Material Loss Reviews

BRIAN SULLIVAN: Welcome to the FDIC podcast. I'm Brian Sullivan with the Federal Deposit Insurance Corporation. In prior episodes we've discussed bank failures—how the FDIC prepares for them, and how the agency resolves banks after they fail. Well, today, we're going to examine how the FDIC's Office of Inspector General reacts to bank failures, as a key aspect of the OIG's statutory mission is to conduct so-called 'material loss reviews' following certain bank failures. And joining us to discuss these material loss reviews are two folks from the FDIC's Office of Inspector General –Luke Itnyre and Katie Boutwell. Welcome.

LUKE ITNYRE AND KATIE BOUTWELL: Hi, Brian. Thank you for having us.

BRIAN SULLIVAN: So, Luke, you and Katie work in--let me get this straight. The Office of Audits, Evaluations and Cyber, the office that conducts these material loss reviews. Let's start with what these things are.

LUKE ITNYRE: So thanks for the question, Brian. These reviews are actually required any time the Deposit Insurance Fund receives a material loss, which the statute defines as $50 million or more.
So these reviews, when we conduct them, we look at the reason for the bank's failure. We conduct an assessment of the FDIC supervision and as it relates to the reasons for the bank's failure. And we also are statutorily required to examine how the FDIC enacted Prompt Corrective Action, which is essentially a series of actions when banks, when their capital begins to deplete-- based on defined capital ratios that results in essentially escalating supervisory actions to the institution.

BRIAN SULLIVAN: Right. Prompt Corrective Action.

LUKE ITNYRE: That's correct.

BRIAN SULLIVAN: Okay, Katie. The law also requires that your office do these materials reviews pretty quickly after a bank fails. That's a bit of a challenge.

KATIE BOUTWELL: Yes, I would agree with that. Yes. Brian. So the statute-- by statute, we're required to conduct these reviews within six months from the FDIC determination of the loss to the DIF. As you can imagine, six months to conduct the type of work we do is a challenge.
So for us to do that, what we really focus on, we focus on the bank's operations for the last five years--that can sometimes be a little less, if appropriate. We typically will conduct the material loss reviews ourselves. At times we could use a contractor resources if necessary. Also, to keep in mind too, the bank's operations itself is a challenge for us, such as the banks operations and also the vast amount of the financial regulatory requirements that we're required to understand.

BRIAN SULLIVAN: So you go back five years.

KATIE BOUTWELL: We go back five years typically, sometimes a little less. Just depends on the circumstances surrounding the bank failure.

BRIAN SULLIVAN: Well, we had in March of 2023 the failure of two pretty large regional banks and pretty quickly—Silicon Valley Bank and Signature Bank. That prompted the federal government to make a systemic risk determination. So, to protect not only the insured depositors but the uninsured depositors of both of these institutions -- that had to have triggered a material loss review after all that.

LUKE ITNYRE: It absolutely did, Brian. So as I mentioned previously, regarding the statutory requirement, each primary federal regulator of the institution essentially has that requirement. So in the cases of the recent failures, Signature Bank of New York and First Republic Bank were primarily regulated by the FDIC, which means it essentially falls in our wheelhouse to conduct these material loss reviews. So those particular institutions, as you mentioned, the systemic risk exception, they both really failed due to liquidity depletion brought on by some of the contagion effects in the market, both the self-liquidation announcement of Silvergate Bank and then the failure of Silicon Valley.
Brian--Right. So to get our timeline--Silvergate Bank self-liquidated before these two bank failures, Silicon Valley Bank and Signature Bank.

LUKE ITNYRE: Correct.

BRIAN SULLIVAN: And then correct two months later, First Republic Bank fails.

LUKE ITNYRE: That’s correct.

BRIAN SULLIVAN: But there are different primary federal regulators for all of these banks, for the FDIC, though, that was Signature Bank and First Republic Bank. But they're different because Signature Bank had a systemic risk determination. But first Republic did not. Do you treat those differently?

LUKE ITNYRE: Not necessarily from our responsibilities. The systemic risk, determination or exception, if you will, really doesn't fall into our statutory obligations to conduct the material loss reviews. It's really how much of a loss that the Deposit Insurance Fund sustained. Right now, the Government Accountability Office does have some responsibilities for assessing the reasons for the systemic risk exception. But that, again, is separate from our responsibilities.

BRIAN SULLIVAN: How are your material loss reviews any different from how an agency like the FDIC? They conduct their own review of a bank failure like this, or are they complementary or are they different?

LUKE ITNYRE: That's a great question. So our office essentially under the under the Inspector General Act, essentially we're required to be independent evaluators really overseeing the operations of any federal agency.

So while in the cases of Signature Bank and First Republic Bank, the FDIC Chairman requested the Chief Risk Officer to conduct their own separate assessments of the institutions just due to the surprising nature and rapid aspect of these failures. Under the material loss reviews, you know, our office is

looking at things independently as far as, you know, while the FDIC documentation likely has or lays out the causes for failure of the institution, we take an independent look at that and make sure we agree with it.

And then we're also scrutinizing the FDIC's supervision related to the reasons that the institution failed. Did they identify the weaknesses? Did they identify or recommend corrective actions for the bank to improve their operations? And then did they escalate things in cases when the bank was not responsive to FDIC supervisory actions ?

BRIAN SULLIVAN: You know, not every bank failure is the same. Katie-- you know, financial institutions can fail for all kinds of different reasons. And do you take a standard approach to these material loss reviews? Or how can you when all these bank failures could be very much different from each other? Katie-Yeah. So we you know, because these can happen at any time. So we have a standard template that we use for all of our assignments for material loss reviews. And those help us to like have a standard approach to make sure that we do assess all of the areas that we're required to assess. And that's very helpful in doing our assignments.

BRIAN SULLIVAN: So to build off of that, Luke--with these bank failures being so different, sometimes they could be attributed to market conditions and maybe failure to manage interest rate risk or maybe even involve some malfeasance at the bank level. I mean, how do you approach something that could be an accounting problem versus maybe not an accounting problem?

LUKE ITNYRE: Yeah, that's a great question. So the FDIC's manual for examination policies really lays out how they approach things from a supervisory perspective. And it gets into all of the different categories you just mentioned, whether it's, you know, liquidity-related issues with the institution, potential suspicious activity on behalf of the bank. So we have a very standardized and structured process where we look at a series of detailed steps as it relates to what the FDIC refers as, you know, the CAMELS components for the institution. So that being…

BRIAN SULLIVAN: …That's a reference to the yardsticks we use to measure bank health, safety and soundness.

LUKE ITNYRE: Correct. So **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, **S**ensitivity to market risk. So we're taking a very structured approach in each of these areas. We might focus more if that's area apparent, that the institution had particular problems in one specific CAMELS component. In the cases of Signature Bank and in First Republic Bank, I mentioned before, you know, both banks failed essentially due to liquidity-related effects from contagion within the market…

BRIAN SULLIVAN: …a bank run.

LUKE ITNYRE: A bank run yes, which essentially wiped out the totality of uninsured and deposits at both institutions. What we found, though, there were some stark differences in the profile of each institution, whereas Signature Bank had, you know, really didn't have well-established liquidity contingency mechanisms in place. And they were also very unresponsive to prior FDIC recommendations to improve their liquidity weaknesses, whereas First Republic Bank actually did have very robust liquidity contingency funding mechanisms in place. It was generally regarded as a well-managed bank by the public and federal regulators.

BRIAN SULLIVAN: So again, they failed for all kinds of different reasons. Katie, you and Luke, you're kind of on the accounting side as opposed to maybe the other side of the coin at the IG. Tell us the difference between these two sides of the coin, if you will.

KATIE BOUTWELL: Yeah, sure. So the Office of Investigations, they conduct criminal investigations. We're more of the regulatory side, if you will. So we look at the operations, what FDIC did during their supervisions of the bank, whereas during our work for the material loss reviews or any other work we do, if we do find indicators of fraud or criminal conduct, we do refer that to our Office of Investigations, and then they will take whatever we give to them and do their investigation.

BRIAN SULLIVAN: So, Katie, when the OIG makes a recommendation to the agency, to the FDIC, are those recommendations binding?

KATIE BOUTWELL: Yes, that's correct. So under the Inspector General Act and the Office of Management and Budget, if the FDIC agrees to those recommendations, and we do believe that they are responsive to the recommendations, there is an expectation that the FDIC does implement those corrective actions, and we call that in our audit world "final action." Once the FDIC does implement that final action, they will send us a package and that includes a description of their final action, also with the documents that show the evidence of that final action. We take that package, we review it to determine whether or not we believe that they did meet the intention of the recommendation.

BRIAN SULLIVAN: It all seems very structured and I gather it's driven by law. And one of the legal responsibilities you have, Luke, is it not to adequately report or timely report--in a timely fashion to Congress?

LUKE ITNYRE: Yes, that's correct. So any time under the IG Act that we report findings and recommendations to the agency for improvement, we have statutory requirements to post our reports publicly and at the same time ensure that Congress is made aware of such reports, findings and recommendations. So that has to occur by statute, I believe, with within three days of issuing the report to the federal agency. On top of that, under the IG Act, IGs are required semiannually to report to Congress on the status of their findings and recommendations.

BRIAN SULLIVAN: Right. Well, this transparency is important, right?

LUKE ITNYRE: Absolutely right.

BRIAN SULLIVAN: So it's kind of part of your very mission. Now, it should also be noted that the agency--we've been talking about how you approach these bank failures from an audit point of view and or an accounting point of view, a management point of view, and maybe how in some circumstances, through an investigation of potential wrongdoing. But the agency itself does all of this, does it not? And so just to get back to your independence from the agency, but still-- is there any duplication of work here or is it more complementary or how would you describe that?

LUKE ITNYRE: That's a great question. So I think in the case of these recent failures, there was a lot of oversight going on between our material loss reviews, the FDIC Chairman requested that the Chief Risk Officer conduct reviews, and then the GAO also had statutory obligations to look at systemic risk exception and I believe had other requests from congressional officials to look at that. So this was maybe a unique scenario, but there is a lot of oversight in that in that space. And we ensure, to the

extent possible, to make sure we're not duplicating efforts, we're not being overly burdensome to the FDIC. I think in these recent failures, there was some benefit to having multiple parties look at these particular failures and the FDIC's supervision over them.

I think all the entities essentially reached the same conclusions and issued different recommendations for improvement. Our particular reports maybe took it a little further as far as, you know, critiquing the FDIC supervision in certain areas and then also proposing the potential need to consider non-capital triggers as it relates to the FDIC safety and soundness approach.

BRIAN SULLIVAN: Katie, in everything that you have to do with all these material loss reviews, you still have other work to do in your day to day. How do you balance these material loss reviews with everything else you have to do?

KATIE BOUTWELL: Yeah, that's correct. So our management had the foresight to plan for instances like this. We have a lot of planning that goes into the work we do. And so what they did was they established an agreement so that if we needed contractor resources, we could get them pretty quickly. So we did that for these material loss reviews of Signature Bank and First Republic Bank. So it was very helpful.

LUKE ITNYRE: And we're really serving in an oversight role with these contractors. I believe at the FDIC, they refer to it as the technical monitor. So we're engaged with them. We provide them our standard templates, which we referred to earlier, and just ensuring that they execute the assignment against the timeframes required by the material loss review, making sure that the FDIC is responsive to their information requests, talking through findings with them, and just it's more of a collaborative approach to ensure that they're meeting the requirements under the statute.

BRIAN SULLIVAN: Okay. Well, I want to end all of this and to get both of your observations about, you know, for those people who aren't you know, they've heard now what you've had to say about material loss reviews and why they're so important. But what is there at the end of the day, what is the benefit of these reviews to our understanding about how banks fail, why they, you know, and maybe how to I don't know how to avoid them from failing? We'll start with you, Katie.

KATIE BOUTWELL: So yeah it's different for us -- we're looking at it from a different perspective. Like we said earlier, we're an independent organization. By standards, we have to make sure we're free from conflicts of interest. So we're, we're diving in a little deeper. And I think it's important that for our material loss reviews, we dive deep to see like, where can improvements be made within the FDIC supervision program. And that way it could help reduce the risk in the future.

LUKE ITNYRE: And I do think it's important to clarify that the FDIC can't really prevent bank failures. They're really tasked with assessing risk to bank safety and soundness, to protecting consumers from harm and ultimately to protect the Deposit Insurance Fund from losses. It really is the bank's Board and the bank's Management that is ultimately responsible for effective risk management and addressing risk within their institutions.

The FDIC could do everything right from a supervisory perspective and an institution could still fail. For these recent failures, as far as improvements to the FDIC supervision, which Katie mentioned, the FDIC really has already taken a number of actions that are responsive to the recommendations. A couple of

big improvements are, you know, guidance for enhanced follow-up and escalation of action when banks aren't responsive to supervisory recommendations.

And then I think I mentioned previously, there's also a major consideration looking at the non-capital triggers as it relates to safety and soundness for institutions, should they not operate the bank in a safe and sound manner.
BRIAN SULLIVAN: Well, Katie Boutwell and Luke Itnyre from the FDIC's Office of Inspector General. Thank you so much for stopping by and talking about material loss reviews and why they matter.

KATIE BOUTWELL & LUKE ITNYRE--Thank you. Thank you, Brian.