Office of Inspector General

July 7, 2000
Audit Report No. 00-027

Audit of the FDIC's Identification and Classification of Environmentally Impaired Assets

OFFICE OF INSPECTOR GENERAL
DELIVERING QUALITY TIMELINESS VALUE
OFFICE OF AUDITS

DATE: July 7, 2000

TO: Gail Patelunas, Deputy Director
Asset Management Branch
Division of Resolutions and Receiverships

FROM: Sharon M. Smith
Assistant Inspector General

SUBJECT: *Audit of the FDIC's Identification and Classification of Environmentally Impaired Assets* (Audit Report No. 00-027)

This report presents the results of an audit of the Federal Deposit Insurance Corporation's (FDIC) identification and classification of environmentally impaired assets. The Office of Inspector General (OIG) performed the audit to determine whether the FDIC followed its policies and procedures for identifying and classifying assets with environmental conditions.

BACKGROUND

As the receiver for failed financial institutions, the FDIC manages and markets real estate and loans secured by real estate. The FDIC also acquires some of those real estate and loan assets in its corporate capacity. To better understand the risks associated with the real estate portfolio under its control, the FDIC has taken the position that it would identify and classify those real estate assets having potential environmental issues. Environmental issues may not only affect the marketability of many of the assets but also expose the FDIC to potential lawsuits.

In October 1993, the FDIC developed specific guidelines for screening and handling assets with potential environmental issues. The *Environmental Guidelines* generally require—for other than single-family properties—an environmental review to be performed on all owned real estate (ORE) and nonperforming loans secured by real estate.

The FDIC's Division of Resolutions and Receiverships (DRR), which is responsible for the management and disposition of the assets of failed financial institutions, identifies and evaluates potential environmental concerns associated with ORE and real estate collateral. Specifically, the FDIC's *Environmental Guidelines* require DRR account officers to screen assets for potential environmental issues. The asset screening process calls for the account officer to review all asset files for evidence of environmental issues. Depending upon whether the initial asset file screening identifies any environmental issues, the account officer will request that a DRR environmental coordinator perform either (1) an "environmental checklist review" (for those assets where the screening process did not surface any obvious environmental issues) or (2) a more detailed “Phase I Review” (for those assets where environmental concerns are deemed to be more likely). Depending upon the results of the Phase I Review, the guidelines call for the environmental coordinator to assist the account officer in developing liquidation and marketing strategies for those assets with environmental issues. Finally, the environmental coordinator is responsible for maintaining a local database for tracking those assets with environmental issues until the assets are liquidated.

The FDIC classifies environmental issues in one of two ways—environmental hazards or special resources. Environmental hazards could contaminate the property; reduce the property’s value; and subject the FDIC to regulatory compliance, costs for corrective action, liability for personal injury, and civil or criminal penalties for noncompliance. Examples of environmental hazards include above and below ground storage tanks, disposal sites (landfills, dumps, and surface impoundments), soil or groundwater contamination, and other hazardous substances such as asbestos and lead-based paints. Special resource environmental issues are specific characteristics of a property that require unique marketing considerations. Special resource properties include wetlands, threatened or endangered species habitats, properties covered by the *Coastal Barrier Improvement Act of 1990*, and historically significant properties—historic buildings, structures, sites, designated natural landmarks, and archaeological resources.

Environmental information obtained from the environmental coordinators’ local databases and other FDIC systems is accumulated in the National Asset Inventory System (NAIS). DRR uses NAIS to monitor assets, including those assets with environmental concerns. For assets with environmental concerns, NAIS includes information on the types of environmental issues, environmental review dates, remediation dates, and costs of evaluating and addressing environmental problems.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether the FDIC followed its policies and procedures for identifying and classifying environmentally impaired assets. The audit covered assets in the FDIC’s inventory during the period of October 1, 1999 through January 19, 2000. During the survey phase of our audit, we identified several issues related to DRR’s compliance with certain aspects of the *Environmental Guidelines*. In this report, our conclusions are based on the limited work we performed during our audit.

To accomplish the objective, we reviewed the FDIC’s policies and procedures for identifying and classifying environmental assets and interviewed DRR personnel in Washington, D.C.; Dallas, Texas; and Hartford, Connecticut. We judgmentally selected a sample of assets from both the Dallas, Texas, and Hartford, Connecticut, offices. In selecting our sample, we reviewed and compared various FDIC databases including NAIS and the tracking reports prepared by the environmental coordinators for evidence of environmental issues. From the Dallas office inventory, we selected

- 10 ORE assets and 5 nonperforming loans secured by real estate that were not identified on the environmental coordinator’s tracking report,

- 3 ORE assets and 2 nonperforming loans secured by real estate that were identified on the environmental coordinator's tracking report, and

- 3 subsidiary ORE assets with no evidence in NAIS of an environmental review.

From the Hartford office inventory, we selected 20 ORE assets and 8 nonperforming loans secured by real estate that were not identified on the environmental coordinator's tracking report. We also selected four ORE assets with environmental issues that were sold in December 1999 or January 2000. We reviewed the selected Dallas and Hartford office asset files to determine whether environmental coordinators (1) performed environmental assessments in accordance with the FDIC's guidelines and (2) tracked the results of the environmental assessments.

We did not perform a review of internal controls because the OIG concluded that the audit objectives could be met more efficiently by conducting substantive tests rather than by placing reliance on the internal control system. We conducted the audit from December 1999 through March 2000 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

DRR staff did not always follow the FDIC's written policies and procedures for identifying and classifying assets with environmental issues. Specifically, the asset account officers did not always request the required environmental reviews and the environmental coordinators did not always complete environmental checklists and track assets with environmental issues. Accordingly, there is an increased risk that environmental assets could be improperly managed and liquidated.

Environmental Reviews Not Performed

Account officers did not refer five of the assets included in our sample to the environmental coordinators for review. Two of the five assets that the account officer did not refer to the environmental coordinator for review were nonperforming loans secured by real estate. The two loans were repurchased from buyers under the representations and warranties claim process because of environmental problems with the collateral. The asset files clearly documented the environmental issues associated with the collateral. In addition, for one of the two loans, the NAIS system contained information on the repurchase including the fact that it was repurchased because of environmental problems.

In addition, the account officers did not request environmental reviews for the three subsidiary ORE assets in our sample, although for two of the subsidiary assets known environmental issues existed. Specifically, two of the subsidiary assets were coal mines with significant contamination. The subsidiary asset files contained information showing that the state in which the coal mines were located was monitoring site cleanup. The third subsidiary asset, a vacant 37-acre lot, had no information in the asset file to determine if an environmental issue existed.

Because the subsidiary account officers did not request environmental reviews, the assets were not identified as having environmental issues and tracked accordingly. The environmental coordinator was not aware of the environmental conditions and said that he could not perform an environmental review until the account officers requested one.

Environmental Checklists Not Completed

The environmental coordinator in the Hartford office did not use the checklist included in the FDIC's *Environmental Guidelines*. Instead, the coordinator prepared narrative summaries of the site inspections. However, because the narrative summaries did not address all of the elements included in the environmental checklist, we could not readily determine if the environmental coordinator considered all potential environmental issues for the assets.

Assets with Environmental Issues Not Tracked

The environmental coordinator in the Hartford office did not include all assets with environmental issues in the tracking reports. We identified three nonperforming loans secured by real estate and six ORE assets with environmental issues that were not being tracked by the environmental coordinator. The environmental coordinator stated that he did not track the assets because (1) he did not consider the problem to be significant enough to warrant tracking or (2) the asset was pending sale. The FDIC's *Environmental Guidelines* require tracking reports to include all assets with environmental problems until the assets are liquidated.

CONCLUSIONS AND RECOMMENDATIONS

Environmental policies and procedures are necessary to ensure that assets with environmental issues are properly identified and handled in a consistent manner. However, account officers and environmental coordinators sometimes deviated from the FDIC's established requirements. Moreover, our limited audit work indicated that the FDIC could further strengthen its policies for identifying assets with environmental issues by having the environmental coordinators compare the environmental data in NAIS to their tracking reports.

Accordingly, we recommend that the Deputy Director, Asset Management Branch, DRR, take the following actions:

(1) Issue a memorandum to all DRR account officers and environmental coordinators emphasizing the importance of complying with the FDIC's policies and procedures for identifying, classifying, and tracking assets with environmental issues.

(2) Have account officers ensure that required environmental reviews have been performed on all applicable assets in their portfolios.

(3) Establish a policy that requires environmental coordinators to periodically reconcile tracking reports to assets reported in NAIS.

CORPORATION COMMENTS AND OIG EVALUATION

On June 23, 2000, the Deputy Director, Asset Management Branch, DRR, provided a written response to a draft of this report. The Deputy Director's response agreed with the recommendations and provided the requisites for a management decision on each of the three recommendations. The Deputy Director also indicated that DRR would take our recommendation 2 a step further by modifying DRR's management control plan for 2000 to provide for an internal control review under the Chief Financial Officers' Act. The Deputy Director's response is not summarized here because the actions planned or completed are identical to those recommended. The response is presented as appendix I to this report.

Appendix II presents management's proposed actions on our recommendations and shows that there is a management decision for each recommendation in the report.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, DC 20429
Division of Resolutions and Receiverships

June 23, 2000

MEMORANDUM

TO: Sharon M. Smith
Director, Field Audit Operations

FROM: Gail Patelunas
Deputy Director, DRR

SUBJECT: *Audit of the FDIC's Identification and Classification of Environmentally Impaired Assets (99-107)*

DIVISION OF RESOLUTIONS AND RECEIVERSHIPS RESPONSE

(1) OIG RECOMMENDATION: Issue a memorandum to all DRR account officers and environmental coordinators emphasizing the importance of complying with the FDIC's policies and procedures for identifying, classifying, and tracking assets with environmental issues.
RESPONSE: ***Within 90 days of the issuance of the Audit Report, the Deputy Director, as recommended, will issue a memorandum to all ORE, Credit and Subsidiary account officers and to the Environmental Coordinator emphasizing the importance of compliance with the FDIC's policies and procedures for identifying, classifying and tracking assets with environmental issues.***

(2) OIG RECOMMENDATION: Have account officers ensure that required environmental reviews have been performed on all applicable assets in their portfolios.
RESPONSE: ***Within 90 days of the issuance of the Audit Report, Management will issue a memorandum to ORE, Credit, and Subsidiary account officers re-emphasizing the importance of periodic asset reviews to ensure that all required environmental reviews have been performed on all applicable assets in their portfolios. In addition,***

the DRR Management Control Plan for 2000 will be modified to provide for an Internal Control Review under the Chief Financial Officers Act (Accountability Unit 7, Risk 04 – "Failure to screen assets for appropriate environmental issues and concerns").

(3) OIG RECOMMENDATION: Establish a policy that requires environmental coordinators to periodically reconcile tracking reports to assets reported in NAIS as having environmental issues.

RESPONSE: ***Within 90 days of the issuance of the Audit Report, the recommended Policy will be issued to take effect at the completion of the integration of NAIS with ORES and CNS.***

Response OIG 99-107.doc

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report on the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider the FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount that the FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid.

Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned / Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	The Deputy Director, Asset Management Branch, DRR agreed with our recommendation and stated that DRR will issue a memorandum to all affected staff emphasizing the importance of complying with the FDIC's policies and procedures for environmental assets.	09/30/00	Copy of memorandum.	$-0-	Yes
2	The Deputy Director, Asset Management Branch, DRR agreed with our recommendation and stated that DRR will issue a memorandum to all affected staff emphasizing the importance of ensuring that all required environmental reviews have been performed. The Deputy Director also stated that the DRR Management Control Plan for	09/30/00	Copy of memorandum.	$-0-	Yes

Rec. Number	Corrective Action: Taken or Planned / Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
2	2000 will be modified to provide for an internal control review under the *Chief Financial Officers Act* (Accountability Unit 7, Risk 04: "Failure to screen assets for appropriate environmental issues and concerns").				
3	The Deputy Director, Asset Management Branch, DRR agreed with our recommendation and stated that DRR will issue a policy requiring environmental coordinators to periodically reconcile tracking reports to assets reported in NAIS.	09/30/00	Copy of policy.	$-0-	Yes