STAFF RESPONSES TO QUESTIONS IN CHAIRMAN BARNARD'S
NOVEMBER 6, 1987 LETTER

This staff report is intended to supplement Chairman Seidman's testimony before the Subcommittee on November 19, 1987. Question A1 is addressed in the Chairman's testimony and in our earlier submission.

NATURE AND EXTENT OF ABUSE AND MISCONDUCT IN COMMERCIAL BANKS

A.2.Question:

Based on the agency's analysis of those criminal referrals included in the Criminal Division's Significant Referral Tracking System, please identify (a) any trends or patterns of fraud or other misconduct, and (b) the types of institutions most affected (such as by categories of asset sizes or geographical distributions).

A.2.Answer:

On a geographic basis, criminal referrals pertaining to banks under our supervision tend to be concentrated in the larger states and in states suffering economic problems. Texas, Illinois and California head the list followed by Louisiana, Florida and Georgia. Tennessee and Oklahoma are also in the top ten. As in past years, criminal referrals continue to cite embezzlement, false entries and misapplication of funds as the main violations. However, more and more cases are being reported under the new Bank Fraud Statute. These violations usually involve outsiders rather than

insiders. The trend to more violations by outsiders in the last year and one-half diverges from the historical norm. Historically, the proportion has been about 20 percent outsiders to 80 percent insiders. We have seen that proportion change to 30 percent outsiders to 70 percent insiders for "significant" referrals and to almost 40/60 percent when all referrals over $10,000 are considered. This trend probably reflects the vulnerable state in which many banks find themselves as they try to survive severe economic conditions and increased competitive pressures. Faced with possible insolvency and meager prospects for recapitalizing, bank mangers and owners stretch for high yields and sometimes get caught by fraudsters and con artists.

During 1985, 1986 and through the first half of 1987, ninety-eight (or 28%) of the 354 banks that failed were cited by examiners as having at least some element of fraud or insider abuse. The 98 banks had assets of $2.7 billion and the cost to the FDIC is estimated at $676 million. These losses, however, represent the estimate of <u>total</u> losses, not just those caused by fraud and abuse and should not be viewed as an accurate gauge of fraud and abuse losses. While still significant, our experience since 1985 reflects a somewhat lessened impact of fraud and abuse compared to the period studied by the Subcommittee leading to the 1984 report. During that period we estimated that about 45 percent of bank failures involved fraud and abuse. 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 which cited defalcation, embezzlement or manipulation in 31.3 percent of the failures.

A.3.Question:

Are there certain kinds of misconduct becoming more prevalent and are certain schemes being utilized more frequently, particularly in problem or subsequently insolvent institutions (often where there is no formal referral but where there are FDIC lawsuits or criminal investigations)? What kinds of misconduct are more difficult for examiners to detect in solvent institutions?

A.3.Answer:

As in past years, criminal referrals continue to cite embezzlement, false entries and misapplication of funds as the main violations. However, as stated in our answer to Question A.2., we are seeing more fraudulent attempts to obtain funds from banks by outsiders. Some of these attempts have led to bank failures and reflect deliberate criminal activity. More illegal takeovers of small banks have occurred or have been attempted in recent years. In some of these situations, the Change in Bank Control Act requirements have been completely ignored. In others, Change in Control Notices were filed, but control was acquired before the FDIC could act to disapprove the transaction. We successfully thwarted a number of these attempts through aggressive supervisory efforts and with the assistance of local FBI agents. Appraisal fraud is apparently more prevalent than in the past. Currently, a real estate appraisal fraud in the Southwest has impacted fifteen state nonmember banks, two of which have recently failed, though not as a direct result of fraudulent real estate loans.

Virtually any kind of theft or fraud can be concealed from an examiner for some period of time -- until it becomes so large it can no longer be covered-up. Examiners are present in a bank for a very small amount of time. That is why

banks themselves bear the primary responsibility for preventing fraud and abuse and why we are encouraging the accounting profession to assume a greater responsibility for fraud detection when conducting outside audits.

<u>A.4.Question</u>:

4. The FDIC advised the subcommittee that "banks can protect themselves from undue risk [when purchasing loan participations] by employing fundamental credit analysis and instituting sound documentation controls." The Home Loan Bank Board has attempted to address the problem of loan participations involving fraudulent or unsafe loans by requiring that the purchasing institution obtain copies of certain relevant and specific underwriting documents. Has the FDIC implemented such a regulation? If not, why not?

<u>A.4.Answer</u>:

We do not believe that loan participations should be singled out from other types of lending instruments, all of which can be subject to various types of fraud or other misconduct limited only, in many respects, by the imagination of the individual or individuals involved in this activity. Traditionally, the FDIC has not regulated the lending practices of state nonmember banks although lending practices are supervised closely. We do not see a serious, widespread problem involving loan participations which cannot be corrected by normal supervisory means. Furthermore, while the requirement of having the purchasing institution obtain copies of certain relevant and specific underwriting documents is a sound banking practice, it does not address all of the potential problems related to loan participations. Banks would still need to establish sound internal controls and lending constraints to avoid trouble.

Loan participations are closely scrutinized by FDIC examiners. Examiners are instructed to determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the participation to the same extent as if it were a direct obligation of the bank. In this regard, all relevant loan documentation and credit information should be obtained prior to any commitment being made to purchase the asset. Failure to follow these minimum procedures would be considered an unsatisfactory banking practice. To assist our examiners with early detection of apparent bank fraud and insider abuse, a list of early warning signs ("Red Flags") was developed earlier this year for a number of subject areas, including loan participations. By following this guide, the examiner not only will be reviewing loan participations for compliance with sound policies and operating procedures but also will be alert to the possibility of abuse and misconduct.

MANPOWER RESOURCES AND FREQUENCY OF EXAMINATIONS

B.1.Question: Manpower Resources and Difficulties:

a. Please describe examiner manpower levels for FY 1985, 1986, and 1987, indicating (i) net increases in numbers of examiners, (ii) numbers of examiners which have left the agency, and (iii) the number which have been hired. How many examiners is the agency system planning to hire in 1988? Have salaries been increased? b. In which regions or states has the agency made the greatest percentage increases in the number of examiners?

B.1.Answer:

(a)

Year End	FDIC Field Examiner Level	(i) Net Increase in Examiners	(ii) Number Left FDIC	(iii) Number Hired
1985	1,547	158	144	362
1986	1,726	179	152	336
September 30, 1987	1,919	193	153	357
1987 (Estimate)	2,000	274	204	489
1988 (Estimate)	2,034	34	220	254

The only salary increases have been periodic cost-of-living adjustments accorded to Federal employees.

(b) The FDIC Chicago Region has had the greatest percentage increase in field examiners so far this year. The number of field examiners increased by 24.04 percent from 183 on January 1, 1987 to 227 as of September 30, 1987. The Dallas Region was the second highest with 20.50 percent.

B.2.Question:

(a) What is the actual frequency of examinations at present for (i) nonproblem institutions and (ii) problem institutions, and what was it in the recent past? Do you have any data showing frequency of examinations for failed State nonmember banks? If so, please provide. (b) What examination frequency would you prefer, and how many examiners and how much time would it require to reach that frequency? (c) Has the agency done any studies or analyses to determine whether there is a correlation between either frequency of examinations or time elapsed since the last examination and the existence of insider abuse or misconduct?

B.2.Answer:

(a) Average intervals between regular FDIC examinations for State nonmember banks vary dramatically by region based on such factors as economic conditions, regional banking structures, size and number of problem institutions, quality of State examination programs and staff availability. Our policy calls for examinations of 3-, 4- and 5-rated institutions every 12 months with 1- and 2-rated institutions examined as often as necessary but with a maximum interval of 36 months between examinations. The policy permits the Regional Director to extend the intervals for 1- and 2-rated institutions up to 60 months for good cause. At this time, our examination aging schedule shows that 33 percent of the 4- and 5-rated institutions and 40 percent of the 3-rated institutions have not been examined within 12 months, while 25 percent of the 1- and 2-rated institutions have not been examined within 3 years.

The FDIC's regular examination program is supplemented with a variety of other examination tools that are not included in the above statistics. These tools include onsite visitations, offsite monitoring and analysis, and review of interim State examinations. Based on the results of any one or a combination of these tools, together with other relevant factors such as staff availability, the FDIC Regional Director has the authority to set Regional examination priorities.

We do not maintain statistics on the frequency of examinations for failed State nonmember banks. However, the relationship between failed state nonmember banks and examination intervals could be developed from information in our supervisory files. The vast majority of the failed institutions would

have been rated 3, 4 or 5 which would place them in our most stringent examination frequency cycle.

(b) We would like to examine all 3-, 4-, and 5-rated institutions at least annually and 1- and 2-rated institutions once every 24 months, unless other factors, such as economic conditions and offsite surveillance, indicate that a longer interval can be allowed safely. In order to achieve such a level of examinations, we estimate that we would need approximately 2,300 experienced examiners. It would take about 2 years to increase our staff from the 2,000 estimated for year-end 1987 to the 2,300 level, and an additional 3 years for those new hires to become experienced.

(c) The FDIC has not studied the correlation between examination frequency and the existence of insider abuse.

<u>B.3.Question</u>:

From which state banking authorities do FDIC regional offices routinely not enter examination report data in its own database, nor recognize such examination efforts, concerning state-chartered banks. (Please list.) Do state-chartered banks in these states have a higher incidence of insider abuse, criminal misconduct, or unsafe or unsound practices than banks in those states whose state examinations are accepted and recognized?

<u>B.3.Answer</u>:

State examination reports received by the FDIC are reviewed at the Regional Office level and become part of our examination records. Because of the wide variance in the size and abilities of the State banking department programs, the FDIC, over the years, has entered into a variety of formal and informal

examination arrangements designed to best utilize the resources available. For example, the FDIC may conduct joint examinations, concurrent examinations, independent examinations or any combination of such with the State department depending on the resources available and the circumstances involved. While it is clear that some State banking departments are better than others and consequently some State examination reports are more reliable than others, the FDIC has not identified specific criteria or developed accurate methods to evaluate State departments.

The decision to enter or not enter State examination results into our mainframe database is currently left to the discretion of the Regional Director and is not necessarily based on the competence of the State banking department. Some of the other factors considered in that decision include the scope of the State examination, date of the examination, date received by the FDIC, date of next scheduled FDIC examination, and the workload and priorities of the Regional Office staff.

The FDIC has not studied the correlation between a higher incidence of insider abuse, criminal misconduct or unsafe and unsound practices in banks and the strength of the state's banking department.

PROPOSALS TO IMPROVE AUDIT CAPABILITIES AND RELY ON BOARDS OF DIRECTORS TO PREVENT OR DETECT FRAUD OR OTHER MISCONDUCT

C.1.Question:

The FDIC has proposed requiring independent financial audits of all State nonmember banks it supervises. However, it advised the subcommittee that "for an audit requirement to be most effective, it should apply to all insured

banks," not simply the banks for which it is the primary regulator. Hence, FDIC staff has been working with staff of the OCC and the FRB to gain their cooperation in developing a joint audit requirement applicable to all banks. (a) What has been the reaction of the OCC staff and the FRB staff to this proposal? (b) If the other agencies do not cooperate, does the FDIC have statutory authority to impose such a requirement on all Federally insured banks, as a condition of continued deposit insurance? (c) Turning to the FDIC's policy toward applicants for Federal deposit insurance (adopted 5/28/87), which states that the FDIC "expects" such audits, what actions will the FDIC take if such is not done?

C.1.Answer:

(a) The FDIC has been continuing its efforts to obtain interagency agreement on an independent audit requirement for banks through discussions with staff members from both the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (Fed). Both the OCC and the Fed have been cooperative in this effort, and we believe we will be able to reach an interagency agreement.

(b) The FDIC believes that under its existing statutory authority it would be limited to imposing an audit requirement on insured state nonmember banks only.

(c) To date, no operating institution applying for deposit insurance has failed to satisfy our expectation that it have an annual audit. Since the Federal Home Loan Bank Board has an audit requirement for institutions under its supervision, it is not surprising that no operating FSLIC-insured institution applying for FDIC insurance coverage has encountered problems with this expectation.

C.2.Question:

The Federal Home Loan Bank Board requires the submission of audit reports by thrift institutions to the district bank supervisors within 15 days of the receipt of the audit report. However, all of the other Federal bank regulatory agencies, including your own, only require that examiners review the report during the next examination. In view of the frequency of agency examinations, would it not be useful to issue a similar agency requirement, notwithstanding the lack of an audit requirement, to promptly receive and review audit reports in order to detect problems early on and, as necessary, take prompt supervisory action?

C.2.Answer:

The FDIC has not wanted to discourage those banks that voluntarily have independent audits from continuing to do so by imposing more requirements on them than on unaudited institutions. Nevertheless, many banks routinely submit their audit reports and/or management letters to our regional offices. Since we are continuing to pursue the possibility of an audit regulation, we would plan to include in it a requirement that audit reports and management letters be filed promptly with the FDIC. As an interim step, the staff is also considering having FDIC examiners seek the commitment of an audited bank's management or board of directors to submit these letters promptly after the bank is audited. Should we determine not to proceed with an audit regulation, we may decide to require that reports from voluntary audits be filed with the FDIC.

C.3.Question:

None of the bank regulatory agencies requires (as opposed to allows) that examination reports be provided to independent auditors hired by financial institutions. In their responses to the subcommittee, all of the agencies (but the NCUA) expressed concerns that mandating disclosure of examination reports to independent auditors would compromise the ability to keep the reports confidential. I sent to the Federal Reserve Board my views on a proposed regulation which furthers this policy (see attached October 9, 1987, letter). Please respond to my concerns that troubled institutions or ones in which misconduct is occurring will not volunteer such examination reports and my belief that it is possible to place conditions on auditors who review such reports, such as only onsite reviews and written pledges of confidentiality, particularly in view of a certified public accountant's ethical duties to its client.

C.3.Answer:

While the FDIC has long opposed mandatory disclosure of examination reports to independent auditors hired by financial institutions because of our concern for the confidential nature of the report, the financial integrity of the bank, the legitimate privacy interests of any individual named in the report, and the independence of the supervisory agencies and their examinaticn process, we are considering a requirement that audited banks show the bank examination report to their independent auditor.

In our opinion, independent auditors should review the most recent supervisory examination report and, in their capacity as bank agents, they are allowed to

review examination reports routinely without prior FDIC approval. If a situation developed whereby a bank refused to allow an independent auditor access to the examination report, the auditors probably would not give the bank an unqualified opinion. Moreover, the auditors still could obtain access to the report by making a written request to the FDIC outlining the specific records requested and the reasons for the request. Such a request would alert the FDIC to a potential problem at the bank.

PROPOSALS TO INCREASE RESPONSIBILITIES OF BOARDS OF DIRECTORS

C.4.Question:

a. The FDIC is working with all of the other bank regulators to develop a code of conduct for bank directors, to place more responsibility on them. What actual proposals are being considered? (Furnish a draft if one is available.) What proposals would the FDIC like to see implemented?

b. Does the FDIC require that management send to the board of directors copies of all informal and formal civil enforcement or supervisory actions? If not, why not? If so, how is compliance enforced?

c. Two agencies have suggested to the subcommittee that the responsibility to check into the background of employees, including officers, rests with management and boards of directors, not the bank regulatory agencies. Does the FDIC conduct a name check and provide information on an individual at the request of a financial institution hiring such person to determine the

existence of prior civil enforcement orders, criminal referrals, or any other information maintained by the agency? If not, why not?

C.4.Answer:

a. The FDIC has worked with the other depository institution regulators, including the FHLBB, to develop a relatively short, plain English set of guidelines for financial institution directors. The guidelines essentially mirror existing law and sound banking practices but place no new responsibilities on financial institution directors. A copy of the guidelines is attached. The FDIC Board of Directors has approved the guidelines which are now being printed for distribution to banks and bank directors.

b. Copies of all formal enforcement actions issued by the FDIC are sent directly to the respondent bank's board of directors. In general, proposed Orders are discussed and negotiated with the board rather than with management and in all instances the final decisions regarding Section 8(b) enforcement actions must be acted upon by the board as a corporate body. Informal actions in the form of Memoranda of Understanding carry the signature of each bank director. Thus, since the FDIC deals directly with the board of directors with respect to formal and informal civil enforcement and supervisory actions, we do not see a need to require a bank's management to send the board copies of such actions. Compliance with enforcement actions is enforced through various means, including frequent visitations and examinations, the detailing of compliance with each point in an Order in visitation and examination reports, meetings with management and/or the board, follow-up correspondence between our Regional Office and the bank, off-site monitoring, etc.

c. The FDIC does not routinely conduct name checks on individuals at the request of financial institutions. Personal information contained in criminal referrals is covered by the Privacy Act of 1974, and the FDIC strictly adheres to its provisions. Should the circumstance arise where an inquiry is made by a bank regarding an individual who has been the subject of an FDIC enforcement action which has become final, such information would be appropriately disclosed. Should an individual who has been removed from one bank pursuant to section 8(e) of the Federal Deposit Insurance Act become employed by another insured institution, the FDIC would seek enforcement of its Order in accordance with the provisions of the Act.

INTERAGENCY COORDINATION AND CONSULTATION AMONG AND BETWEEN BANK REGULATORY AGENCIES AND LAW ENFORCEMENT AGENCIES

D.1, 2(a), 2(b).Questions:

Do you have any views on improvements to the structure and operations of the Interagency Bank Fraud Working Group. (To prevent repetition and save time, I would request that you not discuss the accomplishments of the interagency bank fraud working group, unless directly relevant in answering this question, as the Federal Reserve Board and the Criminal Division witnesses have been asked to provide this information.)

2. The subcommittee has uncovered problems due to a lack of coordination and communication between the Justice Department (including the FBI) and the bank regulatory agencies and fee counsel at local levels, with one notable exception, the Chicago area (and now perhaps California). At the subcommittee's June 13, 1987, hearing in Los Angeles, U.S. Attorney Bonner

testified, "It would be helpful to have the FBI periodically meet with examiners to discuss the types of bank frauds prevalent in a given district. Many frauds follow certain patterns. Experienced FBI agents and examiners could exchange information which would assist examiners in identifying the 'badges' of fraud." (His office subsequently advised us that, as a consequence of our hearing, communications, training and coordination have improved significantly in Southern California. Several other U.S. Attorneys surveyed by the subcommittee confirmed the lack of such coordination in their districts. The U.S. Attorney in Chicago has formed a Banking Regulators Forum, made up of representatives from Federal and State banking agencies and also several law enforcement agencies, which meets every 6 to 8 weeks, and has been reportedly very successful in carrying out joint efforts and communicating instances of misconduct.

a. Does the FDIC support the formal creation of such task forces or groups, particularly in those districts with large numbers of cases or where there have been problems in the past? If not, why not? If so, has the agency considered taking steps to work with other agencies, to create them? Which agency should serve as the lead agency in this effort or should it be a joint effort?

b. Irrespective of the creation of such interagency groups, what steps is the FDIC prepared to take to foster improved coordination and communication at the local level, particularly between the FBI/U.S. Attorneys offices and your agency's examination and supervision staff?

D.1, 2(a), 2(b).Answers:

The Bank Fraud Enforcement Working Group is functioning very effectively at the headquarters level. However, any real progress in overcoming bureaucratic inertia and other obstacles to effective cooperation must be made at the local level, where information in one form or another is critical to the success of specific investigations and prosecutions. We have always supported the formation of local interagency groups, both formal and informal, to deal with criminal activity. In fact, we were initially skeptical of a Washington level concept such as the Bank Fraud Working Group fearing that its scope would not reach far enough into each participating organization to be effective. We have been pleased, however, 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 are also pleased with the efforts of many U.S. Attorneys to carry this commitment to local areas. 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 these forums established in all districts. In our view, local forums are effective for several reasons. First, if organized by the U.S. Attorney, they demonstrate the U.S. Attorney's commitment to prosecuting bank fraud cases. Second, examiners get feedback on the results of recent cases and are directly informed of any changes in investigative or prosecutive policies. And third, crimes affecting banks that are outside the FBI's jurisdiction, such as money laundering, can also be discussed at the meetings, bringing in the views of other investigative agencies, such as Customs, IRS, and the Secret Service.

The FDIC has, for several years now, encouraged its field office supervisors to initiate contacts with FBI agents in their local areas. Names and phone numbers of field office supervisors are provided to the FBI periodically. We have initiated dialogue with law enforcement officials in all of our regional locations and, in some cases (Atlanta and Kansas City, for example), the FDIC has taken the lead in organizing interagency meetings. As we stated earlier, the FDIC encourages frequent contact with law enforcement officials at all levels; however, we believe the U.S. Attorney is in the best position to coordinate resources in local jurisdictions.

D.3.Question:

Based on all of the bank regulatory agencies recent submissions to the subcommittee, it appears that lists of persons suspected of and financial institutions affected by alleged criminal misconduct (and the outcome of any investigations) are not systematically shared or received among the agencies. Since the FBI's FOIM System will not be fully operational for at least one year, what are your views on developing a policy whereby at least all significant referral information (names and institutions) would be automatically (a) shared by each agency with all other banking agencies and (b) entered into every agency's computer system, to track individuals who move among different kinds of financial institutions?

D.3.Answer:

Managing all the information generated to deal with individual fraud and insider abuse presents a real challenge. The information originates from thousands of financial institutions, a half-dozen regulatory agencies, the

FBI, Secret Service and Justice Department, not to mention state regulators and prosecutors. FOIMS, the FBI's Field Office Management System, represents the most efficient system for collecting and disseminating the information needed for regulatory and law enforcement purposes. In the time remaining before FOIMS becomes fully operational, the regulatory agencies have agreed to exchange lists of significant criminal referrals at the Washington level and to exchange actual copies of criminal referrals at the regional level. We believe this type of information exchange will minimize the risks without causing the establishment of redundant computer systems.

IMPROVEMENTS IN EXCHANGES OF INFORMATION

E.1.Question:

1. Mr. Jeffrey Jamar, chief of the FBI's white collar crime section, testified at the subcommittee's June 13th hearing, as follows: "It is preferable for appropriate banking agencies to refer any criminal misconduct uncovered while examinations are still underway rather than waiting until the institution is actually closed (or afterwards). This facilitates the investigative process by allowing FBI agents to interview examiners and/or institution employees while they are still available and while the records are still accessible and available for review by both the examiner and the FBI agents...." Several U.S. Attorneys have made similar recommendations, strongly urging that FBI agents be brought into the institution at the time of failure, if not before. Questions: Please respond to this recommendation. Should the bank regulatory agencies consider changing their policies so that FBI agents can be present prior to, at the time of, or immediately after an

institution's closing, if abusive practices or criminal activities are suspected? Is the FDIC prepared to take steps to seek a change in policy and procedures?

E.1.Answer:

Communication between the FDIC and the FBI prior, during and after a bank fails has never been better. While we do not notify the FBI of the time and place of all bank failures, it is our practice to keep them informed of the pending failure of banks in which criminal conduct has been identified or is strongly suspected. In many of these cases, FBI agents are invited along to the bank on the day it closes. Through the network of contacts established by the Bank Fraud Working Group, and as a result of local meetings such as the Chicago forum, examiners, liquidators and federal investigators are prepared well in advance of a bank failure to deal with the consequences of criminal conduct during and after the bank fails.

If FDIC examiners have identified possible fraud and abuse in a failing bank a criminal referral will be made prior to the failure. In these cases, it is our practice to work closely with the FBI before, during and after the closing. In other cases, where criminal wrongdoing was not identified or suspected prior to the failure but was discovered after FDIC liquidators had an opportunity to review the records of the failed bank, the FBI would be notified after the bank closed. In either case, communication channels have been established between liquidators and FBI agents to enable information about suspicious activity or potential criminal misconduct to be passed in both directions.

E.2.Question:

U.S. Attorneys, the Fraud Section, and the FBI have encountered problems interviewing examiners and work papers. In its 7/9/87 submission to the subcommittee, the Criminal Division states that, while it is often necessary for FBI agents and prosecutors to interview the agency examiners whose work product was crucial to relevant examination reports, "by that time the examiners are examining a bank or thrift in yet another city. Their schedules and memoranda are in storage in another city. Therefore, it is not easy to bring the agents, the examiners and their work product together." (One U.S. Attorney had to send an assistant to travel to other regions of the country because of this problem.) In his 6/13/87 testimony, FBI official Jamar stated: "Easier access to both examination reports and the examiner most knowledgeable in the area of the reports would be of great assistance, [particularly in cities] where neither the FDIC nor the FSLIC maintain offices." Part of the problem arises, because, as U.S. Attorney Robert Bonner testified (subcommittee's 6/13/87 hearing), banking agency examiners do not follow-up on referrals which they do make and do not provide copies of key documents and interview memoranda of key witnesses at an early stage, preferably close to the time of the examination. Question: How can this problem be resolved? What steps is the FDIC prepared to take to overcome the problems cited?

E.2.Answer:

It is FDIC's policy (and the policy extends to outside counsel) to promptly refer apparent criminal activity to appropriate law enforcement officials. We are committed to providing the assistance and expertise of FDIC examiners

wherever and whenever they are needed to improve the prospects of a bank fraud prosecution. Logistical problems in gathering evidence and staging interviews are inevitable given the requirements of a bank examiner's job. Nonetheless, these problems are being minimized as prosecutors and FBI Agents become more familiar with the examination process. Through periodic meetings between bank regulators and law enforcement officials and formal and informal channels of communication, the bank fraud threat in each district can be better understood.

E.3.Question:

(a) Please discuss any recent typical problems which the FDIC has had with both the Right to Financial Privacy Act and with obtaining information under Rule 6(e). (b) What specific changes do you recommend in the Act? (c) Over the years this subcommittee has heard (and been sympathetic to) complaints about the RFPA from the bank regulatory agencies and the Justice Department, which have urged the Congress to change the statute. What specific efforts has the FDIC made, to attempt to convince both the House and Senate Banking Committees of the need to do so?

E.3.Answer:

The flow of information that is critical to effective prosecutions and to informal bank supervision is circumscribed by the Right to Financial Privacy Act (RFPA) and Rule 6(e). In a sense, the Rule 6(e) problem was exacerbated by the RFPA. Both problems can be lessened considerably by eliminating RFPA restrictions covering transfers of information from bank regulators to law enforcement authorities and vice versa.

If FDIC were free from the RFPA customer notice requirements -- which Justice wants to avoid in criminal cases -- information acquired for supervisory purposes could be transferred and fully explained without causing the U.S. Attorney to issue a grand jury subpoena. Thus, the preliminary information provided would not be subject to Rule 6(e). Should the Congress enact the amendments recommended by the Bank Fraud Working Group and included in the regulators' legislative package, U.S. Attorneys could gather evidence from banks or from regulators prior to convening a grand jury. Material obtained this way would remain outside the ambit of Rule 6(e) and, if appropriate, could be lawfully provided to bank regulators for legitimate regulatory purposes.

Probably the most adverse impact of the RFPA on our cooperative efforts is the chilling effect or psychological impediment the Act exerts on the relations and interactions of examiners and law enforcement agents. We will never know how many cases were jeopardized by this chilling effect. Nevertheless, the public interest can be seriously harmed by closing off the flow of critical information between federal agencies.

To illustrate, because of the RFPA, and to some extent Rule 6(e) restrictions, the FBI is prohibited from informing FDIC liquidators of information its agents learn from closed bank investigations. We know of one instance involving millions of dollars, the whereabouts of which was learned by the FBI in its criminal investigation. Because of legal restrictions, however, this crucial information could not be passed on to the FDIC, removing the opportunity to restore millions of dollars to the FDIC insurance fund.

Amending the RFPA as recommended by the Bank Fraud Working Group would give Justice greater latitude to investigate and collect evidence before convening a grand jury. Under the amendments, information gathered this way could be exchanged with the banking agencies for regulatory purposes and with the FDIC for receivership purposes.

E.4.Question:
Other than amendments to Rule 6(e), what recommendations, if any, would you make to improve the exchange of information from Federal law enforcement agencies to the bank regulatory agencies?

E.4.Answer:
We strongly recommend amending the RFPA as proposed by the Bank Fraud Working Group and the financial institution regulators.

E.5.Question:
Mr. Jamar also testified, "The FBI's experience is that in some failures, fee counsel have not made timely and adequate referrals while in other instances they have not." The FDIC's 10/30/87 letter to the subcommittee pointed out some reasons why fee counsel are reluctant to make criminal referrals, but indicated that it is considering providing guidance to fee counsel. What directive is the FDIC prepared to send to all fee counsel requiring timely criminal referrals? (The FDIC's Guide for Legal Representation which governs the activities of outside counsel does not provide clear guidance on this issue to fee counsel.)

E.5.Answers:

Copies of the directives are attached.

SUFFICENCY AND ALLOCATION OF PROSECUTIONAL RESOURCES AND EVALUATION OF PROSECUTORIAL DECLINATIONS OF SUFFICANT REFERRALS

F.1.Question:

(a) Based on the experience of FDIC regional officials, please identify those FBI divisions where long investigative delays have occurred and which probably have lacked sufficient manpower resources? (b) Please describe any efforts taken to remedy this lack of resources, including meetings at the local level or at headquarters, and indicate the outcome.

F.1.Answers:

(a) The majority of the FDIC Regional Offices report no long investigative delays at FBI divisions within their areas. The Chicago Regional Office reported some delays in investigations in Wisconsin and the Columbus Regional Office reported some investigative delays in Eastern Kentucky that may be attributed to manpower shortages. The San Francisco Regional Office reported some past investigative delays in Los Angeles and Orange County, California, but indicated that the situation is improving, particularly in cases involving $100,000 or more in estimated losses.

F.2.Question:

Similarly, which U.S. Attorneys' Offices have backlogs in prosecuting bank fraud and embezzlement cases arising out of open State nonmember banks of

failed FDIC-insured banks? Please identify the U.S. Attorneys' Offices involved and quantify the problem. (Give a representative example of a matter long delayed, without naming suspects.)

F.2.Answer:

The FDIC's Columbus Regional Office reported one case involving about $3.5 million in losses which has been pending since February, 1983 in the Eastern District of Kentucky. The delay appears to be due to limited manpower resources; however, trial has been scheduled for early in 1988. The FDIC's Memphis Regional Office reported some prosecutive delays in the Eastern District of Tennessee and in some parts of Louisiana. The delays appear to be due to manpower shortages and heavy case loads. One case in the Eastern District of Tennessee involves approximately $12 million in estimated losses and has been pending since 1984. It should be noted that it is not always possible for the FDIC to determine whether delays are attributable to delays in investigations or delays in prosecution. In many cases, we are not informed when an investigation is completed and turned over to the prosecutors.

F.3.Question:

U.S. Attorneys' Offices have declined 16 referrals designated as significant by the FDIC (Attached are summaries provided by the Criminal Division). (a) In each case, was the FDIC satisfied with the prosecutorial decision? If not, identify the case (by summary sheet) and describe the efforts made to have the matter reconsidered? (b) Did the FDIC take any civil enforcement actions against any of the individuals against whom a prosecution was declined? Reference each summary page and indicate any civil enforcement action taken.

F.3.Answer:

(a) The FDIC Regional Offices indicated some dissatisfaction with the prosecutorial decisions involving control numbers 8600753, 8600276 and 8700705. We were advised that briefings on all three cases were being sought by regional officials either at an interagency session or by some other means, probably over the telephone.

(b) Civil actions have been taken against some of the individuals identified in the declinations. The individual involved in case control number 8600753 was the subject of a Section 8(e) removal order on July 22, 1986. The individual involved in case control number 8700705 was the subject of a removal settlement agreement dated August 19, 1983. Some cases involved outside borrowers or other bank customers which are not subject to FDIC's civil enforcement authority.

G.Question:

The OCC, FRB, the FDIC, and the NCUA have been considering a legislative package to increase the agencies' civil enforcement authority, such as allowing the agencies to proceed against individuals who have resigned from a financial institutions and to issue industrywide prohibition orders. (Some of the provisions are similar to those in the proposed Depository Institutions Insider Fraud Prevention Act of 1986 (99th Congress). Please indicate the status of that legislative proposal, and, if possible, provide a copy.

G.Answer:

The financial institution agencies' joint enforcement proposal recently has been completed and is being prepared for submission to the appropriate

Congressional committees for their consideration. We anticipate that a copy of the proposal will be delivered to you by the time our testimony is presented.

The proposal would amend the enforcement statutes to improve the agencies' ability to combat insider abuse, misconduct and fraud at our nation's depository institutions. Examples of changes included in the proposal are amendments (1) to clarify that the agencies may require affirmative action in cease and desist orders to correct the conditions which resulted from unsafe or unsound banking practices, (2) to specifically allow the agencies to place limitations on the activities of an individual at a bank without having to completely remove the individual from banking, and (3) to make certain that termination of employment or other separation from an insured bank by a bank-related person does not affect the agency's authority to bring removal actions against that person for improper conduct.