AUDIT OF LOAN PROCESSING AND DISPOSITION PROCEDURES SOUTHWEST BANK, JENNINGS, LOUISIANA

Audit Report No. 99-044
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OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

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MEMORANDUM TO: Mitchell Glassman, Acting Director
Division of Resolutions and Receiverships

FROM: David H. Loewenstein
Assistant Inspector General

SUBJECT: *Audit of Loan Processing and Disposition Procedures*
Southwest Bank, Jennings, Louisiana
(Audit Report Number 99-044)

The Office of Inspector General (OIG) recently completed an audit of the loan processing and disposition procedures followed by the Division of Resolutions and Receiverships (DRR) for loans acquired from the failure of Southwest Bank, Jennings, Louisiana. On June 9, 1999, Senator Kay Bailey Hutchison contacted the OIG and asked that this office pursue two matters related to the failure of Southwest Bank. First, she asked that the OIG determine whether the FDIC followed all applicable procedures in the processing and disposition of past due loans for farmers in the Sulphur Springs, Texas, area. Second, she requested that the OIG review whether any fraudulent activity by bank employees was responsible for a number of loans that were made to persons in the Sulphur Springs area and have since gone into default. On June 18, 1999, the OIG responded to the Senator's office that a team of auditors and investigators would address the issues she raised.

BACKGROUND

Southwest Bank began operations in 1961 under the name of Allen State Bank in Oakdale, Louisiana. Operations were eventually relocated to Jennings, Louisiana, and the name of the institution was changed to Southwest Bank in 1992. Southwest Bank's problems began in 1990 when control of the institution changed. At that time, the bank began aggressively originating farm loans, many of which were 90 percent guaranteed by the Farm Service Agency (FSA) of the United States Department of Agriculture. (FSA was previously known as the Farmers Home Administration.) In 1993, Southwest Bank opened a loan processing office in Sulphur Springs, Texas, and began actively originating guaranteed agriculture loans in that area. At the time of failure, approximately 89 percent of Southwest Bank's loans were agriculture related.

During 1996 and 1997, federal and state bank regulators monitored Southwest Bank's financial condition and required the bank to develop a plan to address its capital deficiency. The bank submitted a plan; however, the plan never materialized because of the ongoing litigation between the bank and FSA related to the loan guarantees. On November 21, 1997, the FDIC was appointed receiver for the failed Southwest Bank. The deposits and some other assets were assumed by First Southwest Bank, a newly chartered bank. The Commissioner of Financial Institutions for Louisiana attributed the bank's failure to losses on out-of-state agriculture loans guaranteed by the FSA. Many of the guarantees were discounted or forfeited, because prior bank management did not comply with all requirements of the FSA guarantees.

The FSA guarantees were affected to a certain extent by fraud in the loan application process. A Southwest Bank loan officer admitted that he and a former FSA county supervisor conspired to submit and approve a total of 28 fraudulent loan applications before the county supervisor's retirement. After retirement, the former county supervisor was hired by Southwest Bank. The loan officer also admitted to submitting an additional 77 fraudulent guaranteed loan applications, which were approved by the new FSA county supervisor. The new county supervisor was unaware of the fraudulent information on the applications. The loan officer performed these fraudulent acts from 1993 through 1994.

Because of the fraudulent loan applications, FSA filed two claims with FDIC as receiver for reimbursement of 41 loan guarantees paid by FSA. The FDIC denied these claims, attributing some blame to FSA through its former employee. Borrowers from the Sulphur Springs area also submitted claims to FDIC as receiver relating to the handling of their loans by both the failed bank and the FDIC. The FDIC has either denied the claims or taken no final action. Some of these borrowers contacted Senator Hutchison's office to express their concerns over the FDIC's actions related to DRR processing the loans and selling the loans to private investors.

OBJECTIVES, SCOPE, AND METHODOLOGY

As a result of Senator Hutchison's request, we performed an audit of DRR's processing and disposition of certain loans received in the failure of Southwest Bank. In addition, based on information received during the initial survey phase of the audit, we expanded the scope of our review of DRR's receivership activities to include their managing of the receivership claims receipt and review process. The objective of our audit was to determine whether DRR properly processed and disposed of loans the FDIC received after the failure of Southwest Bank. The scope of our audit was limited to loans made to farmers in the Sulphur Springs area.

As part of the audit fieldwork, Office of Audits' staff met with senior management of DRR in Washington, field staff in DRR's Dallas office, the current FSA county supervisor in Sulphur Springs, and some of the borrowers. We have obtained and reviewed information regarding the failure of Southwest Bank, the FSA's guaranteed loan program, and the bank and FDIC's files for selected loans and claims. Since the FDIC sold some of the loans in bulk sale packages, we also visited two of the purchasers and discussed their experiences in the resolutions of these assets.

Investigative efforts have been handled separately by the OIG Office of Investigations. The OIG's Office of Investigations is coordinating with the United States Department of Agriculture Office of Inspector General, which has an ongoing investigation into the matter.

According to information maintained by DRR, FDIC received 187 loans from Southwest Bank at the time of the institution's failure. These loans had a book value of nearly $20 million. As of June 29, 1999, the status of these loans was as follows:

Action	No. of Loans	Book Value
Restructured	21	$ 1,557,253
Written off	47	3,474,027
Sold	66	9,755,211
Being marketed	48	3,191,493
Settlement process	22	2,078,064
Total	204[1]	$20,056,048

Of these loans, 49 were made to borrowers in the Sulphur Springs area. The breakdown of the Sulphur Springs loans was as follows:

Action	No. of Loans	Book Value
Chapter 7 bankruptcy	8	$ 1,051,873
Active bankruptcy	16	1,602,781
Reduced to judgment	6	702,094
Paid off/settled	4	434,468
Litigation	11	1,131,744
Negotiations	4	990,810
Total	49	$ 5,913,770

From this list, we judgmentally selected a sample of 29 loans for review. The loans sampled had been received by 16 borrowers. These loans had a book value at the time of failure of $3.8 million. The sample included loans from each category.

In addition, we reviewed 11 of the 32 claims filed against the receivership. Of the 11 claims reviewed, nine were filed by borrowers from the Sulphur Springs area, and two were filed by FSA. Eight of those nine borrowers had loans that were included in our sample of loans. The amount of claims sampled, $61,381,980, accounted for more than 99 percent of the amount of claims filed, $61,445,204. Each of the claims reviewed involved an FSA-guaranteed loan.

[1] The total number of loans is greater than the number received because a loan may fall in more than one category.

We conducted the audit from June 1999 through August 1999 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

The audit of the bank files and asset files available from DRR showed that DRR had followed standard procedures in the processing and disposition of loans received from the failure of Southwest Bank. Each borrower was contacted by DRR and was provided the name of an account officer to contact about the loans. The bulk sale of these small loans was conducted within DRR guidelines. DRR met and negotiated with each borrower who expressed any interest. Of the 16 borrowers in our sample, 10 of them negotiated with either the FDIC or the private investor and all but one reached a settlement of their debt. We were unable to find any support for the borrowers' allegation that either Southwest Bank or the FDIC had contributed to their business failures.

None of the 11 receivership claims we reviewed was approved by DRR for payment. The majority of the 21 remaining claims were for legal services provided to Southwest Bank before failure. DRR approved part or all of 19 of the remaining 21 claims, issuing receivership certificates for 8 of the approved claims. All of the claims sampled were denied following review by the Legal Division, which considered both information filed by the claimant and information available in the bank file and the FDIC asset file. Our review of the claim files did not reveal any material noncompliance with the claims procedures. DRR's decision to deny the claim was supported by the information submitted by the claimant or available from the bank and asset files.

Because we found no material noncompliance with DRR policies and procedures, we are making no formal recommendations as a result of our audit.

The sections that follow explain the responsibilities of each of the key parties involved in the loans received by the borrowers in the Sulphur Springs area. Both Southwest Bank and DRR had specific responsibilities associated with the origination, servicing, or disposition of the loans. In addition, DRR had receivership claims responsibilities that involved some of the Sulphur Springs borrowers. We have also included a section related to the economic conditions existing at the time of the events in question, as we believe that these conditions had a direct impact on the borrower's operations and expectations.

SOUTHWEST BANK'S RESPONSIBILITIES

Prior to the failure, Southwest Bank had the primary relationship with each borrower. We divided Southwest's actions into two categories: loan application and loan servicing.

Loan Application Process

Overall, there was no indication that any fraudulent practices in the loan application process had harmed the borrowers. As of August 1999, none of the borrowers had been charged with filing a false loan application. Also, none of the borrowers alleged that they did not receive all their loan funds.

Southwest Bank achieved certified lender status with the FSA in Louisiana, which was reciprocated by Texas when the bank branched into east Texas. As a certified lender, Southwest Bank had a greater level of autonomy in approving loans for participation in FSA's guaranteed loan programs. Certified lenders evaluated the financial information of the borrower and the quality of the security pledged. FSA relied on summaries of this information to make its guarantee decisions. FSA would review a sample of information supporting the loan application to ensure the quality of the information provided by the bank.

According to the current FSA county supervisor we interviewed, the 16 borrowers responsible for the 29 loans we selected were marginal loan candidates. He said that this was not unusual since FSA is a "lender of last resort" and expects to take greater risks with the loans made. For example, 12 of the borrowers we sampled used their Southwest Bank loans to refinance existing debt. Normally, this would be an indication of a poor risk for a loan. However, the county supervisor stated that this is not an automatic disqualification in the guaranteed loan program but an indication of special servicing needs.

There were instances when the FSA asked for additional information on a particular application. The county supervisor stated that this was not because the agency believed there was anything wrong with the data submitted; rather it was a clarification of a point or an acknowledgement of the special servicing needs of a particular borrower. Some of the borrowers whose loans we sampled were the unknowing subjects of fraudulent applications made by the former Southwest Bank employee. However, the county supervisor stated that he did not believe the fraudulent actions on the part of the bank employee had actually harmed the borrowers. It was the county supervisor's position that the fraudulent actions on the part of the bank employee had, in fact, aided the borrowers by enabling them to receive loans for which they would not otherwise be eligible.

Loan Servicing

The files reviewed in our sample contained evidence of poor servicing on the part of Southwest Bank. There was incomplete follow-up of correspondence, gaps in contacts between the bank and the borrower, irregular status reporting to FSA, and outdated borrower financial data. However, there was no indication that this poor servicing contributed to the business failures of the borrowers. The FSA county supervisor averred that the poor servicing actually aided the borrowers by allowing them to continue their businesses longer than otherwise possible. Again, he believed that the harm was actually to the FSA since the poor servicing affected the quality of collateral securing the loans and may have increased the loss paid on the guarantee. In some cases, the poor servicing resulted in a reduction of the guarantee, which may have increased the

FDIC's loss. In either case, the harm was not to the borrowers but to the taxpayers and the insured institution.

DRR RESPONSIBILITIES

The FDIC has a statutory responsibility to the creditors and shareholders of a failed bank to minimize losses by obtaining maximum recovery from the assets of the receivership. In reviewing DRR's actions with respect to the loans received from Southwest Bank, the OIG divided DRR responsibilities into four areas: borrower relations, asset file maintenance, asset disposition, and receivership claims.

Borrower Relations

The account officer stated that each borrower was contacted by the FDIC when the loan files were returned from the interim servicer. A letter was sent in February or March 1998 explaining that the bank had failed and that all future contact should be with one of the account officers named. The letters contained direct phone numbers for both of the account officers. DRR provided us a list of the borrowers contacted and a copy of the letter sent to each. Ten of the borrowers provided requested documentation or entered into negotiations with the FDIC or the private investor who purchased the loan in a bulk sale and all but one were able to reach a satisfactory resolution of their debts. The other six borrowers did not cooperate with the FDIC by providing the financial and tax information required to initiate settlement negotiations.

Asset File Maintenance

DRR's Asset Disposition Manual contained guidance on information to be included in the asset files maintained by the account officers. The manual also contained guidance on handling loans guaranteed by FSA. According to the Asset Disposition Manual, the asset file should contain the following information:

- loan agreements,
- notice to the borrower with FDIC contact information,
- contact with FSA immediately following the bank closing,
- requests for and receipt of financial information from the borrower, and
- documentation of all FDIC actions in disposing of or resolving the asset.

In addition, the account officer was required to establish a file in the Credit Notation System (CNS) for each asset assigned to him. The CNS is a central system for tracking the assets while they are the responsibility of the FDIC. Asset information from the account officer and from other divisions within the FDIC resides in CNS.

We reviewed the FDIC's asset file for each loan sampled. In no case did we find an incomplete asset file at DRR. Each file contained a copy of the borrower's promissory note and a record of the actions taken by DRR once the loan had been received from the failed bank. The account officer was able to provide us with a report from the CNS for each loan. This system documented DRR's action in resolving the asset, as well as DRR correspondence with other divisions within the FDIC.

Asset Disposition Methods

The Asset Disposition Manual also established DRR's business plan for resolving assets received from a bank failure. For most classes of nonperforming loans, it is DRR's policy to package immediately for bulk sale any loan with a book value of less than $250,000. Of the 29 loans selected for review, 25 of them had book values below this threshold. The 4 remaining loans had book values ranging from $262,300 to $290,000. DRR policy is to package loans over $250,000 for bulk sale within 180 days of acquisition. Although the borrowers from Sulphur Springs, Texas, objected to the FDIC selling their loans, these loans were rightly packaged for bulk sale. We did not review the loan packaging and sale process. There were no allegations made that this process was in any way improper.

Receivership Claims

We reviewed 11 of the 32 claims filed against the receivership. None of the claims reviewed were approved for payment. The majority of the remaining 21 claims were for legal services provided to Southwest Bank prior to failure. DRR approved part or all of 19 of the remaining 21 claims, issuing receivership certificates for 8 of the approved claims.

Only 3 of the 11 claims reviewed were filed using the FDIC Proof of Claim form. The other claims were filed using a form designed by the claimant. All of the claims sampled were denied following review by the Legal Division which considered both information filed by the claimant and information available in the bank file and the FDIC asset file. Five of the claimants were involved in litigation with the bank at the time of failure. In six cases, the FDIC asked the claimant to provide additional information, but only one claimant complied with this request. Our review of the claim files did not reveal any material noncompliance with the claims procedures. DRR's decision to deny the claim was supported by the information submitted by the claimant or available from the bank and asset files.

ECONOMIC CONDITIONS

We asked the FSA county supervisor about other circumstances which may have negatively affected the borrowers' operations. He said that the economy had a significant impact on the situation. From 1993 forward (the time when many of these loans were first made), dairy farmers were caught in a price squeeze between declining milk income and increasing feed costs.

Statistics published by the State of Texas Agricultural Statistics Service showed that for the period from 1993 through 1997 that feed costs rose about 18.7 percent per 100 pounds fed, while milk prices only increased about 3 percent per 100 pounds produced. In 1995 there was a nationwide grain shortage and feed prices in 1996 rose precipitously by 34.3 percent. Milk prices only went up 16.2 percent in 1996. The combination of rising costs and fairly stable income levels was the major problem facing the borrowers, according to the county supervisor.

The county supervisor also stated that some of the borrowers may have had unreal expectations about the dairy farming business. He believed that some of the borrowers thought that they could "get rich" milking cows. He explained that Hopkins County is a historically successful dairy area and some local families may appear wealthy. However, such perceived wealth is related to their position of having little or no long-term debt on their farm land and operations. This was not the situation for most of the Southwest Bank borrowers. The county supervisor estimated that 75 percent of all milk income is used to maintain the herd. This leaves 25 percent for all other farm expenses, family living expenses, and debt service. Such income does not allow a borrower to incur extensive outside debt.

CORPORATION COMMENTS AND OIG EVALUATION

Because we are making no formal recommendations, DRR was not required to make a formal response to this report. However, the results of our audit were discussed with DRR management on October 7, 1999, and they agreed with the report's contents.