for courses to NASS&LS, which then notifies the States of the training available. NASS&LS receives a listing of State examiners
who wish to attend the training, selects the examiners, and provides OES with a list of the selections. OES then processes the necessary travel authorizations and hotel accommodations and subsequently processes travel vouchers for reimbursement.

There are currently approximately 1,400 State examiners, about 600 of whom are assigned to examine FSLIC-insured, State-chartered associations. OES does not receive any biographical data from the States or NASS&LS that would allow for a determination of whether a State examiner was either qualified for or in need of any specific training. Also, the OES training section has no guidelines to make such a determination if such information were available.

Training of some State examiners is of limited benefit to the FHLBB.

The FHLBB has funded the training of examiners from States that either do not have State-chartered, FSLIC-insured savings and loan associations or refuse to participate with the FHLBB in any joint or concurrent examination program. \(^1\) This training has been of limited benefit to the FHLBB in that these examiners will not assume any of the examination workload of the FHLBB.

The FHLBB has funded 14 examiner training slots for the State of Massachusetts where there are no FSLIC-insured, State-chartered associations. FHLBB officials stated that they were unaware training was provided to Massachusetts examiners.

The FHLBB has also funded training to 21 examiners from three States that conduct examinations completely separate from OES because the States refuse to participate in joint or concurrent examination programs. The FHLBB has also refused to accept the reports of these States in lieu of its own examinations.

The FHLBB has recently funded nine training slots for Texas which discontinued joint examinations with the FHLBB in 1972. In 1978, Texas reiterated its position by informing NASS&LS that it had no desire to participate in the joint examination program.

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\(^1\) Concurrent examinations involve State and Federal examiners reviewing the same association at the same time but preparing separate reports; joint examinations result in only one report.
Indiana State examiners received eight training slots funded by the FHLBB even though Indiana no longer conducts concurrent examinations. An OES official stated that, even when concurrent examinations were conducted, the program was not efficient and did not benefit the FHLBB.

New Mexico used four training slots although it conducts separate examinations that do not reduce FHLBB examination workload.

**Competency of State examiners not reflected in priority of training**

The FHLBB makes a continuous evaluation of the competency of the various States' examination capabilities. FHLBB has identified weaknesses in State examination programs which preclude the FHLBB from conducting effective joint or concurrent examinations with these States. This information is relayed to NASS&LS but is not used in the selection of State examiners for training.

FHLBB officials have stated that some States have excellent examination staffs and would be capable of conducting examinations and filing reports acceptable to the FHLBB, while other States have staffs of limited competence. This information is relayed to NASS&LS; however, some States have received a substantial number of training slots even though, according to FHLBB officials, the potential for proceeding beyond concurrent examinations is not good.

The evaluation of the State's examination capabilities should be used by the FHLBB to select State examiners for participation in the training program. Examiners from States which have effective joint or concurrent examination programs with the FHLBB or desire to establish such programs should receive priority in the training program.

**CONGRESSIONAL INTENT OF STATE EXAMINER TRAINING PROGRAM NOT FULLY REALIZED**

The intent of the Congress in establishing the State examiner training program in 1978 was to provide the means whereby the FHLBB could reduce its examination burden by relying on State examination reports for State-chartered, federally insured associations. Despite this intent, the FHLBB does not rely solely on State examination reports from any State. The FHLBB is reluctant to rely on State reports because the FHLBB believes it cannot retreat from being directly involved in the examination and supervision of all institutions insured by FSLIC. Other reasons cited by FHLBB officials include
the beliefs that not all State examiners have the ability to adequately examine savings and loan associations, State examiners may lack independence, and Federal and State laws and regulations differ.

Several State examination departments are considered competent by the FHLBB to perform examinations of savings and loan associations with minimum participation by the FHLBB.

**FHLBB does not rely on State examination reports but conducts joint examinations**

The FHLBB does not rely on independent State examination reports for State-chartered, federally insured associations. However, in most States the FHLBB works with the State to conduct joint examinations. In the joint examination, State and Federal examiners examine the institutions together, generally share the work, and prepare a single examination report. In other States where concurrent examinations are conducted, the Federal and State examiners schedule the examinations together and sometimes share workpapers but prepare separate reports.

Thirty-seven States and the territory of Guam conduct either joint or concurrent examinations with the FHLBB; five States conduct separate examinations of State-chartered, federally insured savings and loan associations, and their reports of examinations are not furnished to the FHLBB. In addition, eight States conduct either no examinations or examine only State-insured associations.

**FHLBB's concerns in using State examination reports**

According to OES officials, they do not rely on State examination reports because they believe the FHLBB cannot withdraw from direct participation in the examination of State-chartered, federally insured associations. These officials also expressed concerns surrounding the scope and quality of the reports. They contend the State examiners conduct audits rather than examinations as performed by the FHLBB. They believe State examinations are oriented towards the propriety of accounting, rather than to operating policies, underlying values of investments, and regulatory requirements.

Other obstacles FHLBB officials cite to fulfilling the program's objectives include (1) the potential inability of States to maintain an examination force in light of State budget cuts; (2) the movement of examiners in some States between examinations of savings and loan associations, commercial banks, and other financial institutions; (3) the Federal
examiners' union contracts; and (4) the FHLBB's legislative responsibility to ensure the safety and soundness of federally insured savings and loan associations.

Despite these and other concerns, the FHLBB believes that some State examining agencies are capable of conducting examinations and filing reports that are acceptable. The examination staff in Ohio, for which the FHLBB has funded over 160 training slots for a staff of about 40 examiners, is considered to be a very able one with which a program of sharing examination reports could be developed. To date the FHLBB has shown no inclination to start such a program.

Obstacles to using State examination reports can be overcome

Although the problems in using State examination reports are formidable, progress can be made toward their solution. FHLBB officials have stated that a mutually beneficial agreement for examining savings and loan associations which are not of a supervisory concern could be developed with some States. Nonproblem associations could be divided equally for the purpose of examination by the State and the FHLBB on a rotation basis. This agreement, the FHLBB believes, could be developed with those States that are considered to have a strong, competent examiner staff and have the desire to have a close relationship with the FHLBB.

The Federal Deposit Insurance Corporation (FDIC) has reported success with a divided examination program covering 3,200 commercial banks in 18 States. The FDIC is responsible for protecting the insurance fund for commercial banks as the FHLBB is for protecting the FSLIC fund for savings and loan associations.

The concept the FDIC uses is a simple one: the FDIC and the States jointly identify banks not of supervisory concern and divide them equally for the purpose of examination. The State examines one half, the FDIC the other, and they exchange reports. The next year, they switch halves. By conducting fewer examinations, the FDIC anticipates that this division of examinations will conserve resources that both the FDIC and the State can use for other purposes.

DIVIDED EXAMINATION PROGRAM WOULD BE CONSISTENT WITH OUR JANUARY 6, 1981, REPORT

The initiation of a FHLBB program of divided responsibility for the examination of State-chartered, federally insured associations would be consistent with our January 6, 1981, report,
"Federal Examinations of Financial Institutions: Issues That Need To Be Resolved," (GGD-81-12). In this report we suggested the Federal financial institutions regulators rely, to the extent possible, on State examinations and examination reports. We specifically recommended the Federal Financial Institutions Examination Council: 1/

--Develop criteria for Federal regulators to assess the quality of examinations performed by State agencies, and to monitor the States' examination programs to assess changes which may affect the acceptability of the States' programs for Federal needs.

--Develop a Federal Government-wide policy under which Federal regulators, using the above criteria, would assess and monitor the quality of State examinations and accept examinations that are competently performed by State agencies in lieu of their own.

In its September 15, 1980, response to our draft report, the FHLBB agreed that examinations should be conducted in such a way to avoid duplication of State and Federal examiners, to maximize the limited resources of each level of government, and to reduce the examination burden on the industry. The FHLBB disagreed that accepting State examination reports is the best approach. The FHLBB stated it favored a program of joint and concurrent examinations.

CONCLUSIONS

The FHLBB does not rely, to any great extent, on independent State examinations and reports for State-chartered, federally insured savings and loan associations, as intended by the Congress. Instead, the FHLBB favors a different approach involving the joint State and Federal examination program. The FHLBB's approach will, to some extent, avoid duplication of State and Federal examiners, reduce the examination burden on the industry, and make better use of limited Federal and State resources. The

1/ In November 1978, the Congress established the Federal Financial Institutions Examination Council (12 U.S.C. 3301). The Examination Council, which began operation on March 16, 1979, was mandated to prescribe uniform principles and standards for the Federal examination of financial institutions, to make recommendations to promote progressive and vigilant supervision of financial institutions, and to conduct schools for examiners.
approach will not, however, lead to the potential resource savings envisioned by the Congress in establishing the State examiner training program.

Although we question whether, under its current policies regarding State examinations, the FHLBB will be able to fully meet the intent of the State examiner training program, the program needs to be more closely linked to the FHLBB's current relationships with the States. The FHLBB does not have control over the training program and does not select State examiners for training or provide criteria to NASS&LS for their selection. As a result, in many cases, the training provided to State examiners has been of little or no benefit to the FHLBB. To assure the most efficient and effective use of the training funds, we believe the FHLBB should develop guidance to use in identifying examiners that have a need and will benefit from the training. Once guidance has been established, the FHLBB's District Directors, whose staffs work with the State examiners, should be a valuable source of information in selecting State training participants.

Obviously, the FHLBB cannot readily rely on examinations performed by all States, and their work may overlap to some degree. In some States the FDIC has developed a mutually beneficial agreement for sharing examination reports of commercial banks that are not of supervisory concern. We believe the FHLBB should attempt to reach similar agreements with those States in which a solid working relationship exists.

RECOMMENDATIONS TO THE CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD

We recommend that the FHLBB:

--Assume greater control over the selection of the States from which examiners are trained.

--Select the States on the basis of criteria which will give priority to examiners needing training from those States participating in or offering the greatest potential for participation in joint examination or shared report programs.

AGENCY COMMENTS

The FHLBB generally agreed with the contents of this chapter but did have several specific comments. All comments were considered and, where appropriate, changes to the text were made.
The FHLBB's principal question focused on our interpretation of the Congress' intent in requesting the FHLBB to undertake the training of State examiners which would enable the States to assume greater responsibility for the examination of federally insured, State-chartered associations. The FHLBB does not believe that it was the intent of the Congress to train State examiners to reduce the FHLBB's examination burden by relying on reports prepared by the State examiners. As stated in this chapter, the FHLBB does not rely on State examination reports, but does have a joint State examination program where both the Federal and State examiners conduct a joint examination and prepare one report.

We do not share the FHLBB's view on the congressional intent of the State examination training program. Our analysis of the congressional intent is that the Congress expected the FHLBB to place greater reliance on the reports of State examiners and the States to complete a greater share of the examinations. The Senate committee report that accompanied the bill which eventually established the State examiner training program stated, "The Committee wishes the Board to place greater reliance on the reports of state savings and loan examiners as a long term means of controlling the spiraling cost of savings and loan examination." In order to improve the examination skills of State examiners, the Congress recommended funds be allocated for the training of State examiners, and specified the training that was to be made available.
APPENDIX I

FHLBB'S FORMAL ENFORCEMENT POWERS

The FHLBB has a variety of formal enforcement actions available to attempt to correct savings and loan association problems. The authority to use these tools is provided in the Home Owners' Loan Act of 1933 (12 U.S.C. 1464), the National Housing Act (12 U.S.C. 1730), the Financial Institutions Supervisory Act of 1966 (68 U.S.C. 634), and the Financial Institutions Regulatory and Interest Control Act of 1978 (12 U.S.C. 226).

SUPERVISORY AGREEMENT

The supervisory agreement is used by the FHLBB to enforce insurance regulations which require associations to maintain specific levels of net worth. The agreement should include provisions to eliminate the net worth deficiency and prevent recurrence of the problems leading to the failure. The agreement is signed by the association and the Board, and a violated agreement can be the basis for a cease and desist order.

The supervisory agreement is unique to the FHLBB in that other supervisory agencies use a formal written agreement, or memorandum of understanding, but do not limit its use to net worth failure.

CEASE AND DESIST ORDERS

The Financial Institutions Supervisory Act of 1966 provided the FHLBB and other financial institutions regulators with the authority to issue cease and desist orders against associations to correct problems. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 expanded this authority to allow issuance of a cease and desist order against any director, officer, employee, agent, or other persons participating in the affairs of the association.

First, a notice of charges is served upon the person or association

--that engaged or is engaging in unsafe or unsound practices,

--that has violated a law, rule, regulation, or a written agreement with the agencies, or any condition imposed in writing by the agencies in connection with the granting of any application or other request, or

--that is about to do any of the above.
APPENDIX I

The notice of charges contains a statement of facts about the alleged violations or unsound practices and establishes a time and place for a hearing to determine whether a cease and desist order should be issued.

If the association or party does not appear at the hearing or if the hearing confirms the violation or the unsafe or unsound practices, the agencies may issue the cease and desist order. The party or parties can consent to the cease and desist order, thus obviating a hearing. The order remains in effect until stayed, modified, terminated, or set aside by the agency or a reviewing court.

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 also provided the FHLBB with the authority to levy civil penalties of up to $1,000 per day against an association or person who violates a cease and desist order.

The FHLBB may also issue a temporary cease and desist order requiring the association or person to cease and desist from any violation or unsound practice. The temporary order is effective upon service to the association and remains effective until a hearing is held and the FHLBB dismisses the charges or, if a cease and desist order is issued, until the effective date of any such order.

REMOVAL OF MANAGEMENT

The FHLBB may order the removal of directors or officers of an association when

---the director or officer has violated a law, rule, regulation, or final cease and desist order; has participated in any unsafe or unsound banking practice; or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary duty;

---as a result, the association has suffered or will probably suffer substantial financial loss or other damage, or the interests of its depositors could be seriously prejudiced; and

---the violation, practice, or breach involved personal dishonesty on the part of the director or officer.
The FHLBB must first serve the director or officer with a written notice of its intention to remove him/her from office. The notice of intention establishes the grounds for removal and a time and place for a hearing. As with a cease and desist order, the FHLBB can remove the director or officer if he fails to appear at the hearing or if the charges specified in the notice of intention are substantiated. The removal order, too, remains in effect until stayed, modified, terminated, or set aside by the agency or a reviewing court.

In addition, the FHLBB has the authority to suspend any director or officer indicted for a felony involving dishonesty or breach of trust. The statute provides that such a suspension can be enforced by written notice and remains in effect until the charges are disposed of or the suspension is terminated by the agency.

APPENDIX I

**APPENDIX I**

**APPOINTMENT OF A CONSERVATOR OR RECEIVER**

The FHLBB may appoint a conservator or receiver for an association without notice if

-- the association is insolvent,

-- there is substantial dissipation of assets due to any violation or unsafe or unsound practice,

-- the association conducts unsafe or unsound transactions, or

-- the association conceals or refuses to submit books, papers, records, or affairs of the association for inspection by examiners or lawful agents of the FHLBB.

The appointment will stay in effect until modified or set aside by the Board or court review.

**TERMINATION OF DEPOSIT INSURANCE**

The FHLBB can terminate the insurance of accounts of any association if

-- the association has engaged in an unsafe or unsound practice in conducting its business,

-- it is in an unsafe or unsound condition, or

-- it has violated an applicable law, rule, regulation, order, or a written agreement with either the FHLBB or FSLIC.
When the FHLBB proceeds to terminate insurance, it may give the association up to 120 days to correct its problems. If the problems are corrected, the FHLBB may drop its proceedings.

CANCELLATION OF FHLBB MEMBERSHIP

The FHLBB may terminate an association's membership in a Federal home loan bank. This also automatically constitutes termination of insurance of accounts.