



Audit Report



OIG-19-009

FINANCIAL REGULATION AND OVERSIGHT

Material Loss Review of Washington Federal Bank for Savings

November 6, 2018

Office of
Inspector General

Department of the Treasury

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Contents

Audit Report

Cause of Washington Federal’s Failure	5
OCC’s Supervision of Washington Federal	7
Weaknesses in Supervision	8
Recommendations	11
OCC Did Not Act Promptly to Address Significant Weaknesses in the Loan Portfolio Reporting Capability of the Bank’s Management Information System	12
Recommendation	15
Examiners Did Not Timely Identify Risk and Expand Core Assessment	
Examination Procedures	16
Recommendation	20
Examiners Did Not Identify Inconsistencies or Report Policy Exceptions with Supervisory Guidance Related to the Bank’s Appraisal Program	21
Recommendation	23
Examiners Did Not Identify a Lack of Independence in the Bank’s Lending and Internal Loan Review Function	24
Lending Function	24
Internal Loan Review	24
Recommendation	26
OCC’s Use of Prompt Corrective Action	26

Appendices

Appendix 1: Objectives, Scope, and Methodology	28
Appendix 2: Background	31
Appendix 3: Management Response	32
Appendix 4: Major Contributors to This Report	36
Appendix 5: Report Distribution	37

Abbreviations

ADC	Assistant Deputy Comptroller
AEIC	Assistant Examiners-in-Charge
Board	Board of Directors
DIF	Deposit Insurance Fund
EIC	Examiner-in-Charge
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
JAMES	Joint Audit Management Enterprise System
MIS	management information system
MRA	matter requiring attention
NCT	National Credit Tool
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	prompt corrective action
ROE	report of examination
Washington Federal	Washington Federal Bank for Savings

*The Department of the Treasury
Office of Inspector General*

November 6, 2018

Joseph M. Otting
Comptroller of the Currency

This report presents the results of our material loss review of the failure of Washington Federal Bank for Savings (Washington Federal) located in Chicago, Illinois and of the Office of the Comptroller of the Currency's (OCC) supervision of the institution. OCC closed Washington Federal and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on December 15, 2017. Section 38(k)¹ of the Federal Deposit Insurance Act (FDIA)² mandated this review because of the magnitude of the bank's estimated loss to the Deposit Insurance Fund (DIF).^{3,4} As of September 30, 2018, FDIC estimated the loss at \$82.6 million.

The objectives of our audit were to (1) determine the causes of the bank's failure; (2) assess OCC's supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and (3) make recommendations for preventing any such loss in the future. To accomplish these objectives, we reviewed OCC and FDIC supervisory files from 2011 through 2017, reviewed bank supervision guidance, and interviewed OCC officials involved in the regulatory enforcement matters. Appendix 1 contains a more detailed description of our objectives, scope, and methodology. Appendix 2 contains background information on Washington Federal's supervisory history.

¹ 12 U.S.C. 1831o

² 12 U.S.C. 1811 et seq.

³ For losses incurred on or after January 1, 2014, Section 38(k) defines a loss as material if it exceeds \$50 million (with a provision that the threshold can be raised temporarily to \$75 million if certain conditions are met).

⁴ Certain terms that are underlined when first used in this report, are defined in *Safety and Soundness: Material Loss Review Glossary*, OIG-11-065 (April 11, 2011). That document is available on the Department of the Treasury Office of Inspector General's (OIG) website at <http://www.treasury.gov/about/organizational-structure/ig/Pages/by-date-2011.aspx>.

In brief, we found Washington Federal failed because of fraud⁵ in the bank's loan activity perpetrated by bank employees. The fraudulent activity depleted the bank's capital, with the result that the bank was insolvent and was in an extremely unsafe or unsound condition to transact business.

Regarding supervision, OCC generally performed examinations of Washington Federal in accordance with laws, regulations and guidance; however, we identified weaknesses in the execution of OCC's supervision of the bank that led to missed opportunities for timely enforcement actions related to the bank's loan portfolio. Specifically, we identified the following supervisory weaknesses:

- the Supervisory Office and Examiners-in-Charge (EIC) did not provide sufficient supervision of examination staff comprised mainly of first-time Assistant Examiners-in-Charge (AEIC) and examiners with limited experience;
- examiner conclusions were contradicted by documentation in the OCC work papers;
- examiners did not act promptly to address significant weaknesses in the loan portfolio reporting capability of the bank's management information system;
- examiners missed red flags related to Washington Federal's loan portfolio and resultantly did not timely expand the core assessment minimum procedures;⁶
- examiners did not identify and did not report unsafe or unsound practices that were contrary to agency guidance and bank policy related to the appraisal program; and
- examiners did not identify a lack of independence in the bank's lending or loan review function.

We believe that had the OCC examination teams identified and addressed these issues timely, the fraud at Washington Federal may

⁵ All uses of this term (fraud) in this report come from OCC's finding in its Supervisory Memorandum. As of the date of this report, no criminal or civil judicial finding of fraud has been made and applied to the bank's activities.

⁶ According to OCC's *Bank Supervision Process* Comptroller's Handbook, OCC's supervisory framework consists of three components: core knowledge; core assessment; and expanded procedures.

have been uncovered sooner and the loss to the DIF and individual account holders may have been reduced.

As of the date of this report, there is an open investigation of Washington Federal involving the Department of the Treasury Inspector General's Office of Investigations.

We are recommending the Comptroller of the Currency:

1. Assess the need for additional guidance related to the supervision of non-commissioned examiners by the EIC and the Supervisory Office including the need to require that supervision be documented.
2. Revise examination guidance to clarify the roles and responsibilities of an EIC in supervising an examination team, with an emphasis on reviewing work papers and confirming that conclusions in work papers are supported by the documentation.
3. Reinforce to examiners and provide training where necessary to ensure they understand:
 - the requirements of OCC Bulletin 2000-20 and the importance of the bank maintaining sufficient loan portfolio reporting for extensions, deferrals, renewals, and rewrites of closed-end loans;
 - that bank assurances made to examiners regarding deficiencies being resolved should be viewed with skepticism unless support for the assurances is provided and the examiner validates the effectiveness of the bank's corrective actions, especially when the deficiencies result in noncompliance with regulation or law;
 - that expanded procedures are recommended when an examination team is comprised of examiners in training positions and those with limited experience, including AEICs;
 - that expanded procedures are recommended for banks, or examination areas, that are consistently considered low risk;
 - the need to identify and report appraisal exceptions as required by the *Interagency Appraisal and Evaluation Guidelines*; and

- the need to identify and address issues of independence in small banks where employees or board members are participating in more than one function or committee.

In a written response, provided in its entirety in appendix 3, management concurred that there are often red flags that can aid in the detection of fraud and outlined planned corrective actions. In response to our recommendations, management stated that it will take the following corrective actions:

- OCC will reiterate the guidance that specifies the commissioned examiner or the Assistant Deputy Comptroller's (ADC) responsibilities for supervising a non-commissioned examiner in a communication to examination staff by February 28, 2019.
- OCC will reinforce the guidance pertaining to the roles and responsibilities of an EIC and ADC in supervising an examination team, including reviewing the accuracy of the examiner's work before findings are communicated to bank management, through a communication to all examination staff by February 28, 2019.
- OCC will reinforce the requirements of OCC Bulletin 2000-20 in a communication with the agency's examination staff. OCC has trained examiners on the principles and requirements of verification and validation and will continue to reinforce those requirements.
- OCC will reinforce the policy that examiners with limited experience should use expanded procedures when performing examinations. In addition, OCC will reiterate to its examination staff the importance of doing thorough reviews of lower-risk areas at least once during a three cycle timeline by February 28, 2019.
- OCC will reinforce its policy for citing violations of laws and regulations in a communication to our examination staff by February 28, 2019.
- OCC will reinforce the existing guidance pertaining to the independence of board members and employees in a communication to examination staff by February 28, 2019.

We consider OCC's planned actions responsive to our recommendations. We have summarized the response in the recommendation sections of this report. Management will need to record the estimated date for completing its planned corrective actions in the Joint Audit Management Enterprise System (JAMES), Treasury's audit recommendation tracking system.

Cause of Washington Federal's Failure

During the full-scope examination in October 2017, OCC examiners presented Washington Federal with a written request for its loan and credit files, payment histories, general ledger tickets, and other records related to several loans on the trial balance Washington Federal provided in response to OCC's examination request.

Prior to the start of the 2017 examination, a new ADC assumed responsibility for the supervision of Washington Federal. This ADC (referred to as ADC2 in this report)⁷ noticed several "red flags" at the beginning of the examination:

- the loan trial balance provided by the bank looked odd because it was in portable document format (pdf);
- the bank was not providing information to the examiners in a timely manner;
- there were several people on vacation, including the Chief Financial Officer and the bank's designated loan officer; and
- the bank's compliance officer never reviewed loan compliance because the officer claimed not to have access to the information.

On November 28, 2017, OCC examiners met with Washington Federal's Board of Directors (Board) to convey significant concerns identified during the examination, including, but not limited to, the failure of the bank to provide OCC with requested documents and loan files.

On the same day, November 28th, a member of Washington Federal's management advised OCC examiners that there was a major fraud

⁷ The previous ADC was assigned to the bank from 2011 to 2016 and is referred to as ADC1 throughout this report.

occurring at the bank. The manager disclosed that she had been informed by a bank employee that the employee and the bank's then President had been regularly falsifying loan payments for at least 29 loans-totaling approximately \$68 million in aggregate assets-and had falsified Washington Federal's loan trial balance before providing it to examiners. Following these discussions, OCC examiners immediately commenced a review of the 29 loans in question and confirmed that there was fraud on a magnitude that jeopardized Washington Federal's safety and soundness.

On November 29, 2017, OCC transferred Washington Federal to OCC's Special Supervision division, which oversees the supervision of OCC's critical problem mid-size and community banks. On November 30, 2017, OCC notified Washington Federal in writing that it was in "troubled condition" as a result of the deficiencies discovered.⁸

On December 5, 2017, OCC presented Washington Federal's Board with substantive interim results of the in-process 2017 examination. In the interim report of examination results, OCC stated its concerns about the falsified entries in Washington Federal's books and expressed its conclusion that the bank's capital, management and Board supervision, asset quality, earnings, liquidity, and sensitivity to market risk are all critically deficient as a result of the numerous unsafe or unsound banking practices as well as actual and potential violations of law and regulation.

As a result, OCC directed Washington Federal to recognize \$39.4 million in loan losses, corresponding to the estimated loss examiners had determined by the issuance date of the interim report, after reviewing 13 of the 29 loans in question. The interim report of examination also expressed examiners' determination that those losses had depleted the bank's capital, with the result that the bank was insolvent, and that it was in an extremely unsafe or unsound condition to transact business.

After issuing the interim report of examination, OCC examiners continued the review of Washington Federal's loans. The examiners determined there were losses totaling at least \$61.5 million, including the previously identified \$39.4 million, and directed Washington Federal to recognize an additional \$22.2 million in loan losses. On

⁸ The term "troubled condition" is defined in 12 CFR 5.51. The troubled condition designation imposes additional requirements on banks. See, e.g., 12 USC 1828(k); 12 CFR 5.51; 12 CFR Part 359.

December 15, 2017, OCC closed Washington Federal and appointed FDIC as receiver.

OCC's Supervision of Washington Federal

OCC employs a risk-based supervision approach. Supervision is based on the unique characteristics of each bank, including size and risk profile. Based on risk evaluations, examiners tailor supervisory activities to the risks identified.

According to OCC's *Bank Supervision Process* Comptroller's Handbook, OCC's supervisory framework consists of three components: core knowledge; core assessment; and expanded procedures. Core knowledge provides a foundation for risk assessment by capturing elements of the bank's culture, risk appetite, products and services, and other internal and external factors. The core assessment establishes the minimum conclusions examiners must reach to assess risks and assign regulatory ratings. The core assessment helps examiners determine how much supporting detail or work is required in each area by considering the bank's condition, nature of the risks, risk management components, background and experience of the examination teams, and other relevant information.

OCC assumed supervisory authority over Washington Federal from the Office of Thrift Supervision (OTS)⁹ in July 2011. During the last OTS examination of the bank, OTS assigned a composite CAMELS rating¹⁰ of "1". Accordingly, OCC considered Washington Federal a low-risk bank.

According to OCC's *Community Bank Supervision* Comptroller's Handbook, when examining low-risk banks or low-risk areas of banks, generally only the first, or minimum, objective under each section of the core assessment is completed. Expanded procedures are found in specialized Comptroller Handbooks and can be used to examine bank activities that warrant extra attention beyond the core assessment. Examiners determine which, if any, expanded procedures to use during examinations. Examination staff told us that other than the

⁹ Prior to July 2011, Washington Federal was supervised by the Office of Thrift Supervision (OTS). OCC became the bank's regulator in July 2011 when it assumed regulatory responsibility for federal savings associations pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203).

¹⁰ A composite rating of "1" is the highest rating and represents the least supervisory concern, indicating the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile.

minimum objectives of the core assessment, there are no examination procedures that must be performed at each examination and that examiners have substantial discretion in deciding what procedures to perform. Due to the examiners assessment that the bank or an area was low-risk, only the first objective under each section of the core assessment needed to be completed. We found that examiners sometimes completed additional objectives in the core assessment; however no expanded procedures outside of the core assessment were performed at Washington Federal.

Table 1 summarizes the results of OCC’s full-scope safety and soundness examinations and the interim results of the 2017 full-scope examination of Washington Federal from 2011 until the bank’s closure. In general, a matter requiring attention (MRA) is the lowest level supervisory response to a bank’s practices, or lack of practices, that deviate from sound governance, internal control, or risk management principles.

Table 1: Summary of OCC’s Examinations and Enforcement Actions for Washington Federal

Date started/ Type of Examination	Assets (in millions)	CAMELS Rating	Number of MRAs	Number of Corrective Actions	Enforcement Actions
10/24/2011 Full-scope examination	\$106	1/1111111	0	0	0
6/10/2013 Full-scope Examination	\$124	1/1111111	0	0	0
12/1/2014 Full-scope examination	\$132	1/1111111	0	0	0
5/16/2016 Full-scope examination	\$146	1/1111111	1	0	0
10/30/2017 Interim examination	\$115	5/555555	0	0	Prompt corrective action directive ¹¹

Finding 1: Weaknesses in Supervision

OCC’s Supervisory Office and EICs did not provide sufficient supervision of examination staff comprised mainly of first-time

¹¹ A prompt corrective action directive is a formal enforcement action used against a bank under the PCA provision of the FDIA.

Assistant Examiners-in-Charge (AEIC) and examiners with limited experience. In addition, examiner conclusions were contradicted by documentation in the OCC work papers.

Based on the perception that Washington Federal was a non-complex bank with a low risk profile, OCC considered the bank a good place to assign pre-commissioned examiners to work as first-time AEICs under the supervision of an experienced EIC. OCC's *Bank Supervision Process* Comptroller's Handbook allows non-commissioned examiners to act as AEICs, as long as the AEICs are supervised by either a commissioned examiner or the ADC. In addition, OCC's *Community Bank Supervision* Comptroller's Handbook identifies the risk associated with conducting examinations with examiners in training positions and those with little experience. It states, "expanded reviews and procedures may be appropriate in larger community banks; when banks engage in more complex operations; when the OCC conducts training assignments; when assignments are being completed by less-experienced examiners; and in other situations that benefit from increased testing and validation, as determined by the EIC and ADC."

For each examination from 2011 to 2016, OCC assigned non-commissioned examiners to lead the examinations. In 2013 and 2014, the AEICs were leading examinations for the first time. Five (5) of the 11 examiners we interviewed had limited experience, between 1 and 3 years, when they were assigned to the bank. A few of the examiners told us that Washington Federal was perceived as a "training" or "practice" bank.

The AEIC who led the 2013 examination told us that she had very little supervision. Although a commissioned examiner functioned as the Loan Portfolio Manager, she said this person did not provide any supervision.¹² The AEIC told us that she checked-in with the Supervisory Office periodically, but that it would have been helpful to have more supervision since this was the first time she had been assigned as an AEIC.

In 2014, the AEIC was supervised by an EIC who was on a part-time schedule (worked approximately 80 percent of a full-time schedule). The AEIC told us that he thought the supervision provided by the EIC and ADC¹ could have been better. He felt that because the EIC worked part-time, her availability and ability to provide direction was

¹² A Loan Portfolio Manager is an examiner who is responsible for performing the asset quality review during an examination.

limited. The EIC, by her own admission, was only minimally involved in the examination because she worked part-time and had other duties. The AEIC communicated with ADC1 on a weekly basis, but ADC1 was never on-site at the bank.

In 2016, the AEIC had led several examinations in the past, but was not supervised by a commissioned examiner.

OCC's practice of assigning AEICs to lead examinations is predicated on proper supervision, either by a commissioned examiner, an EIC or the ADC. The assertions made by the AEICs that (1) a commissioned examiner was assigned to the 2013 examination, but functioned as the Loan Portfolio Manager and not an EIC, and (2) there was no commissioned examiner assigned to oversee the 2016 examination are supported by documentary evidence in the supervisory file. The assertion that the EIC assigned to the 2014 examination provided only limited direction and had limited availability is corroborated by her own admission of being minimally involved.

ADC1 told us that he delegates examination responsibilities to his examination teams, but directs and oversees them. He stated that he mostly works with examiners on strategy, and although he gets weekly updates, he is not involved in conducting examinations. We were told that the examination teams met with ADC1 on a weekly basis to provide status updates on what was happening at the examination site, get a status of the examination, discuss any shifts of focus or deviations from the supervisory strategy, and discuss potential matters requiring attention. The degree of supervision provided by ADC1 during these meetings and the topics discussed are unclear as these meetings were not documented by the examination staff or the Supervisory Office.

As it relates to Finding 1, we found contradictions between the 2013 and 2016 examination work papers and examiner conclusions. Specifically, during the 2013 examination we note the following.

- An examiner reviewing a sample of loans identified a mortgage loan granted to the bank President's niece. The examiner noted correctly that since the bank President was on the loan committee, he should have abstained from voting to approve the loan. The examiner concluded that no such abstention was recorded in the loan committee minutes. We reviewed the loan committee minutes and found that the President abstained

from voting on the loan and the abstention was properly recorded.

- An examiner concluded that based on her review of the loan sample, the Washington Federal appraisal reviews were being done by a loan officer independent of the transaction. Our review of OCC's loan sample spreadsheet revealed three transactions in which the same person listed as either the loan officer or approving officer was also listed as the appraisal reviewer — and thus not independent of the transaction.
- An examiner concluded that the bank had no insider loans or transactions. Documentation in the supervisory file showed that the bank had two outstanding insider loans at the time.

During the 2016 examination, an examiner concluded that all the loans in the loan sample contained appraisals that were reviewed in a timely manner. Our review of OCC's retail loan spreadsheet revealed that 6 of the 10 loans reviewed contained appraisals that were reviewed after the loan was originated — ranging from 1 week to 6 months after origination.

We reviewed various OCC Comptroller Examination Handbooks and found no clear description of the specific duties of an EIC in the supervision of subordinate staff during examinations.

We believe that the use of insufficiently supervised inexperienced examiners significantly contributed to the failure of OCC to timely identify Washington Federal's deficiencies.

Recommendations

We recommend the Comptroller of the Currency:

1. Assess the need for additional guidance related to the supervision of non-commissioned examiners by the EIC and the Supervisory Office including the need to require that supervision be documented.
2. Revise examination guidance to clarify the roles and responsibilities of an EIC in supervising an examination team, with an emphasis on reviewing work papers and confirming that conclusions in work papers are supported by the documentation.

Management Response

Management noted that the Comptroller's Handbook on *Community Bank Supervision*, revised in June 2018, specifies the commissioned examiner or ADC's responsibilities for supervising a non-commissioned examiner, including: reviewing the accuracy of the examiner's work before findings are communicated to bank management; attending exit and board meetings with the examiner to provide for consistent and effective communication; and signing reports of examination and supervisory letters. Management will reiterate this guidance in a communication to examination staff by February 28, 2019.

For the second recommendation, Management noted that the Comptroller's Handbook on *Bank Supervision Process* and *Community Bank Supervision* booklets, revised in June 2018, clarify the roles and responsibilities of an EIC and ADC in supervising an examination team, including reviewing "the accuracy of the examiner's work before findings are communicated to bank management." Management will reinforce the guidance through a communication to all examination staff by February 28, 2019.

OIG Comment

Management's planned actions meet the intent of our recommendations.

Finding 2: OCC Did Not Act Promptly to Address Significant Weaknesses in the Loan Portfolio Reporting Capability of the Bank's Management Information System

OCC did not identify until 2016 that the bank had significant weaknesses in the loan portfolio reporting capability of the bank's management information system (MIS) that were present in prior years. OCC's PPM 5400-11 *Matters Requiring Attention* requires supervision staff to identify supervisory concerns promptly and proactively and directs examiners not to defer issuing a MRA pending the bank's efforts to address the concern. Additionally, the bank's inability to generate any reports relating to loan extensions or renewals was not consistent with safe and sound practices described in OCC Bulletin 2000-20 *Uniform Retail Credit Classification and Account Management Policy* (issued June 20, 2000). The policy provides supervisory guidance for banks, among other things, to establish explicit standards that control the use of extensions,

deferrals, renewals, and rewrites for closed-end loans. More specifically, the policy states that to be effective, the MIS should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten.

In 2016, OCC issued a MRA to address weaknesses in the bank's MIS. OCC uses MRAs to describe practices, or lack of practices that deviate from sound governance, internal control, or risk management principles, and have the potential to adversely affect the bank's condition. According to OCC examiners, the bank's MIS did not have sufficient loan reporting capability to enable effective management of the bank's loan portfolio. The bank's MIS could not generate a loan trial balance containing system-generated loan portfolio information. The MIS was also incapable of generating a loan report detailing the volume of investor-owned real estate and owner-occupied 1-4 family mortgages, therefore examiners could not determine the loan concentrations.

Because of these weaknesses, OCC examiners could not efficiently examine the bank's loan portfolio, including the inability to use the National Credit Tool (NCT)¹³ to review the loans in their samples. Examiners had to conduct the loan review manually by reviewing loan files and collecting loan information in a spreadsheet. According to one examiner, the bank would provide a listing of loans and examiners would choose their sample from that list. The examiners would select loans based on new loan originations since the last examination and areas of growth.

Based on our review of the examination work papers, we found that examiners continually had difficulty obtaining a loan trial balance. During each examination from 2011 to 2014, examiners noted in their work papers that the bank could not provide a loan trial balance in a format compatible with NCT. An examiner did discuss the format of the loan trial balance with the bank's President twice in 2013 while conducting periodic monitoring of the bank between examinations. However, we found no other evidence in the supervisory file showing any additional follow-up was attempted until the MRA was issued in 2016.

¹³ The National Credit Tool (NCT) is an examination tool used in loan reviews in community and midsize banks. The NCT enhances the efficiency and quality of the loan portfolio examination process by automatically producing valid statistical samples for examinations, automatically preparing worksheets, and generating standardized reports. The improved efficiency allows examiners to devote more time to the analysis of bank data.

ADC1 told us that the bank did not see a need to upgrade their core processing system because the bank saw itself as a simple, residential lender. He accepted the bank's reasoning and did not force an upgrade until 2016. He explained that based on what the examination staff knew about the bank's portfolio at the time,¹⁴ and that the bank's credit risk rating was satisfactory, the issue with the loan trial balance was not a supervisory concern. He was not aware that the loan trial balance being given to examiners was manual, not system-generated, until 2016. He also told us that he did not think that the other issues noted in the MRA were happening in previous exams.

The bank maintained the same data processing and core banking service provider throughout our audit scope (July 2011 through December 2017). We did not see any evidence in the supervisory file showing that the capabilities of the bank's system changed at any time during the period of 2011 to 2016, nor was any such evidence presented during our interviews with the examination staff. Accordingly, we believe it is reasonable to conclude that the weaknesses in the bank's MIS and the corresponding risks identified by examiners in 2016 were present in previous years. In June 2018, OCC personnel acknowledged that the limitations identified in 2016 were also present in prior years.

We believe OCC examiners did not timely address the weaknesses in the bank's loan portfolio reporting including the non-compliance with Bulletin 2000-20 because they did not identify the following "red flags": (1) the bank's claims of never having any credit losses in its history; (2) a pattern of past due loans, that had been reported on Call Reports, being brought current by the beginning of onsite examinations; and (3) the bank's claim that several loans included in the examiners' 2013 loan sample were paid off when examiners inquired about them. These "red flags" are discussed further in Finding 3. Instead of questioning these claims, the examiners used them to explain their inability to perform transaction testing on past due loans to determine compliance with Bulletin 2000-20. Further, the examiners cited the lack of credit losses and past due loans as

¹⁴ OCC considered the bank low-risk, partly based on the composition of the bank's loan portfolio, which primarily consisted of 1-4 residential loans.

support for their conclusion that the bank's policies and procedures were sufficient to ensure compliance with Bulletin 2000-20.

We asked the OCC Analyst assigned to the bank why the MRA was not issued sooner.¹⁵ She told us that the examination teams relied too much on bank assurances that the bank was in the process of upgrading its MIS.

Based on the weaknesses noted in the 2016 MRA, OCC was concerned that bank management could be masking delinquencies or potential losses in the loan portfolio and improperly assessing the bank's credit risk profile.

We believe that had the examination teams identified and addressed this issue in a timelier manner, the fraud may have been uncovered sooner and the loss to the DIF and individual account holders may have been reduced.

Recommendation

We recommend the Comptroller of the Currency:

3. Reinforce to examiners and provide training where necessary to ensure they understand:
 - The requirements of OCC Bulletin 2000-20 and the importance of the bank maintaining sufficient loan portfolio reporting for extensions, deferrals, renewals, and rewrites of closed-end loans.
 - That bank assurances made to examiners regarding deficiencies being resolved should be viewed with skepticism unless support for the assurances is provided and the examiner validates the effectiveness of the bank's corrective actions, especially when the deficiencies result in noncompliance with regulation or law.

¹⁵ The Analyst position resides at the Supervisory Office and touches all aspects of the examination including: ensuring written communication is in compliance with guidance; performing preliminary reviews before reports go to ADCs; and participating in weekly status updates with the examination team and the ADC to discuss any shifts of focus or deviations from the supervisory strategy and potential matters requiring enforcement action.

Management Response

Management plans to reinforce the requirements of OCC Bulletin 2000-20 in a communication with the agency's examination staff. OCC issued OCC Bulletin 2017-48 *Bank Enforcement Actions and Related Matters* on October 31, 2017, and OCC Bulletin 2018-18 *Comptroller's Handbook: Revised and Updated Booklets and Rescissions* on June 28, 2018. OCC Bulletin 2018-18 incorporates OCC Bulletin 2014-52 *Matters Requiring Attention: Updated Guidance* and OCC Bulletin 2017-18 *Violations of Laws and Regulations: Updated Guidance into the Comptroller's Handbook*. Each of these booklets and guidance describe the OCC's process for verifying and validating the effectiveness of a bank's corrective action, which requires examiners to review documentation to confirm that the bank implemented the corrective action. Additionally the guidance requires examiners to validate the effectiveness and sustainability of the corrective action before determining that the bank has complied with the requirement. Management has trained examiners on the principles and requirements of verification and validation and will continue to reinforce those requirements.

OIG Comment

Management's planned actions meet the intent of our recommendations.

Finding 3: Examiners Did Not Timely Identify Risk and Expand Core Assessment Examination Procedures

The Washington Federal examination team did not follow OCC guidance that recommended expanding examination procedures beyond those required by the core assessment to mitigate the risk associated with conducting examinations with examiners in training positions and those with little experience. The examination team also did not follow additional recommendations in the *Community Bank Supervision* Comptroller's Handbook to periodically expand supervisory activities beyond the minimum objectives to determine whether supervisory concerns are present in areas that are consistently identified as low risk. OCC examiners completed the core assessment at each examination of Washington Federal. Expanded

examination procedures beyond the core assessment were only used by a training team during the 2016 examination.

Examiners use judgement to determine how much work or supporting detail is necessary to complete the core assessment, which establishes the minimum conclusions examiners must reach to assess risks and assign regulatory ratings. Further, examination staff told us that other than the minimum objectives of the core assessment, there were no procedures that were required in examining the bank and that examiners have substantial discretion in deciding what procedures to perform. This is confirmed by OCC's *Community Bank Supervision* Comptroller's Handbook, which states that examiners determine which, if any, expanded procedures to use during examinations.

During the course of OCC's supervision of the bank, there were several "red flags" that we believe should have raised concern with examiners.

- The bank claimed never to have a credit loss in its 103 year history. Instead of arousing suspicion, examiners used this claim as a positive attribute to support their supervisory strategy, plan the scope of the examinations, and assess compliance with agency policy.
- The bank continually reported no classified or special mention loans.
- The bank repeatedly reported past due loans in Call Reports, and then at examination time when examiners inquired about past due loans, told examiners that the loans had been brought current.
- In 2013, the bank claimed that several loan files selected for review were paid off when examiners inquired about them during the examination.
- Each member of the bank's loan committee was involved in underwriting and approving loans.

- The bank had significant weaknesses in the loan reporting capability of its MIS, as previously discussed.

During the 2013 examination, the bank told examiners that five of the loans selected for review had been paid-off, so the examiners did not review these loans. The AEIC assigned to lead the examination told us that they did not validate that the loans were paid-off because she assumed the loans were miscoded due to the loan trial balance being in a spreadsheet format.

During the 2017 examination, examiners were told that 5 of the 9 loans in their loan sample were paid off. They requested additional information about the paid-off loans, but had difficulty obtaining information from the bank. ADC2 instructed the EIC to inform the bank's President that the examiners would not leave the bank until the bank provided the requested information.

In November 2017, OCC examiners met with the bank's Board of Directors to convey significant concerns identified during the examination, including the failure of the bank to provide requested documents and loan files. After the meeting, a member of the bank's management, who was also a Board member, advised OCC examiners that there was a major fraud occurring at the bank. ADC2 told us that if previous examiners would have validated that the loans the bank reported as paid-off were indeed paid-off, the fraud would have been uncovered sooner.

Also as previously discussed, we found additional "red flags" where the bank's MIS could not generate: a loan trial balance containing system-generated loan portfolio information; any reports relating to loan extensions or renewals; and a loan report detailing the volume of investor-owned real estate and owner-occupied 1-4 family mortgages. Examiners had to conduct the loan review manually, by reviewing loan files and collecting loan information in a spreadsheet. According to one examiner, the bank would provide a listing of loans and examiners would choose their sample from that list. Based on the "red flags", we believe the examination teams should have expanded procedures and validated the universe of loans at the bank.

Examiners did not take any action to validate the loan universe provided to them by the bank. An examiner told us that they trust that a bank is giving them a complete and accurate loan trial balance and accept the loan trial balance in good faith unless there is reason to question it. Another examiner told us that examiners do not review the complete loan trial balance and she was not aware of any OCC

examination practices used to validate the loan trial balance. She added that examiners rely on the bank's financial audits to identify any problems with the loan trial balance.

We asked the ADC assigned to the bank at that time, ADC1, how examiners validate the loan universe. He told us that examiners rely on the bank's internal audit function to do this and explained that examiners review audit reports and work papers and rely on that information.

The bank's external auditor conducted audits of the bank's financial statements on a yearly basis from 2011 to 2016, which included a review of the bank's loan assets, and never reported any issues with the bank's loan trial balance. However, examiners did not review any of the external auditor's work papers during their examinations of the bank.

OCC's *Residential Real Estate* Comptroller's Handbook includes a verification procedure to test the reliability of financial records, including a specific procedure to reconcile loan trial balances to the general ledger. The handbook explains that examiners generally only perform verification procedures as part of an examination when substantive safety and soundness concerns are identified and not mitigated by the bank's risk management systems and internal controls. The use of verification procedures is considered an expanded examination procedure. Examiners did not use any expanded procedures in conducting their asset quality reviews during any of the examinations.

We believe that the bank's inability to provide a loan trial balance containing system-generated loan portfolio information; any reports relating to loan extensions or renewals; and, a loan report detailing the volume of investor-owned real estate and owner-occupied 1-4 family mortgages should have concerned examiners enough to question its validity.

We believe that the weaknesses in supervision addressed in Finding 1 were the reason that the "red flags" were not identified by OCC examination teams prior to 2017. In addition, we believe it would have been prudent for the Washington Federal examination teams to have followed OCC recommended guidance and expanded examination procedures to mitigate the risk of relying on inexperienced examiners and those in training positions to conduct

examinations, as well as the risk that supervisory concerns are present in areas that are consistently identified as low risk.

When we interviewed ADC2, he explained that there were several “red flags” from the beginning of the 2017 examination that concerned him: the loan trial balance provided by the bank looked odd because it was in pdf; the bank was not providing information to the examiners in a timely manner; there were several people on vacation, including the Chief Financial Officer and the bank’s designated loan officer; and the bank’s compliance officer never reviewed loan compliance because the officer claimed not to have access to the information. We believe that the “red flags” present during the 2011 through 2016 examinations should have raised concerns with ADC1 well before they were ultimately identified by ADC2 and the 2017 examination team which included an experienced EIC.

Recommendation

We recommend the Comptroller of the Currency:

4. Reinforce to examiners and provide training where necessary that expanded procedures are recommended:
 - when an examination team is comprised of examiners in training positions and those with limited experience, including AEICs; and
 - for banks, or examination areas, that are consistently considered low risk.

Management Response

Management will reinforce its policy that examiners with limited experience should use expanded procedures when performing examinations. Per practice, OCC will continue to use expanded procedures in instances where training teams are performing examinations. OCC also conducts risk-based supervision. Examiners develop supervision strategies to ensure that all risk areas are reviewed in depth at least once during three examination cycles. OCC believes this approach enhances its focus and resources on the highest risk examination areas; and that it also ensures areas of lower risk receive greater supervisory attention at least once during the three cycle examination period. Management will reiterate to its examination staff the importance of doing thorough reviews of lower-

risk areas at least once during a three cycle timeline by February 28, 2019.

OIG Comment

Management's planned actions meet the intent of our recommendations.

Finding 4: Examiners Did Not Identify Inconsistencies or Report Policy Exceptions with Supervisory Guidance Related to the Bank's Appraisal Program

During each examination from 2011 to 2016, examiners reviewed a sample of loans. The purpose of the review, among other things, was to determine whether the bank's loan underwriting practices conformed to bank policy and OCC guidelines.

Our review of OCC's work papers showed examiners did not consistently identify exceptions of appraisal regulations and the bank's failure to adhere to its appraisal policy. For the exceptions that they did identify, they did not cite the bank with a supervisory letter or report the exceptions in their examination reports as required by the *Interagency Appraisal and Evaluation Guidelines*.¹⁶ The guidelines indicate banks should review appraisals as part of the credit approval process and prior to the credit decision. In addition, the guidelines required OCC to cite the bank, in either a supervisory letter or examination report, for failure to maintain an appraisal program consistent with appraisal regulations.

Washington Federal's *Appraisal Policy* required that appraisals be reviewed prior to funding to ensure that the methods, assumptions, and conclusion in the appraisal are reasonable, well-supported, and appropriate for the transaction.

Using OCC examiner-prepared loan review work papers, we found a significant number of loans in which the appraisal was reviewed by Washington Federal personnel after the loan was originated, or not

¹⁶ OCC, along with other federal regulators, adopted the Interagency Guidelines in 2010. The guidelines provide guidance for banks and examiners on prudent appraisal policies, practices, and standards. The guidelines address supervisory matters related to real estate appraisals used to support real estate-related financial transactions.

reviewed at all. Many reviews were conducted months after origination and one was done a full year after origination.

In 2011, examiners reviewed a sample of 17 commercial loans. An examiner documented in the work papers that a review of the appraisal was not done for 8 of the 17 loans in the sample. Although the examiner documented the missing appraisal reviews in the work papers, OCC did not report them as deficient practices. The AEIC that reviewed the loan work papers told us that she could not remember any concerns with the appraisal review process.

In 2013, examiners reviewed a sample of 19 retail loans. An examiner documented in the work papers that she identified only one policy exception¹⁷ in the sample. Our review of OCC's loan review work papers revealed five additional exceptions, each for appraisal reviews done after origination. The examiner that reviewed the loans told us that she did not notice the late appraisal reviews at the time. The AEIC told us that she was not aware of the late appraisal reviews.

In 2014, examiners selected 11 retail loans to review. An examiner noted four policy exceptions in the retail loan sample, three loans were missing an appraisal review, and one loan's appraisal was done after loan origination. Our review of OCC's loan review work papers found six exceptions not identified by the examiners: three loans had no appraisal review in the file and three loans had appraisals that were reviewed after loan origination. The examiner told us that he was not aware at the time that missing and late appraisal reviews were exceptions, but he is aware of this now. The EIC told us that she was not aware of these issues.

In 2016, examiners selected a sample of 10 retail loans to review. An examiner noted that no exceptions were identified during her loan review. In addition, the same examiner noted that the appraisal reviews were completed in a timely manner. Our review of OCC's loan review work papers found six exceptions. In all six of the loans, the appraisal review was done after origination. The AEIC told us that he was not aware of the late appraisal reviews and that the examiner

¹⁷ According to OCC's Loan Portfolio Management Comptroller's Handbook, a policy exception is a condition in an approved loan that violates the bank's loan policy.

who did the loan review may have made a mistake by not reporting this to him.

We noted these policy exceptions and deviations from guidance by reviewing work papers prepared by OCC examiners. It is unclear to us why the examiners were not aware of them. We believe that this is a result of a (1) lack of thorough review of work papers by the EICs, AEICs, and Loan Portfolio Managers; and (2) lack of knowledge of the proper handling of policy exceptions and deficient practices.

We believe that had examiners documented and reported the policy exceptions and deficient appraisal review practices, the examination teams may have downgraded the bank's risk assessment and found it necessary to expand examination procedures.

Recommendation

We recommend the Comptroller of the Currency:

5. Reinforce to examiners and provide training where necessary of the need to identify and report appraisal exceptions as required by the *Interagency Appraisal and Evaluation Guidelines*.

Management Response

Management noted that it issued OCC Bulletin 2018-18 *Comptroller's Handbook: Revised and Updated Booklets and Rescissions* on June 28, 2018. OCC Bulletin 2018-18 incorporated OCC Bulletin 2017-18 *Violations of Laws and Regulations: Updated Guidance into the Comptroller's Handbook*. The OCC provided examiner training on the updated *Violations of Laws and Regulations* guidance in June 2017, subsequent to the deficiency that we cited. Management will reinforce the agency's policy for citing violations of laws and regulations in a communication to its examination staff by February 28, 2019.

OIG Comment

Management's planned actions meet the intent of our recommendation.

Finding 5: Examiners Did Not Identify a Lack of Independence in the Bank's Lending and Internal Loan Review Function

Lending Function

Washington Federal had a loan committee that was comprised of four members. The loan committee reviewed and approved pending loans. Two members of the loan committee were employees of the bank: one was the bank's President and the other a Senior Vice President, who was also the Commercial and Residential Real Estate Manager. The other two members were outside directors, one of which was the Chairman of the Loan Committee.

During our review of OCC's work papers, we noticed that each member of the loan committee was also involved in the underwriting of loans. OCC's loan review work papers identified the loan officer, loan approver, and appraisal reviewer for most loans in their loan samples. In addition, we noticed several loan transactions in the 2013 and 2016 loan samples in which a member of the loan committee is listed as having dual roles in the transaction, as either loan officer or loan approver, and appraisal reviewer.

The *Interagency Appraisal and Evaluation Guidelines* describe safe and sound appraisal review practices to include independence for individuals who conduct appraisal reviews from the transaction. The guidelines explain that when absolute lines of independence cannot be achieved, a loan officer can review appraisals, as long as the loan officer abstains from voting to approve the loan.

The supervisory file contained loan committee meeting minutes from 2011 to 2017. Our review found only one instance where a member of the committee abstained from voting on a loan and it was not related to any of the loans we identified with independence issues.

Internal Loan Review

During the 2013 examination, examiners reviewed the bank's internal loan function. The purpose of Washington Federal's internal review was to assess the adequacy of credit administration practices, the accuracy of credit risk identification, and the quality of credit risk management. The review was conducted by an outside director, who

was also the Chairman of the Loan Committee (referred to in this report as Person A).

In the work papers, an OCC examiner explained that the examination team obtained and reviewed the internal loan review work papers to determine the quality of the loan review. The examiner noted that Person A's loan review was sufficient based on the size and risk profile of the bank. The examiner also noted that since Person A was a voting member of the loan committee, a conflict of interest could be created if he reviewed any of the loans that he approved.

We reviewed the internal loan work papers and found that Person A reviewed five loans as part of his loan review that he had previously approved. Person A was listed as both "Approving Officer" and "Reviewer" on Washington Federal's Consumer Loan Grading Worksheet. Person A evaluated each loan underwriting criterion and assigned a grade to each loan. He reported the results of his review to the bank's audit committee. Person A approved these loans twice, once at origination as the approving officer, and again as a voting member of the loan committee.

OCC's *Community Bank Supervision* Comptroller's Handbook requires examiners to assess the quality of the control systems over the credit function. To do so, examiners must determine if the bank has an established system of independent credit review.

According to OCC's *Loan Portfolio Management* Comptroller's Handbook, loan review is one of the primary controls over a bank's lending activities and its independence should be protected.

We discussed the lack of independence with the examiner who conducted the 2013 review of both the loan samples and the internal loan function. She told us that she (1) was not aware of any independence issues with the bank's lending function, and (2) did not notice that Person A had reviewed loans that he previously approved. We believe this erroneous conclusion could have been avoided with a more thorough work paper review and supervision.

As a result of the lack of independence, both the bank's lending and internal loan review function operated without proper oversight. Had this been identified, we believe examiners may have downgraded the

bank's risk rating and possibly expanded examination procedures to mitigate the risk.

Recommendation

We recommend the Comptroller of the Currency:

6. Reinforce to examiners and provide training where necessary of the need to identify and address issues of independence in small banks where employees or board members are participating in more than one function or committee.

Management Response

Management noted that the Comptroller's Handbook stresses the importance of independence for board members and employees in multiple booklets including, but not limited to, the *Corporate and Risk Governance*, *Community Bank Supervision*, and *Internal Controls* booklets. Management will reinforce the existing guidance in a communication to examination staff by February 28, 2019.

OIG Comment

Management's planned actions meet the intent of our recommendation.

OCC's Use of Prompt Corrective Action

The purpose of PCA is to resolve problems of insured depository institutions with the least possible long-term loss to the DIF. The PCA requires federal banking agencies to take certain actions when an institution's capital drops below certain levels. Depending on the capital level, some PCA restrictions are imposed automatically, and others are discretionary. PCA requires regulators to take prompt corrective action to resolve an insured institution's problems once a bank becomes undercapitalized.

According to OCC guidance, *Enforcement Action Policy* PPM 5310-3, the use of a prompt corrective action directive is preferred over other enforcement actions when a bank is undercapitalized and its viability is in doubt.

Based on the interim findings of the October 2017 full scope examination, OCC determined that the bank was critically

undercapitalized for PCA purposes. The loan losses associated with the fraud entirely depleted the bank's capital. As a result, OCC issued a prompt corrective action directive on December 7, 2017, and the bank closed on December 15, 2017.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384 or Andrew Morgan, Audit Manager, at (202) 927-8121. Major contributors to this report are listed in appendix 4. A distribution list for this report is provided in appendix 5.

/s/

Jeffrey Dye
Director, Financial Regulation and Oversight

We conducted a material loss review of Washington Federal Bank for Savings (Washington Federal), located in Chicago, Illinois, in response to our mandate under section 38(k)¹⁸ of the Federal Deposit Insurance Act. This section provides that if the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general for the appropriate federal banking agency is to prepare a report to the agency that

- ascertains why the institution's problems resulted in a material loss to the insurance fund;
- reviews the agency's supervision of the institution; and
- makes recommendations for preventing any such loss in the future.

At the time of Washington Federal's failure on December 15, 2017, section 38(k) defined a loss as material if it exceeded \$50 million. The law also requires the inspector general to complete the report within 6 months after it becomes apparent that a material loss to the Deposit Insurance Fund has been incurred. We initiated this material loss review of Washington Federal based on the loss estimate by the Federal Deposit Insurance Corporation (FDIC), which was \$60.5 million at the time of closing. As of September 30, 2018, FDIC estimated that the loss would be \$82.6 million.

To accomplish our reporting objectives under section 38(k), we conducted fieldwork from February 2018 through June 2018 at the Office of the Comptroller of the Currency's (OCC) headquarters in Washington, DC, OCC's Schaumburg, Illinois field office, and at FDIC's offices in Arlington, Virginia.

To assess the adequacy of OCC's supervision of Washington Federal, we determined whether OCC (1) conducted examinations in accordance with agency guidance; (2) provided sufficient supervision of examination staff; (3) identified and reported weaknesses in the bank's lending activity; and (4) took action to address any identified weaknesses. We also assessed whether

¹⁸ 12 U.S.C. 1831o.

there was anything the examination staff could have done to enable OCC to detect the fraud sooner.

Specifically, we performed the following work:

- We determined that the period covered by our audit would be from October 2011, through the bank's failure on December 15, 2017. This period included four full-scope safety and soundness examinations, and one limited-scope examination of Washington Federal by OCC.
- We reviewed OCC's supervisory files and records for the bank from 2011 through 2017. We analyzed examination reports, supporting work papers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the action used by OCC to compel bank management to address deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated work papers other than those incidentally available through the supervisory files.
- We reviewed the bank's *Real Estate Lending and Appraisal* policies.
- We obtained and reviewed information from OCC that was not in the supervisory files.
- We reviewed available FDIC documents.
- We interviewed and discussed various aspects of the supervision with an FDIC examiner, OCC officials, OCC examiners, and OCC's Assistant District Counsel to obtain their perspectives on the bank's condition and the scope of the examinations.
- We assessed OCC's actions based on its internal guidance and the requirements of the Federal Deposit Insurance Act.¹⁹

¹⁹ 12 U.S.C. 1811 et seq.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Washington Federal Bank History

Washington Federal Bank for Savings (Washington Federal) was founded in 1913 as Washington Savings and Loan Association of Chicago, Chicago, Illinois, and has been federally insured since December 27, 1961. The institution changed its name to Washington Savings Bank and converted its charter to a mutual savings bank on July 22, 1993. Less than 2 years later, on March 1, 1995, the institution changed its name to Washington Federal Bank for Savings and reorganized to a stock-issuing savings association. On July 21, 2011, the Office of the Comptroller of the Currency (OCC) became the institution's primary federal regulator. The bank's main office is located in the Bridgeport neighborhood of the City of Chicago, Cook County, Illinois, and has a single full-service branch located in the Little Italy area of the city.

In its most recent Consolidated Report of Condition and Income, dated September 30, 2017, the bank reported \$166 million in total assets and \$144 million in total deposits. The bank was closed on December 15, 2017. As of September 30, 2018, the Federal Deposit Insurance Corporation estimated that the loss to Deposit Insurance Fund to be \$82.6 million.

The OCC issued an Interim Report of Examination (ROE) on December 5, 2017 and assigned a CAMELS composite rating of "5," with component ratings of 5/5/5/5/5/5. Until the issuance of the Interim ROE, the Bank had a CAMELS composite rating of "1" since 2011, when the OCC obtained jurisdiction over the bank. During the examination commencing on October 30, 2017, examiners uncovered fraud affecting a substantial portion of the bank's loan portfolio. As a result of the fraud, the bank had recognized losses that exceeded the bank's capital, rendering the bank insolvent. The bank had concealed or falsified its records, the bank had experienced a substantial dissipation in assets and earnings, and the bank was in an unsafe or unsound condition to transact business.



Office of the Comptroller of the Currency

Washington, DC 20219

October 22, 2018

Jeffrey Dye
Director, Banking Audits
Office of Inspector General
Department of the Treasury
Washington, DC 20220

Subject: Response to Draft Report titled *Material Loss Review of Washington Federal Bank for Savings*

Dear Mr. Dye:

We have received and reviewed your draft report titled "Material Loss Review of Washington Federal Bank for Savings," (Washington Federal) in Chicago, Illinois. Section 38(k) of the Federal Deposit Insurance Act mandates this review because of the amount of the bank's estimated loss to the Deposit Insurance Fund (DIF). Your objectives were to determine the causes of Washington Federal's failure; assess the Office of the Comptroller of the Currency's (OCC) supervision of the bank, including implementation of the prompt corrective action (PCA) provisions of section 38; and make recommendations for preventing any such loss in the future. To accomplish these objectives, you reviewed OCC and Federal Deposit Insurance Corporation supervisory files from 2011 through 2017, reviewed bank supervision guidance, and interviewed OCC officials involved in the regulatory enforcement matters.

In your report you acknowledged that Washington Federal failed because of fraud¹ in the bank's loan activity perpetrated by bank employees. The fraudulent activity depleted the bank's capital, with the result that the bank was insolvent and was in an extremely unsafe or unsound condition to transact business.

Regarding supervision, OCC generally performed examinations of Washington Federal in accordance with laws, regulations and guidance; however, you identified weaknesses in the execution of OCC's supervision of the bank that led to missed opportunities for timely enforcement actions related to the bank's loan portfolio. Specifically, you identified six supervisory weaknesses.

The weaknesses included: (1) the Supervisory Office and Examiners-in-Charge (EIC) did not provide sufficient supervision of examination staff comprised mainly of first-time Acting Examiners-in-Charge (AEIC) and examiners with limited experience; (2) examiner conclusions

¹ We note, however, as of the date of this report, no criminal or civil judicial finding of fraud has been made and applied to the bank's activities.

were contradicted by documentation in the OCC work papers; (3) examiners did not act promptly to address significant weaknesses in the loan portfolio reporting capability of the bank's management information system; (4) examiners missed red flags related to Washington Federal's loan portfolio and resultantly did not timely expand the core assessment minimum procedures; (5) examiners did not identify and did not report unsafe or unsound practices that were contrary to agency guidance and bank policy related to the appraisal program; and (6) examiners did not identify a lack of independence in the bank's lending or loan review function.

As a result, you concluded that had the OCC examination teams identified and addressed these issues timely, the fraud at Washington Federal may have been uncovered sooner and the loss to the DIF and individual account holders may have been reduced.

Insider abuse and fraud have been contributing factors in several bank failures. Fraud can take many forms and can be isolated or widespread. It is usually accompanied by a lack of policy, oversight, controls, or audit. Fraud and abuse typically are concealed from routine scrutiny; however, the OCC concurs there are often red flags that can aid in detection.

1. Your report recommends the OCC assess the need for additional guidance related to the supervision of non-commissioned examiners by the EIC and the Supervisory Office including the need to require that supervision be documented. We will take the following corrective action.

- The Comptroller's Handbook Community Bank Supervision booklet, revised in June 2018, specifies the commissioned examiner or ADC's responsibilities for supervising a non-commissioned examiner, including:
 - reviewing the accuracy of the examiner's work before findings are communicated to bank management.
 - attending exit and board meetings with the examiner to provide for consistent and effective communication.
 - signing ROEs and supervisory letters.

The OCC will reiterate this guidance in a communication to examination staff by February 28, 2019.

2. Your report recommends the OCC revise examination guidance to clarify the roles and responsibilities of an EIC in supervising an examination team, with an emphasis on reviewing work papers and confirming that conclusions in work papers are supported by the documentation. We will take the following corrective action.

- The Comptroller's Handbook Bank Supervision Process and Community Bank Supervision booklets, revised in June 2018, clarify the roles and responsibilities of an EIC and ADC in supervising an examination team, including reviewing "the accuracy of the examiner's work before findings are communicated to bank management." The OCC will reinforce the guidance through a communication to all examination staff by February 28, 2019.

3. Your report recommends the OCC reinforce to examiners and provide training where necessary:

- The requirements of OCC Bulletin 2000-20 and the importance of the bank maintaining sufficient loan portfolio reporting for extensions, deferrals, renewals, and rewrites of closed end loans.
- That bank assurances made to examiners regarding deficiencies being resolved should be viewed with skepticism unless support for the assurances is provided and the examiner validates the effectiveness of the bank's corrective actions, especially when the deficiencies result in noncompliance with regulation or law.

OCC plans to take the following corrective actions. The OCC will reinforce the requirements of OCC Bulletin 2000-20 in a communication with the agency's examination staff. The OCC issued OCC Bulletin 2017-48 Bank Enforcement Actions and Related Matters on October 31, 2017 and OCC Bulletin 2018-18 Comptroller's Handbook: Revised and Updated Booklets and Rescissions on June 28, 2018. OCC Bulletin 2018-18 incorporates OCC Bulletin 2014-52 Matters Requiring Attention: Updated Guidance and OCC Bulletin 2017-18 Violations of Laws and Regulations: Updated Guidance into the Comptroller's Handbook. Each of these booklets and guidance describe the OCC's process for verifying and validating the effectiveness of a bank's corrective action, which requires examiners to review documentation to confirm that the bank implemented the corrective action. Additionally the guidance requires examiners to validate the effectiveness and sustainability of the corrective action before determining that the bank has complied with the requirement. The OCC has trained examiners on the principles and requirements of verification and validation and will continue to reinforce those requirements.

4. Your report recommends the OCC reinforce to examiners and provide training where necessary that expanded procedures are recommended:

- when an examination team is comprised of examiners in training positions and those with limited experience, including AEICs; and
- for banks, or examination areas, that are consistently considered low risk.

OCC plans to take the following corrective actions. The OCC will reinforce the OCC policy that examiners with limited experience should use expanded procedures when performing examinations. Per OCC practice, we will continue to use expanded procedures in instances where training teams are performing examinations.

The OCC also conducts risk-based supervision. Examiners develop supervision strategies to ensure that all risk areas are reviewed in depth at least once during three examination cycles. This approach enhances our focus and resources on the highest risk examination areas; however, it also ensures areas of lower risk receive greater supervisory attention at least once during the three cycle examination period. The OCC will reiterate to its examination staff the importance of doing thorough reviews of lower-risk areas at least once during a three cycle timeline by February 28, 2019.

5. Your report recommends the OCC reinforce to examiners and provide training where necessary of the need to identify and report appraisal violations as required by the Interagency Appraisal and Evaluation Guidelines.

The OCC issued OCC Bulletin 2018-18 Comptroller's Handbook: Revised and Updated Booklets and Rescissions on June 28, 2018. OCC Bulletin 2018-18 incorporated OCC Bulletin 2017-18 Violations of Laws and Regulations: Updated Guidance into the Comptroller's Handbook. The OCC provided examiner training on the updated Violations of Laws and Regulations guidance in June 2017, subsequent to the deficiency that OIG cited. The OCC will again reinforce the agency's policy for citing violations of laws and regulations in a communication to our examination staff by February 28, 2019.

6. Finally, your report recommended the OCC provide training and reinforce to examiners the need to identify and address issues of independence in small banks where employees or board members are participating in more than one function or committee.

The OCC Comptroller's Handbook stresses the importance of independence for board members and employees in multiple booklets including, but not limited to, the Corporate and Risk Governance, Community Bank Supervision, and Internal Controls booklets. The OCC will reinforce the existing guidance in a communication to examination staff by February 28, 2019.

If you need additional information, please contact Enice Thomas, Senior Advisor to the Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-649-8281.

Sincerely,



Toney M. Bland
Senior Deputy Comptroller
Midsize and Community Bank Supervision

Appendix 4
Major Contributors to This Report

Andrew Morgan, Audit Manager
David Hash, Auditor-in-Charge
Angela Brice, Auditor
Katherine Draper, Auditor
Kevin Guishard, Referencer

Department of the Treasury

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Office of Strategic Planning and Performance Improvement
Office of the Deputy Chief Financial Officer, Risk and Control
Group

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Comptroller of the Currency
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OIG Budget Examiner

U.S. Senate

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Finance

U.S. House of Representatives

Chairman and Ranking Member
Financial Services Committee

Federal Deposit Insurance Corporation

Chairman
Inspector General

U.S. Government Accountability Office

Comptroller General of the United States



Treasury OIG Website

Access Treasury OIG reports and other information online:

<http://www.treasury.gov/about/organizational-structure/ig/Pages/default.aspx>

Report Waste, Fraud, and Abuse

OIG Hotline for Treasury Programs and Operations – Call toll free: 1-800-359-3898

Gulf Coast Restoration Hotline – Call toll free: 1-855-584.GULF (4853)

Email: Hotline@oig.treas.gov

Submit a complaint using our online form:

<https://www.treasury.gov/about/organizational-structure/ig/Pages/OigOnlineHotlineForm.aspx>