Audit Report

OIG-13-028

SAFETY AND SOUNDNESS: Failed Bank Review of Second Federal Savings and Loan Association of Chicago

December 20, 2012

Office of Inspector General

DEPARTMENT OF THE TREASURY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

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MEMORANDUM FOR THOMAS J. CURRY
COMPTROLLER OF THE CURRENCY

FROM: Jeffrey Dye /s/
Director, Banking Audits

SUBJECT: Failed Bank Review of Second Federal Savings and Loan Association of Chicago, Chicago, Illinois

This memorandum presents the results of our review of the failure of Second Federal Savings and Loan Association of Chicago (Second Federal) located in Chicago, Illinois, and the supervision of the bank by the Office of the Comptroller of the Currency (OCC) and the former Office of Thrift Supervision (OTS). OTS regulated Second Federal until July 21, 2011, when OCC assumed regulatory responsibility for federal savings associations pursuant to P.L. 111-203.

Second Federal was established in 1923, and had three offices in Chicago and the adjacent suburb of Cicero, Illinois. Second Federal did not have a holding company. It was designated a minority depository institution (MDI) in November 2010.[1] OCC closed Second Federal and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on July 20, 2012. As of March 31, 2012, Second Federal had approximately $199.1 million in total assets and $175.9 million in total deposits. As of November 30, 2012, FDIC estimated the loss to the Deposit Insurance Fund at $76.9 million.

Because the loss to the Deposit Insurance Fund was less than $150 million, as set forth by section 38(k) of the Federal Deposit Insurance Act, we conducted a review of the failure of Second Federal that was limited to (1) ascertaining the grounds identified by OCC for appointing the FDIC as receiver and (2) determining whether any unusual circumstances exist that might warrant a more in-depth review of the loss. In performing our review we (1) examined documentation related to the appointment of FDIC as receiver, (2) reviewed OTS and OCC reports of

[1] An MDI is defined as any federally insured depository institution where 51 percent or more of the voting stock is owned by minority individuals, or there is 51 percent minority representation on the board of directors. Second Federal obtained the MDI designation with the goal of acquiring funding from other banking institutions, which Second Federal could then count as capital for regulatory purposes. Second Federal was unsuccessful obtaining funds with this designation.

examination, and (3) interviewed an OCC problem bank specialist and the examiners-in-charge for the 2007, 2008, and 2011 examinations. We performed our fieldwork from August to October 2012.

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.

Causes of Second Federal's Failure

OCC appointed FDIC receiver based on the following grounds: (1) the bank had experienced substantial dissipation of assets or earnings due to unsafe or unsound practices, (2) the bank was in an unsafe and unsound condition to transact business, (3) the bank was undercapitalized and failed to submit an acceptable capital restoration plan, and (4) the bank was critically undercapitalized.

Second Federal's failure was primarily caused by losses associated with three types of high-risk loans: loans to individuals with taxpayer identification numbers (ITIN),[2] stated-income residential loans, and stated-income commercial loans. Beginning in 2004, Second Federal originated and purchased a large volume of ITIN loans that resulted in a significant concentration of 402 percent of core capital plus allowance for loan and lease losses (ALLL) at December 2010. OTS examiners found that bank management's execution and oversight of this new and unproven strategy failed to adequately address the risks related to ITIN loans. Risks associated with ITIN loans include (1) the bank's inability to conduct a traditional credit review for loan applicants without social security numbers and (2) the potential increased enforcement of immigration laws that often result in ITIN borrowers forfeiting on their debt and returning to their countries of origin. Also, Second Federal's stated-income residential and stated-income commercial lending resulted in a concentration of 246 percent of core capital plus ALLL at December 2010. These loans were high-risk because the bank originated them without directly verifying the borrower's cash flow or the income-producing capacity of the underlying properties. Second Federal's board and management's lack of sufficient capital

[2] ITINs are issued regardless of immigration status because both resident and nonresident aliens may have U.S. Federal tax filing and payment responsibilities under the Internal Revenue Code. The Internal Revenue Service issues ITINs to help individuals comply with the U.S. tax laws, and to provide a means to process and account for tax returns and payments from those not eligible for social security numbers. IRS Publication 1915 (Rev. 1-2012), p. 6

planning and effective credit risk management led to loan losses which depleted capital and ultimately caused Second Federal's failure.

Conclusion

We determined that an in-depth review of Second Federal's failure is warranted based on what we found to be an unusual circumstance – the nature of the bank's unsafe and unsound lending practices particularly as it related to the ITIN loans. The planned scope of our in-depth review will include, but not be limited to, the current supervisory guidance to banks and examiners on the types of high-risk lending that occurred at Second Federal, particularly ITIN loans. We anticipate completing the in-depth review by no later than August 2013.

We provided a draft of this memorandum to OCC management for comment. In its response, OCC stated it agreed with our conclusion as to the causes of the failure of Second Federal; and that it has no concerns with our determination that an in-depth review of the bank's failure is warranted. The response is provided as Attachment 1. A list of the recipients of this memorandum is provided as Attachment 2.

We appreciate the courtesies and cooperation provided to our staff during the audit. If you have any questions, you may contact me at (202) 927-0384 or Theresa Cameron, Audit Manager, at (202) 927-1011.

Attachments

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Jeffrey Dye, Director, Banking Audits

From: Thomas J. Curry, Comptroller of the Currency /s/

Date: December 17, 2012

Subject: Response to Failed Bank Review of Second Federal Savings and Loan Association of Chicago, Chicago, Illinois

We have received and reviewed your draft report titled "Failed Bank Review of Second Federal Savings and Loan Association of Chicago (Second Federal)." Because the loss to the Deposit Insurance Fund is less than $150 million, as set forth by section 38(k) of the Federal Deposit Insurance Act, you conducted a review of the failure of Second Federal that was limited to: (1) ascertaining the grounds identified by the OCC for appointing the FDIC as receiver; and, (2) determining whether any unusual circumstances exist that might warrant a more in-depth review of the loss. In performing your review you: (1) examined documentation related to the appointment of FDIC as receiver; (2) reviewed OTS and OCC reports of examination; and, (3) interviewed an OCC problem bank specialist and the examiners-in-charge for the 2007, 2008, and 2011 examinations.

You conducted your audit from August to October 2012 in accordance with generally accepted government auditing standards. Those standards require that you plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for your findings and conclusions. You believe that the evidence obtained provides a reasonable basis for your findings and conclusions.

You concluded that the primary cause of Second Federal's failure was losses associated with three types of high-risk loans: loans to individuals with taxpayer identification numbers (ITIN), stated-income residential loans, and stated-income commercial loans.

You determined that an in-depth review of Second Federal's failure is warranted based on what you found to be an unusual circumstance – the nature of the bank's unsafe and unsound lending practices particularly as it related to the ITIN loans.

We agree with your conclusions and have no concerns with your determination that an in-depth review is warranted.
Thank you for the opportunity to review and comment on your draft report. If you need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision at 202-874-5020.

Department of the Treasury

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

Office of the Comptroller of the Currency

Comptroller of the Currency
Liaison Officer

Office of Management and Budget

OIG Budget Examiner