FDIC
Speeches

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TESTIMONY OF

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ON

SUPERVISORY AND ENFORCEMENT EFFORTS
of the F.D.I.C.

BEFORE THE

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

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ROOM 247, RAYBURN HOUSE OFFICE BUILDING

Good morning, Mr. Chairman and members of the Subcommittee. We appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation on a 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. This report has been provided to the Subcommittee as a separate document.

The FDIC directs its supervisory efforts toward maintaining the safety and soundness of the banking and thrift system and protecting the deposit insurance funds. We are the primary federal supervisor for over 8,000 state nonmember commercial and savings banks with over $900 billion in assets. We also monitor the condition of approximately 6,000 national and state member banks and cooperate with the other federal and state regulatory authorities in their efforts to ensure the safe and sound operation of these insured banks. In addition, the Financial Institutions Reform, Recovery, and Enforcement Act assigned the FDIC substantial responsibilities for the supervision of some 2,900 savings associations.

The main theme of our statement today is anticipatory supervision. The FDIC's Division of Supervision is taking a proactive supervisory stance in order to detect potential problems at an early date. Our goal is to limit or prevent losses resulting from operational deficiencies and criminal misconduct in insured depository institutions. We are responding more quickly with appropriate supervisory measures when early signs of problems are identified. We will continue to monitor banks closely with more frequent onsite examinations and more sophisticated offsite monitoring systems. Our ability to do this has been enhanced with an expanded hiring program and more streamlined examination procedures.

Financial institutions operate in an environment in which there are mechanisms for obtaining funding nationwide. These monies are very interest sensitive and are generally invested where there is the greatest return. The institutions which are paying the highest rates also tend to offer the greatest risk to the FDIC. Through careful monitoring of local and regional economies which show indications of becoming overheated, supervision should be able to anticipate and prevent the cycle of unrestrained growth and the losses which tend to follow as the economy contracts.

In addition, to help us deal with these problems we have proposed a regulation for monitoring and controlling rapid growth situations, developed offsite monitoring systems to track growth, and adopted a policy statement that strongly urges banks to have an annual external auditing program performed by an independent party. We believe this is essential for the early detection of problems and determent of unsound practices and fraud.

ANTICIPATORY SUPERVISION

The FDIC continues to emphasize the need for bank supervision to be more anticipatory in nature. Our intent is to identify and obtain corrections of weaknesses in the bank's policies and procedures that have a realistic potential to cause financial problems.

Proactive supervision entails the constant assimilation of information from numerous sources both within and outside the FDIC. In 1989, we distributed a listing of the types of information examiners and supervisors should consider in active supervision (see attached Appendix 1). You might call these items "red flags" for identifying potential risks. In addition, we revised our frequency of examination policy in 1988 to increase the level and frequency of on-site supervision. Our goal is to have an on-site examination every 24 months for well-rated institutions (those rated 1 or 2) and one every 12 months for problem and near-problem institutions (those rated 3, 4, or 5). Some of these intervals can be extended if an acceptable state examination is conducted.

We have also streamlined the examination process. The examination report is automated which saves time in its preparation. Our more sophisticated offsite monitoring system points out areas of supervisory concern. Our examiners have also been given more discretion to expand or contract the scope of an examination to fit the condition of the bank and the problems encountered. We are not only conducting more examinations but also are actively supervising through forms of customized contacts with banks in order to anticipate problems, identify risk in those potential problems and take appropriate preventive action.

In 1989 we conducted 4,089 on-site safety and soundness examinations (including 375 savings associations), compared to 4,019 in 1988 and 3,653 in 1987. We had expected to do considerably more, but had to revise our goal due to our involvement as conservator for the insolvent thrifts. In 1990 we expect to conduct even more examinations.

MONITORING RAPID GROWTH

Over the past few years we have seen a trend of insured banks and thrift institutions growing very rapidly in a short period of time and concurrently developing serious asset and/or other problems, including the presence of fraud. In fact, some of these institutions have failed very quickly thereafter, even though they had operated satisfactorily prior to the unwise growth.

Various mechanisms have been used to fund growth, including brokered deposits, direct borrowing from a Federal Home Loan Bank, use of repurchase agreements, direct solicitation of deposits throughout the country by a "money desk" operation, and simply paying above-market rates.

Often in the environment of accelerated growth, management is spread thin, operational controls are weakened and board supervision is more lax. These situations invite abuse and fraud. Supervisory presence at the early stages of a change in an institution's business plan is an effective method of deterring unsound practices.

To this end, the FDIC proposed in April 1989 to require insured banks to provide the FDIC with prior notice of planned rapid growth. Based on comments received, the FDIC staff is revising the proposal and intends to recommend publishing for comment a revised proposed regulation. The revised regulation, which would apply to both insured banks and savings associations, would require prior notice to the FDIC of planned rapid growth in excess of 7.5 percent over any three-month period which is funded by brokered deposits, out-of-territory deposits, or secured borrowings. Plans for high growth could not be implemented for 30 days following notice in order to afford the appropriate regulatory authorities time to determine the appropriateness of the program and stop it in those cases involving undue risks. Other possible means of growth are typically slower and/or normal for most institutions and we believe these can be monitored safely after-the-fact.

RESPONDING TO CHANGING ECONOMIC CONDITIONS

Although the past several years have been a period of overall growth in the national economy, downturns in regional economies have led to significant increases in banking problems. Ownership and market pressures to continue profits while the quality of the asset base is deteriorating have often added substantially to the difficulties.

Management frequently takes risks in these situations and makes unwarranted debtor concessions based on the assumption that the area's economy will stabilize or improve. When these assumptions are wrong, significant losses have occurred. As the losses increase and the future viability of an institution is threatened, the cost of funding escalates, placing further pressures on profits. This cycle of deficit earnings quickly leads to an insolvency where capital levels are inadequate and investor confidence is such that there is little prospect for obtaining needed capital.

The most representative example of these problems is Texas where the continued decline in real estate values has almost directly correlated to the rise in problem and failed banks. Only six Texas banks failed in 1984, while in 1989 there were 134 insolvencies in the state.

Another example is our Kansas City region, which is comprised of seven Mid-Western states. Bank failures totaled 48 in 1986 when the agricultural sector in that region was in the midst of economic adversity. As the economy of the region improved, the number of bank failures in the seven state area declined to ten during 1989.

The economic collapses in Texas and the agricultural states were preceded by several years of boom times. These overheated economies created an atmosphere of greed and risk taking with poor decisions being masked by ever-appreciating asset values.

It is evident from this history that our anticipatory supervisory efforts must be more directly focused on both those areas where economic indicators show trends towards a decline in a region's economy and those areas that appear to be overheated.

For example, the Pacific Northwest is an area today that displays unusual economic strength. Local industry is going strong and real estate prices are escalating rapidly. However, our examiners in that area are being told to continue to pay close attention to prudent credit standards when evaluating loans and not to acquiesce in relaxed credit criteria which may be set by competitive pressures. In this way we hope to be on top of potential problems and either prevent their occurence or lessen their severity.

New England is the opposite picture. There we have unsettling indicators in the real estate market. This has led to a significant increase in our supervisory efforts in that area.

In situations where problem banks and bank failures are driven to a major extent by bad economic conditions, and where management is honest and competent, we try to work with existing management on an informal basis rather than arbitrarily reverting to formal enforcement actions. This has been reflected in a 23% increase in the number of informal enforcement actions taken in 1989 as compared with 1988.

Insider abuse was identified in 25 percent of the 206 banks that failed in 1989. This is down from 31 percent in 1988 and 42 percent in 1987. This tells us that failures today are more a result of economic factors and management errors. Even when present, insider abuse in most instances has only contributed to failure. It is poor management decisions, particularly when faced with an economic downturn, not fraud, which is the significant cause of bank failures. Although enforcement actions taken against insiders decreased in 1989, we do not hesitate to move aggressively against insiders where needed to halt the deterioration in a bank's condition and remove the persons involved.

URGING INDEPENDENT AUDITS OF BANKS

The FDIC strongly believes that external audits should be mandatory. Such audits not only can detect problems at an early date and limit loss exposure but can in some cases prevent any loss from occurring. This is especially true in instances of criminal misconduct. Potential criminals will be much more reluctant to perpetrate fraud against a bank if they realize that a regularly conducted and vigorous external audit may lead to an early detection. We are agreeable to exclude the smallest banks from this audit requirement since they don't possess the earnings capability to absorb the costs. However, we have been unable to agree on a size exclusion that is low enough to require audits of a large percentage of banks.

The FDIC issued a policy statement, effective December 28, 1988, strongly urging banks to have an annual external audit performed by an independent party. We continue to encourage banks to obtain an annual audit performed by a licensed public accountant. The FDIC Board of Directors on January 16, 1990 followed-up the policy statement by adopting a "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks (see attached Appendix 2)."

The follow-up policy statement encourages certain basic external auditing procedures as a less costly alternative for banks not choosing to have a financial statement audit. The auditing procedures recommended in the policy statement are basic to any sound external auditing program. We will expect that an independent public accountant's opinion audit will generally satisfy the objectives of this statement of policy. The guidance is quite comprehensive, with specific recommended auditing procedures on loans, loan loss reserves, securities, insider transactions, general accounting and administrative controls, and electronic data processing controls.

CONCLUSION

Our goal is to maintain the public's confidence in the financial system by limiting the number of failures and the cost to the insurance funds from the institutions that do fail. We have been sternly tested in this era of deregulation, increased competition and the recent intense volatility of regional economic cycles. Nevertheless, it is our belief that we understand our institutions and are vigilent in our supervision. Bank fraud cannot be entirely prevented but it can be deterred. Through active supervision and forcing banks to implement adequate audit programs, the degree of deterence will increase.

Thank you, Mr. Chairman. We will be happy to answer any questions the Subcommittee may have.