

Perspectives on Insider Abuse

Remarks By
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Thank you for inviting me to address this fourth annual Bank and Savings and Loan Supervision, Enforcement, and Compliance Conference.

Rarely do I get the opportunity to address the right audience at the right time on a subject of highest priority at the FDIC.

The subject I'd like to discuss today is bank fraud and insider abuse. It's a subject of continuing supervisory concern but I do not believe fraud and insider abuse pose any threat to the stability of the system.

Contrary to the public's misperception that fraud undermines the banking system, the fact is that safety supervision keeps such activity to a level that the system can tolerate. Fraud is not a systemic risk.

I'd like to focus on some effects that insider conflicts of interest have on the safety supervision of our financial institutions.

Simply, what can our financial institutions and their regulators do to control insider abuse and fraud? This audience represents a number of backgrounds that share this concern. Each of your separate areas of expertise contributes, on its own, a great deal to the well-being of our financial marketplace.

But the fight against insider abuse and fraud shows the need for teamwork between the lawyers, regulators, bankers, and others like you gathered here today.

As you know, banks are experiencing a post-Depression record number of failures, and the FDIC is finding that abuse of banks by directors or officers is a factor in at least one-third of all failed banks.

But there are other consequences that run much deeper, and which may do more damage to our financial system in the long run.

One of the reasons the FDIC was created was to foster public confidence in the safety and soundness of banks. So it is of concern to my agency that the public's perception of fraud and insider abuse is perhaps the foremost damaging consequence of such misconduct.

The news of each new scandal undermines public confidence in our banks and S&Ls, at a time when the traditional financial institution is under unprecedented pressure.

Reports of insider fraud hurt banks and S&Ls fighting for capital with new competitors such as the money market fund, and fighting for loan customers with new competitors ranging from Sears, to The Money Store, to businesses offering commercial paper.

Yet we know that insider abuse is to banking what the plane crash is to airlines; the rare exception rather than the rule.

Thousands of financial institutions function for decade after decade without being touched by a breath of scandal. Yet a single sensational case of insider abuse sends out shock waves that undermine the credibility of the whole industry.

Problems with insider abuse are nothing new. Historically, the (perhaps exaggerated) fear of insider abuse was the force behind many of the strict banking laws of the 1930s--those same laws which now hamper traditional financial institutions in their ability to compete with new, less regulated players in the marketplace.

At the same time, the perception of insider abuse, or the potential for it, hampers many of our efforts to gain support for programs to reform and restructure our banking laws--Efforts that would see financial institutions and the public BOTH better served.

Part of the problem is that abuse by directors and officers is a hard crime to prevent. Because directors and officers are also usually the customers of a bank or S&L, this industry contains perhaps the biggest, single, all-encompassing POTENTIAL for conflicts of interest to be found in any business I can think of.

Yet it's important to look at the other side of the coin, too.

With this great POTENTIAL for abuse, and the NUMBER of bank and S&L directors and officers EASILY well up in the hundreds of thousands, it is perhaps to the credit of the industry that, for all the attention they receive, these cases of abuse are relatively rare.

Yet a threat DOES exist. Although the vast majority of directors and officers are scrupulously honest, and are chosen for their posts on the basis of their probity and community standing, still there are a few who are not content to earn their money "the old fashioned way."

I'd like to talk for a few minutes about steps FDIC is taking to pull the stops out on our legal and supervisory policing of insider abuse cases; our efforts to foster greater teamwork between agencies, (and within FDIC itself) and the implications these initiatives will have in the Corporation's efforts to fight for banking reform.

DIRECTOR'S LIABILITY

Over the past year, the FDIC has stepped up its efforts to prove liability, and seek redress, using BOTH civil and criminal legal procedures -- when directors and officers are suspected of fraud and other insider abuse.

The FDIC has adopted a policy of landing with both feet on those directors and officers whose misconduct, rather than bad business sense, has contributed to a failure. So far in 1987, the FDIC legal division reports RECOVERIES from directors and officers in excess of \$35 million.

Supervisory enforcement actions are another tool FDIC uses when apparent fraud or insider abuse of a bank is uncovered.

These include powers to remove officers; to assess civil penalties of up to \$1,000 per day; and an array of both routine and special "cease and desist" orders to stop activity that will threaten a bank.

It is again important to note that the FDIC does not wade in with its "big stick" in all cases when a bank gets in trouble. We make every effort to SEPARATE those directors and officers who start out with the INTENTION of abusing a bank, from those who have made poor, but HONEST business decisions.

INTERAGENCY TEAMWORK

We are also increasing our efforts to work with federal law enforcement agencies, particularly the FBI, on a closer basis than ever before.

Part of this is the fruit of the Bank Fraud Enforcement Working Group, an advisory body made up of the federal banking agencies, the Justice Department, and the FBI. This group meets on a monthly basis to discuss specific criminal cases and address common problems.

Already this effort has improved teamwork between FDIC, other regulators, and law enforcement agencies, through a network of personal contacts. And these contacts are not just at the policy level. The spirit of teamwork and cooperation has "trickled down" into the FIELD as well.

We have also been able to institute a computer tracking program for criminal referrals. ALREADY this system has aided us in spotting trends, geographic patterns, and emerging problems.

Six months ago FDIC published a list of "Red Flags" -- indicators of fraud and abuse that have shown up time after time -- and has made this list of warning signs available to help examiners and auditors.

The FDIC has also designated some 60 senior examiners as specialists in bank fraud, and they are in the process of receiving special training in the areas of bank fraud and insider abuse.

Another example of teamwork has been the establishment of an interagency school on white collar crime. There have been joint training sessions for both FBI and bank examiners. The coverage of insider abuse has also recently been emphasized in FDIC's own training schools.

On the regional level, the FDIC has designated special review examiners and counsel to prepare criminal referrals, coordinate investigative assistance and testimony, and advise banks and other examiners on criminal laws and criminal referral requirements.

In addition to these steps, we are emphasizing the importance BOTH of codes of conduct, AND better audit capabilities to deter fraud and abuse.

Last and certainly not least among the areas where teamwork is needed is with regard to working with the financial institutions themselves.

To this end the FDIC is drafting suggested standards of conduct for bank directors.

Among the areas covered are the importance of maintaining an INDEPENDENT board of directors, the need to SELECT and RETAIN qualified management, to SUPERVISE that management adequately, and to establish and MONITOR policies dealing with conflicts of interest, audits, and ethical codes. (Our proposed "short form" code of conduct for directors is available for your review. Copies of it will be distributed at some time during the conference).

The development of knowledgeable, effective, bank directors

is an integral part of keeping the banking system safe and sound. It can be seen as one way of putting an end to insider abuse before it starts. It is hoped that this guide, when completed, can be aggressively put forth not just under the flag of the FDIC, but as a group presentation of several regulatory and law enforcement agencies.

MEANING FOR BANK REFORM

As I stated briefly in my opening to these remarks, the incidence of insider abuse has been a recurring problem both in the past and present of banking. It is important that this nemesis continue to be controlled if efforts to shape a healthier future for banking are to be successful.

Just about a month ago, the FDIC issued the first draft of a new staff study on bank reforms.

A major thrust of this study was a search for simplified ways that a bank could be allowed to compete by offering broader nontraditional services to customers.

It seems fairly clear that both banks and consumers would benefit, were banks allowed to integrate such products as, for instance, financial planning, real estate, and insurance into a bank's more traditional services.

A key to the workability of such a plan lies in protecting the safety and soundness of the "core" bank (and its FDIC insured deposits), while still allowing new, nonbanking activity.

Our solution calls for the creation of an ENHANCED supervisory "wall" around the core bank, where any possible ills of a subsidiary could be "quarantined." We think that this approach will indeed prove "do-able".

Banks could be kept safe, be allowed to compete, attract new customers, and better serve the public. Yet, just as in the 1930s, the spectre of insider abuse remains a stumbling block on the road to a sounder and safer financial system.

At a time when the traditional financial regulators and financial institutions will be pushing for the needed overhaul of our present banking laws, the perception of the public, and of Congress, of the image, reputation, and ethics of the industry could not be more important if we are to win support for new ideas.

Many of you may make the mistake of seeing your jobs just in

day-to-day terms. But as I've tried to indicate, we are really playing for much higher stakes.

Controlling conflicts of interest and insider misbehavior has been a challenge to bank safety supervision since it began. We at FDIC believe the record shows that effective, if not perfect, control, IS POSSIBLE.

But it will take the efforts of everyone here to help us meet the test.

So the future of banking, at least as many at FDIC would like to see it, depends a great deal on the successful efforts of those in this room to insure that insider abuse provides no threat to our financial system.

Your continued INDIVIDUAL efforts, and your continued TEAMWORK, will help to bring a bright future for traditional financial institutions closer to reality.

As President Truman said, "...success will require both boldness in setting our sights and caution in steering our way on an uncharted course."

I feel confident that our combined efforts can supply the maps, the caution, and yes, the boldness, that will guarantee a sound future for our financial institutions, and that our economic system will continue to be one that the American people "can bank on."

Thank you.

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