STATEMENT ON

NATURE AND EXTENT OF ABUSE AND MISCONDUCT
IN COMMERCIAL BANKS

PRESENTED TO

SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES

BY

L. WILLIAM SEIDMAN, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

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Good morning, Mr. Chairman and members of the Subcommittee. I am pleased to be here today to express the views of the Federal Deposit Insurance Corporation on this very important subject -- fraud and abuse of position in the nation's financial institutions. The FDIC staff has prepared detailed answers to the questions contained in your letter of invitation. The staff's report is attached to this statement and I request that it be included in the record.

FRAUD AND INSIDER ABUSE

The number of insured banks that have been victimized by fraud and insider abuse has increased dramatically since 1982 resulting in greater costs to the banking industry and to the FDIC insurance fund. However, while bank fraud is a major concern and area of focus for the FDIC, bank fraud is not at such a level that the safety of the banking system is imperiled.

Bank failures are occurring at a post-depression record rate. We expect about 200 failures this year. As of today, 160 banks already have failed. We had expected a break in this upward trend next year. However, we are now reassessing our projections in light of the recent correction in the stock market and its potential adverse effects on the economy.

We are seeing evidence of insider abuse and fraud in as many as one third of the banks that fail. The "autopsies" the FDIC conducts in the wake of bank failures also show that outright criminal activity is a factor in nearly 15 percent of recent failures.

From January 1985 through June 1987, 98 of the 354 banks that failed were cited by examiners as having at least some element of fraud or insider abuse. These 98 banks had assets of $2.70 billion and the cost to the FDIC of these failures is estimated to be nearly $676 million.

While fraud losses in failed banks are still significant, our experience since 1985 suggests a somewhat lessened impact of fraud and abuse compared to the period studied by your Subcommittee leading to its 1984 report. Our current experience is more in line with the historical trend and is consistent with the impact of fraud and abuse reported in an FDIC study of bank failures between 1960 and 1974.

The FDIC has taken several major steps to improve our supervisory response to fraud and abuse in the banks we supervise. Since the Subcommittee's 1984 report, we have:

- Completely revised the criminal reporting system to require banks, by regulation, to report apparent crimes to U.S. attorneys, federal investigators and the FDIC on a standard referral form.

- Established a network of personal contacts to improve communication and cooperation with law enforcement agencies.

- Published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used as an aid by examiners and auditors.

- Designated some 60 senior examiners as bank fraud specialists to be given specialized training in bank fraud and insider abuse.

- Improved and greatly increased the training opportunities for examiners, investigators, liquidators and prosecutors by the addition of an interagency school on white collar crime, joint FBI/examiner training sessions and expanded treatment in the FDIC schools.

- Designated special review examiners and regional counsel in regional offices to prepare criminal referrals, coordinate investigative assistance and testimony and to advise banks and other examiners on criminal laws and criminal referral requirements.

- Provided liquidators and other employees of our Division of Liquidation with special training and refresher courses on bank fraud and abuse and investigation techniques.

- Installed a computer system to collect information about criminal referrals for tracking and analytical purposes and to identify subjects of criminal referrals by name recognition.

- Decentralized and streamlined our civil enforcement process. Delegations of authority to Regional Directors permits expeditious and efficient administrative actions while maintaining Washington control over issues that are controversial or raise policy questions.

I would like to repeat that current levels of bank fraud, while serious and costly, do not jeopardize the banking system. At the same time, the rising level of failures, and the increased cost of insider abuse and fraudulent behavior, raise issues that we need to explore.

I commend you, Mr. Chairman, for challenging us with some very important questions:

- How do we improve the audit capabilities of banks to prevent and detect fraud and abuse?
- How do we insure that all bank directors adhere to high standards of conduct?
- How do we improve intergovernmental coordination and information sharing to assure vigorous investigations and prosecution of criminal conduct?

INDEPENDENT AUDITS OF BANKS

First, I would like to comment on our proposal to require independent audits of banks. We estimate that around two thirds of the banks in this country already get opinion audits. As would be expected, larger banking organizations are more likely to have independent audits. But even so, about half the banks under $50 million in assets get outside audits.

Nevertheless, more small banks would be impacted by an audit requirement than large banks. And, the smaller the bank, the more difficult a cost effective audit becomes.

We have reviewed about 250 of the banks that failed in 1986 and during the first nine months of 1987. We found that only 40 percent of those banks had an outside audit written during the two years prior to failure. In other words, it appears that deeply troubled banks are much less likely to have an

outside audit. We also found that about 40 percent of the failed banks, with opinion audits, had received qualified opinions from their auditors. Clearly, these audits would have provided information that could have been used by bank supervisors.

We appear to be near agreement with the other bank regulators on requiring annual audits for all banks over a certain asset size threshold. We now are considering a threshold in the range of $100 to $150 million in assets.

Our current proposal would require each state nonmember bank above a threshold size to:

- Engage an independent public accountant to perform an opinion audit each calendar year.
- Have the bank's board of directors perform a timely review of the auditors report and the management letter, with such review noted on the board of directors' minutes. The bank would be required to send copies of these reports to the FDIC.
- Require the bank to notify the FDIC when the bank changes its independent auditor.

We also are considering your idea, Mr. Chairman, of <u>requiring</u> banks to show their auditors the bank's latest examination report.

We also are reviewing the possibility of developing something <u>less</u> than an audit for smaller banks (those under the yet-to-be established threshold). In

other words, we are considering requiring something in the nature of a "checkup" rather than a "complete physical" -- something that smaller banks would find affordable and that focuses on potential problem areas such as internal controls and insider abuse. We have challenged the AICPA to help us develop a program specially designed for a cost effective examination of small banks.

We believe outside audits can benefit the supervision process, as well as shoring up the internal operations of insured banks and aiding in fraud prevention and detection.

DIRECTORS' RESPONSIBILITY AND CODES OF CONDUCT

We also believe that the supervisory process benefits greatly if bank directors adhere to and are held to high standards of conduct and responsibility. While it is true that the great majority of bank directors already meet these high standards, we nevertheless felt it necessary to emphasize this point to all present and prospective bank directors.

The FDIC, along with other agencies, just released final guidelines under the Bank Bribery Statute encouraging banks to establish and maintain effective codes of conduct. The FDIC also has just issued guidelines advising bank directors in "plain English" of their responsibilities to oversee the conduct of the bank's business, to keep informed and exercise independent judgment. The guidelines advocate the avoidance of all preferential transactions involving insiders and related interests and advise directors of their critical role in keeping the banking system safe and sound.

INTERAGENCY TEAMWORK

In December of 1984, the Attorney General established an interagency group to deal with fraud and abuse. This "teamwork" approach has been very successful in coordinating efforts at the headquarters level. Real progress also is being made at the local level, where information in one form or another is critical to the success of specific investigations and prosecutions.

We have been pleased with the commitment demonstrated by the Justice Department's Criminal Division and believe that this commitment is evident in the accomplishments of the Working Group. We also are pleased with the efforts of many U.S. Attorneys to carry this commitment to their local districts. Unquestionably, local forums such as the one established in Chicago represent an effective solution to problems relating to coordination and cooperation. We would like to see more of these forums established, particularly in districts having a heavy load of bank fraud cases.

AGENCIES' JOINT ENFORCEMENT PROPOSAL

A working group of the financial institution agencies recently completed a proposal to amend the enforcement statutes to improve the agencies' ability to address instances of insider abuse, misconduct and fraud at our nation's depository institutions. The amendments clarify the enforcement powers of the agencies in several respects, codify current administrative interpretations and address certain anomalies created by a recent U.S. Circuit Court of Appeals decision.

Several of the amendments contained in that proposal amend the Right to Financial Privacy Act (RFPA). Currently, the flow of information that is critical to successful prosecutions and effective bank supervision is unduly constrained by the RFPA. Probably the most adverse impact of the RFPA on our cooperative efforts to deal with fraud and abuse is the psychological impediment the Act exerts on the interactions between examiners and law enforcement agents. We will never know how many cases have been jeopardized by this chilling effect. However, we do not doubt that the public interest has been harmed by RFPA constraints on intergovernmental exchanges of information.

One case is particularly illustrative. During a criminal investigation of a failed bank, the FBI learned of the whereabouts of millions of dollars. Because of legal restrictions, however, this crucial information could not be passed on to the FDIC. Thus, the FDIC lost the opportunity to restore millions of dollars to the FDIC insurance fund. Amending the RFPA as recommended by the Bank Fraud Working Group and this legislative proposal would enhance greatly our cooperative efforts with Justice in ferreting out and prosecuting fraud and abuse.

CONCLUSION

In conclusion, bank fraud and abuse is costly and serious but does not imperil the banking system. We cannot let up on ferreting out and penalizing fraud and abuse until a strong deterrent to such activities is firmly established.

Thank your Mr. Chairman.