

**Remarks  
By  
Donna Tanoue  
Chairman  
Federal Deposit Insurance Corporation  
Before the  
Conference of State Bank Supervisors  
May 12, 2000**

I originally intended to talk with you today about finding value in today's marketplace. However, I began to revise my plans as I thought about two of our recent announcements at the FDIC. One is that the Bank Insurance Fund last year suffered its first financial loss since 1991. At year-end 1999, the BIF reserve ratio was 1.36 percent. The other is that FDIC staff's projections for year-end 2000 now indicate that the BIF reserve ratio could be as high as 1.42 percent or as low as 1.27 percent. It is remarkable, in the midst of this unprecedented economic expansion, that the BIF ratio conceivably could end up so close to 1.25 percent -- the trigger level for higher premiums. So I thought I would instead address a more immediate concern: troubled institutions. Troubled institutions are small in number but they are the driving force in determining the reserve ratio of our insurance funds.

We've seen common characteristics in four relatively recent, well publicized, high-cost failures: BestBank, in Colorado; First National Bank of Keystone, in West Virginia; Hartford-Carlisle Savings Bank, in Iowa; and Pacific Thrift and Loan Company, here in California.

Each of the failures evidenced one or more of the following behaviors: growing rapidly, booking residuals, engaging in nontraditional lending activities; changing the institution's business plan significantly; entering third-party service arrangements that leave the financial institution at risk; and fraud. Let's look at each.

One, growing rapidly - and in doing so, outstripping the capital and human resources necessary to operate in a safe and sound manner. As bank supervisors, we know that rapid growth should always motivate a closer look at an institution. Our most recent experiences tell us to look even closer. Rapid asset growth often masks many ills. Delinquency and loan loss ratios remain within normal operating levels because the loan portfolio - the denominator in these ratios - is growing so rapidly. Extraordinary examination measures are required in these instances. Management information systems that do not provide sufficient information to properly analyze the performance of a growing portfolio should raise supervisory concerns.

Two, booking residuals in conjunction with securitizations, that is to say, residual interests, and the creation of "illusory capital" through unrealistic valuation of such interests. Capital is the main lever for controlling growth. Illusory capital can feed explosive growth - and lead to catastrophic losses.

Three, engaging in nontraditional lending activities without appropriate underwriting, loan administration, controls or sufficient management expertise.

Four, changing the institution's business plan significantly, often basing the new plan on unrealistic assumptions. Our unprecedented economic boom will not last forever - you know that and I know that, but others have shorter memories than we do. Often a shift in business plans follows a change in the control of the institution, where eager new owners try to extract as much value as they can, as quickly as they can.

Five, entering third-party servicing arrangements that leave the financial institution at risk. Outsourcing critical bank functions has provided considerable efficiency for the banking industry. However, undue delegation of authority to independent sales or service organizations, combined with insufficient oversight and audit controls, has resulted in significant reputation risk and potential dissipation of shareholder value. Indeed, we have seen some small banks fleeced by such arrangements through overly generous compensation packages in favor of the service provider. Further, a bank can suffer extraordinary earnings pressure from direct credit losses and increased litigation expense due to inappropriate sales techniques of an independent sales organization.

Six, and finally, fraud. We all know what that is.

At the time each of the four high-cost institutions collapsed, some observers considered the failure to be an anomaly. But - today - we are seeing institutions bearing similar characteristics not only on our problem list, but also among the better-rated institutions. These characteristics explain, in part, why we have seen more examination downgrades than upgrades in 1998 and 1999 -- the first time since the early 1990s. One of our Regional Directors told me yesterday that management downgrades are outpacing upgrades by a margin of 2-to-1.

Alone, any of these characteristics do not necessarily portend failure. In combination, they may not necessarily doom an institution to failure.

Good times can keep a number of leaky vessels afloat. But not all of them - as we have found at some cost.

And for those supervisors who believe that the so-called New Economy has not repealed the business cycle - and I hope that includes most of you -- these characteristics should raise eyebrows.

I want to talk with you today about two of these characteristics in particular - residual interests and fraud - and what we at the FDIC are doing to address them.

First, residual interests.

You may recall that both First National Bank of Keystone and Pacific Thrift and Loan engaged in a significant level of asset securitization. Both grew quickly -- using the ability to record immediate earnings from their securitization activities, thus growing their capital accounts. In both situations, the financial institutions retained an interest in the securitizations they sold. The legal structure of the transactions greatly affected the realizable value of the residual assets. Both retained first loss positions. And both maintained a concentration of residual assets.

In both of these cases, the external valuation models were inadequate and neglected to incorporate actual performance versus original assumptions. The banks' residual interests were subsequently determined to have significantly less value and are worth mere pennies on the dollar. So their reported capital levels were completely illusory.

Because of these failures - and because of concerns arising from subsequent examinations of other institutions with similar residual interests - the Federal regulators last December issued guidance on what institutions holding retained interests as capital should do to avoid exposure to loss. It requires that the recorded value of these assets must be objectively supported, using reasonable assumptions. And the guidance also requires that residual interests that are not well supported be classified as "Loss" -- and not counted by the regulators as capital. That guidance was a good - and necessary -- first step. But it is not sufficient to completely address the issue.

Other changes are needed to ensure that institutions will hold adequate capital to cover the risk inherent in residual interests -- and to discourage institutions from holding excessive concentrations. So, in December, we also said that we were thinking about limiting - or eliminating - residual interests that could be recognized in regulatory capital.

We are working toward issuing for public comment in the not-too-distant future a joint proposal to toughen the capital requirements for those institutions holding these highly volatile assets. It is anticipated the proposal would require that "dollar-for-dollar" capital be held against the value of residual interests resulting from securitization - and would cap the amount of residual assets a bank can hold for regulatory capital. Why? Because today, we have a number of institutions on our problem list precisely because of this issue. And because we have a good number of other institutions - that are not on our problem list - but that do hold more residual interests in securitized assets than we believe is prudent.

I'm asking you today to support this effort. And to work with us to develop a sensible proposal and to make sure that the reported value of residual interests reflects reality and does not represent an undue concentration.

Now let's turn to fraud. Recently, one of our colleagues observed that fraud in banking is astoundingly rare when you consider how large the industry is, how many institutions comprise the industry, and the number of people who work in it. Certainly, that has been the case historically. But is it the case today? Probably, but there are some disturbing considerations that raise doubt.

One - and our lawyers advise me to say it this way -- fraud appears to have played a role in the failure of BestBank, Keystone, and Hartford-Carlisle.

Two -- we have seen other bankers try to recoup their personal losses - those arising from outside activities or losses resulting from the deteriorating condition of their banks - through illegal activities.

And, three, our examiners are reporting fraud is on the rise.

Why?

In these good, but extremely competitive, times there has been a willingness by bankers to take on increased risk in order to sustain earnings growth. And to assist, some bankers are cutting costs in non-revenue producing back office operations. The result - back offices and internal controls are failing to keep pace with some institutions' growth in transaction volumes and risk. These same cost pressures also may be affecting the scope and quality of some external audits as well. Banks that strive for cost savings in these areas do so at their peril.

In prosperous times - like those we enjoy today - when losses from business recessions are absent - fraud becomes more noticeable as a factor in bank failures. In fact, an FDIC study of the 67 failures that occurred from 1960 through 1974 - a period of general prosperity - concluded that 57 were caused by self-serving loans to bank management or friends of management, defalcations or embezzlement by bank personnel, and various fraudulent manipulations by bank officials. However - as recent failures and recent examinations make clear - technological innovations and the increased liquidity of many bank products have heightened the potential for rapid and large losses from fraud.

So we are being especially vigilant. We have placed our examiners on fraud alert. We have instructed them to look for "red flags" and other warning signs of potential fraud. We have launched a program to refresh skills in transaction testing. We have expanded examiner review of auditor workpapers to identify gaps in controls or review. And we have directed them to investigate any information leading to suspicions of fraud, stressing that they give these investigations the highest priority, using whatever resources necessary. Why? Fraud can result in dramatic losses.

They are to contact our Regional Fraud Specialists if they suspect fraud. These trained and experienced specialists have access to a database of Suspicious Activities Reports and other resources that would aid in an investigation.

Though I don't need to give you an invitation, all state supervisors should feel free to make similar use of our Regional Fraud Specialists. There is an old saying: If you have a problem, we have a problem. In the relationship between the state bank supervisors and the FDIC, nothing could be more true.

Just as bankers are in the business of managing risks, we, as financial institution supervisors, are in the business of managing risks. In bad times. And in good times.

A former Comptroller of the Currency often observed: "When the tide goes out, we see who has been swimming naked." We need to do what we can now - everything we can - to limit exposures later.

Thank you.

Last Updated 05/12/2000