FDIC RESPONSES TO QUESTIONS IN
CHAIRMAN BARNARD'S JUNE 22, 1990 LETTER

A. FDIC INFORMATION ON BANK FINANCED PRECIOUS METALS SCHEMES

1. Failure of Valley Bank: According to California state officials who reviewed FDIC examination reports of Valley State Bank, referenced in the attached 7/26/87 article from the Los Angeles Herald Examiner, two FDIC reports, based on examinations in January and October 1987, dealt specifically with Valley State's involvement with a precious metals program and allegedly express a number of concerns about the bank's involvement and loans. Please respond, as follows:

1(a). Please provide the two referenced examination reports to the subcommittee and any reports produced after the bank's failure which relate to the precious metals financing in any way. In your testimony, please summarize all of the examiner's observations bearing on the bank's involvement with financing the precious metals sales and collateralization.

Please note that the article appearing in the Los Angeles Herald Examiner of July 26, 1987, incorrectly referenced the FDIC examination dates as January and October of 1986. The reports in question were dated October 18, 1985 and January 6, 1986. Both of these reports and an FDIC report of examination as of December 31, 1986, comment extensively on Valley State Bank's involvement with precious metal financing.

The October 1985 report indicated that the bank's association with Moorgate Funding, Ltd., was of concern considering the fact that the bank was aware that Moorgate was under Grand Jury investigation and that the principals had problems with the Commodity Futures Trading Commission. The report stated that the bank did not consider the financial capacity of the potential borrower entering the program. The examiner commented that the bank's relationship with the dealer might not be considered arms length, as the bank lent its good name and its "insured by FDIC" status to Moorgate for marketing purposes.

A review of Moorgate's line of credit to carry inventory revealed a 100% loan to value ratio. The examiner also noted that investor funds and broker funds were commingled, a practice considered highly imprudent. Industry concentration of credit in precious metals and numismatic lending represented 88% of capital and reserves. Nearly $16 million of these loans were referred to the bank by a single broker, Moorgate Funding, Ltd.

The January 1986 compliance examination report disclosed numerous potential reimbursable violations of Truth-in-Lending (Regulation Z) relating to failure to disclose annual percentage rates and finance charges in the collateral loan (precious metals) division. The examiner reported that commingling of investor funds and broker funds was a source of concern.

The December 1986 report disclosed that precious metals collateral and inventory records were suspect. The inability to determine collateral position resulted in a $111,000 loss on secured loans. Numerous lawsuits were pending relative to precious metals lending activities. Precious metals concentrations were equal to 608.26% of capital. Three lending limit violations were noted relating to precious metals. One defalcation in the precious metals department was attributed to poor controls.

1(b). <u>Did the FDIC take any supervisory or civil enforcement action in response to the examiners' findings concerning precious metal sales financing? If so, describe the action taken and what thereafter occurred? If not, why not?</u>

The FDIC initiated extensive enforcement actions against Valley State Bank. The October 1985 examination portrayed an unsatisfactory asset condition as a result of rapid growth, weak lending policies, and an involvement with Moorgate Funding, Inc., a precious metal dealer. A Section 8(b) order was issued on May 29, 1986, as a result of these findings. The cease and desist order was issued based on a combination of unsatisfactory practices found within the bank. While the precious metal lending program contained undesirable features, it was not the only item addressed.

At the January 1986 compliance examination, the bank was cited for reimbursable violations under Regulation Z for failure to provide Truth-in-Lending disclosures for consumer loans of $25,000 and under. The loans in question were used to finance the acquisition of precious metals, numismatic items, and foreign currencies. The vast majority of the loans involved Moorgate Funding.

Based on the December 1986 examination and further deterioration of the bank, action was initiated under section 8(a) for termination of insurance. The bank was declared insolvent by the California Superintendent of Banks and was closed on September 28, 1987.

1(c). What is the cost to the FDIC arising from this failure? And what percentage of losses causing the bank's failure are attributable to the precious metals programs, including inadequate collateral and credit checks?

The total cost to the FDIC arising from the failure of Valley State Bank is $12,477,250, exclusive of projected liquidation expenses. Pre-closing losses attributable to the precious metals program were $1,443,300, or 22% of all pre-closing losses. Post-closing losses attributable to the precious metals program total $783,400, raising the total of all losses attributable to that program to $2,226,700, or 18% of the total losses.

2. Identity of banks and programs and FDIC examination findings & supervisory action: We have been advised that the following state-chartered non-member banks are involved with precious metals financing: Saffra Bank (Encino, Ca), Bank of Delaware (Wilmington), Wilmington Trust Co. (Wilmington), Northern American Bank (Phoenix), First American State Bank (Belleview or Centralia, WA), and Capital Bank (North Bay Village, FL). Also involved are Guardian Trust Bank (Toronto) and Jefferson National Bank, New York, NY.

Please review the examination reports for all of the banks (except for the Guardian Trust Bank, Toronto) issued during the last four years, and (a) identify and list all bank-financed precious metal programs, including the names and addresses of the firms correlated to the banks which finance each firm's particular program; (b) set forth any examiner information about observations on, or comments about the financing of precious metals sales, including the aggregate amounts of such loans; (c) describe any concerns by the examiners, and (d) identify any informal or formal supervisory or civil enforcement actions relating to such sales. Except for correlating a precious metals firm with a bank - information essential for the hearing--, should the FDIC not want to correlate the additional requested information to a particular bank, it would be acceptable for the testimony to refer to Bank A, Bank B, Bank C, etc, advising the subcommittee in a confidential submission the identity of the banks to which the information relates and listing the dates of examination for each such bank.

In addition, we request that the FDIC submit by July 5, those portions of the examination reports covered above which relate to any of the information, observations, comments, concerns, and actions taken by the FDIC, set forth above. (A separate confidential submission would be acceptable.)

Bank A's January 1988 compliance report indicated that the bank could be subject to potential reimbursable Truth-in-Lending violations relating to understated annual percentage rates (APR) on loans to finance the purchase of precious metals. One precious metals dealer is mentioned in the report. In July 1989, the bank made restitution of $176,136 for 17 loans. The region reports that the bank is now complying with the regulation. Other examination reports encompassing the four-year period were reviewed and they contained no information related to precious metal lending.

Bank B's July 1987 examination report revealed 632 loans totaling $18.5 million secured by silver and platinum. Approximately 90% of the extensions were made for the purchase of the metals and were to be repaid from subsequent resale. Lending was strictly on a collateral value basis with little consideration given to the borrower's financial capacity. Margin requirements were 80% of the loan amount, with a call for additional collateral or payment being made at 87% and forced collateral liquidation at 90% in an amount sufficient to return to the initial 80% margin. The bank screened potential brokers with the CFTC prior to accepting referrals; however, specific precious metal brokers/dealers were not mentioned in the report. The precious metal lending function of the bank appeared to conform with the FDIC's Policy Statement on Gold (attached) and procedures and controls appeared acceptable. Other examination reports during the four-year period were reviewed and they contained no information related to precious metal lending.

Bank C's July 1987 examination report revealed the precious metal lending department had outstanding 1,928 loans, totaling $22.1 million, the majority of which were collateralized by silver bullion. Nearly all of the loans were extended for the purpose of purchasing the metal, with its subsequent sale as the method of repayment. The lending criteria was based primarily on the value of the collateral, rather than the financial capacity of the borrower. The bank made an extensive review of any potential brokers' banking and trade references prior to accepting their customers, but specific precious metal brokers/dealers were not mentioned in the report. The initial collateral margin requirement was 70%, with a call for payment or additional collateral within three working days when the margin reached 80%. At 95%, a forced liquidation took place to return to the initial margin. In general, the lending function for precious metals appeared to conform with the FDIC's Policy Statement on Gold. Other bank examination reports during the four-year period were reviewed and they contained no information related to precious metal lending.

Bank D's November 1989 examination report indicated that the bank was involved in pending litigation consisting of 11 lawsuits totaling $85.2 million. The suits involved the bank as a third-party defendent (lending/safekeeping agent) in transactions between a precious metals dealer and its customers. In each case, plaintiffs allegedly gave substantial sums of money to the dealer as a down payment for the purchase of precious metals to be financed by the bank. In all but one of these cases, the bank did not receive the collateral and thus did not disburse any loan proceeds. The bank

contended that it had engaged in no wrongdoing and that the suits would not have an unfavorable result. No estimated loss was shown in the report as a result of these suits. A June 1988 report of examination mentioned one of the eleven lawsuits commented upon in the November 1989 report; again, no estimated loss was reflected in the report as a result of the lawsuit.

Bank E's September 1986 report of examination indicated that the precious metals department's primary function was to supply gold and silver to commercial users of the metals. Secondarily, the department sold gold coins to investors and generated gold secured loans for the commercial loan department. There was no mention of precious metals financing for customers of precious metals brokers. An examination in June 1988 revealed that precious metal sales had ceased in April 1988, with six consignment accounts for commercial users remaining.

North American Bank closed on January 8, 1988. The bank's problems were centered in the loan portfolio and consisted of liberal extensions of credit for the purpose of developing speculative real estate projects. Early in the bank's brief history, it actively extended credit for the purpose of holding precious metals but, when demand declined in response to softening prices, management began in 1984 to stress commercial and real estate lending.

FDIC files on Jefferson National Bank, which is supervised by the Office of the Comptroller of the Currency, do not contain any information related to precious metal lending.

3. Results of FDIC Survey in 1987: On April 8, 1987, Gerald Lewis, Comptroller, Department of Banking and Finance for the State of Florida, wrote a letter to the FDIC (as well as to the other Federal banking agencies), attached, which suggested the need for a new regulatory policy.

The letter stated:

> In public testimony before the Advisory Committee on State/CFTC Cooperation in Washington on February 5, 1987 and in a meeting with the NASAA Commodities Committee in Los Angeles on February 13, 1987, several banks admitted that they were not requiring normal loan documentation. They also stated that most of the customers in this program would not qualify for the amount they were being loaned under normal circumstances. If it were not for the bullion being stored in the bank's vault as collateral, the loans would not be made. This situation may be satisfactory as long as the price of the precious metal remains stable. If there were to be a precipitous fall, however, the customers would be unable to meet the margin calls and the financial institution would suffer an unsecured loss. There is also no apparent attempt to follow the guidelines of the Federal Reserve Regulation T regarding margin limits. The Bank of Delaware and Wilmington Bank and Trust, both in Delaware, as well as Valley State Bank and Safra Bank in California, are offering these arrangements with various sales organizations...(p.2)

During telephone conversations on January 19 and 25, 1989, between subcommittee Counsel Stephen McSpadden and Division of Supervision Director Paul Fritts, Mr. Fritts indicated that the FDIC surveyed its regional offices about the institutions identified by Lewis shortly after receiving the letter, but did not recall what came of that survey. Please locate the survey and its result; summarize it in the testimony; and provide a copy to the subcommittee no later than July 5, 1990.

The survey referred to by Division Director Fritts was conducted informally by telephone by Mr. William Carley of the FDIC's Division of Supervision staff. The four banks mentioned in Mr. Lewis' letter were from the San Francisco and New York Regions and those offices were queried concerning the practices of the referenced banks. With the exception of the Valley State Bank, in which the involvement with a precious metal dealer was only a contributing factor in the bank's failure, the other banks mentioned in Mr. Lewis' letter were not perceived to present problems in the precious metal financing area.

The two Delaware banks were subsequently examined in July 1987 (refer to the response to Question 2.)

4. Recommendations for FDIC regarding bank-financed programs: Please respond to the following recommendations of the Advisory Committee on CFTC/State Cooperation, arising from its October 8, 1987, meeting about these programs. According to the 1/27/88 memorandum from CFTC Commissioner West and other documents referenced below (all of which have been attached), committee members and witness put forth the following ideas, suggestions, and recommendations, to which we would like the FDIC's response, as follows:

a. The Advisory Committee apparently recommended that in those cases "where the Commission has reason to believe that the Commodities Exchange Act may be violated the Division should not hesitate to conduct on-site inspections of bank's 85-2 programs to assure [compliance with Key elements of #85-2]." Questions: (i) Since the beginning of 1987, has the FTC advised you of any or all off-site visits at FDIC-supervised or insured many banks, which the CFTC conducted to determine such compliance? (ii) if so, what did the CFTC advise the FDIC as to its findings (identifying by Bank A, Bank B, etc.); and did the FDIC take any informal or formal supervisory or other action as to each specific bank?

We are aware of only one offsite visit related to an insured state nonmember bank. On July 24, 1987 FDIC staff met with CFTC Enforcement Director Dennis Klejna and his staff. The meeting was held at the request of the CFTC. The purpose of the meeting was to inform us of CFTC's investigation and probable issuance of an Order against Valley State Bank. At that time, permission was granted for CFTC's review of FDIC examination reports of the bank. We made CFTC aware of the FDIC's enforcement actions and the fact that the bank would probably be closed within a short period of time. The bank did close on September 28, 1987. We have heard nothing further on enforcement action contemplated by CFTC. Please refer to our response to Question 1(b) for further comment concerning enforcement actions taken by the FDIC.

4(b). The Advisory Committee recommended that CFTC staff consult with federal bank regulators and the FTC to alert them to the consumer protection concerns involving 85-2 programs and to explore cooperative approaches, including interagency monitoring. The 4/25/88 Summary Report of the Off-Exchange Task Force and the 8/31/88 memorandum to Commissioner West reference information sharing and cooperation between the CFTC and the OCC and FDIC. Questions: (1) What meetings has FDIC held with the CFTC on this subject; (ii) when were the meetings held; (iii) what was discussed at each such meeting; and (iv) what were the outcomes of each meeting?

We are not aware of any meetings held with CFTC in response to the April 25, 1988 Summary Report of the Off-Exchange Task Force.

4(c). One witness at the Advisory Committee's October 8th meeting, suggested (i) consumer protection, (ii) risk disclosure, and (iii) suitability standard, and (iv) capital standard, and (v) recordkeeping requirements, to dealers participating in 85-2 programs". It appears that the CFTC task force did not consider these recommendations, or, if it did, did not implement them. (a) Has the FDIC considered implementing these recommendations? And, if so, what was the outcome? (b) If not, why not? Closely related, does the FDIC have the authority to implement each of these general recommendations under its "safety and soundness" and other broad supervisory and civil enforcement authority?

The FDIC does not consider the precious metal financing area to be a significant bank problem, and we have not considered implementing these recommendations as they were not directed to the FDIC. Also, we do not have regulatory jurisdiction over precious metal dealers nor do we believe we can reach the activities of dealers through our jurisdiction over banks that finance dealer activities. In any event, such an approach would be incomplete in cases where dealers arrange non-bank financing. Precious metal lending was discussed at the FFIEC Task Force on Supervision meeting on June 10, 1987, as a result of Florida Comptroller Lewis' April letter. The Task Force did not perceive this to be a significant problem area, and determined this issue could best be handled on a case-by-case basis

by the responsible regulator. We feel the FDIC has the ability under its broad supervisory and civil authority to address any bank problems in this area. Frequently, our corrective orders require banks to submit loan policies to the Regional Director for review.

5. Compliance with the Truth-in-Lending law: We have been advised on several occasions that there is no disclosure by the banks participating in these programs of any of the terms and conditions of the loan or other information required by the Truth-in-Lending law, on the ground that these are not "consumer" loans but are instead "investment" loans not covered by that statute. (a) Is this a correct interpretation and application of the Truth-in-Lending law? (b) If not, what actions has the FDIC taken to require compliance by the banks involved with the statute? (c) Or, alternatively, if this is the correct interpretation, should this investment be considered more like a "consumer" loan, and is this a gap which needs to be remedied through amendments to the statue.

5(a). The intent of the Truth in Lending Act ("Act") is to assist consumers in making informed decisions about the cost of credit. Accordingly, loans to business enterprises were exempted from coverage by the Act. What remained unclear was the coverage of credit extended to individuals who were self-employed, sole proprietors or farmers. The determination of the purpose of a particular loan and the applicability of the Truth in Lending Act to that loan must be determined on a case-by-case basis. The Federal Reserve's implementation of Regulation Z and the Official Staff Commentary thereto provide guidelines and five factors to be considered when making this determination. Loans made to individuals to purchase precious metals for personal investment are generally deemed to be within the scope of the Act. Again, each individual loan must be reviewed relative to the factors spelled out in Regulation Z.

5(b). We are aware of only two state nonmember banks which failed to provide accurate disclosures as required by Regulation Z in connection with precious metals financing. In those cases, we pursued restitution to affected consumers, as authorized by Title VI of the Depository Institutions Deregulation and Monetary Control Act of 1980. Title VI allows the regulatory agencies to order creditors to make restitution to consumers in cases of nondisclosure or inaccurate disclosure of the annual percentage rate or finance charge.

5(c). Each loan transaction must be reviewed to determine the applicability of Truth-in-Lending coverage. In general, loans made to individuals for personal investment purposes are covered by Truth-in-Lending. Amendment of the statute does not appear to be necessary.

B. FDIC Views of Telemarketing Fraud Generally and Suggestions

1. Does the FDIC, including senior FDIC supervisory staff in the Los Angeles and Miami field offices, have any ideas on how law enforcement efforts and limited agency resources could be better mobilized, coordinated, made more effective and improved in the fight against telemarketing fraud? If so, please set them forth.

We have no suggestions other than the obvious one of information sharing by the relevant agencies. As you are aware, the FDIC belongs to various bank fraud working groups throughout the nation, including Los Angeles and Miami. Major frauds, whether telemarketing or otherwise, can best be handled on a prioritized basis, and we have been working through the Bank Fraud Working Group in Washington to accomplish this task.

2. <u>What are the FDIC's views, if any, on whether amending any existing legislation, such as the forfeiture provisions, other title 18 provisions, the Federal Deposit Insurance Act, or the Commodities Exchange Act be useful and helpful to better regulate against or investigate or prosecute these and other telemarketing frauds?</u>

We believe that any ill-gotten gains from telemarketing frauds should be subject to forfeiture provisions of the law. Since precious metals are commodities, we believe the best approach would be to amend the Commodity Exchange Act to give the CFTC explicit jurisdiction over the retail sale of these metals for investment purposes and impose registration and other requirements on dealers as deemed appropriate by the CFTC and, as necessary, the FTC.

3. <u>What are the FDIC's views on the salary disparities facing federal law enforcement and regulatory agencies in paying investigators and attorneys in Southern California and New York City and on the consequences of these disparities?</u>

The FDIC is not familiar with the specifics of these disparities and the problems which they create. We might note, however, that the FDIC has adopted a salary adjustment to the base salary of examiners and other FDIC staff living in high cost areas. This salary adjustment is based on an adjusted price index of the area. We feel that this is an equitable approach to our salary disparity problem.