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BANKING FRAUD AND INSIDER ABUSE,

AN ADDRESS BY
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BEFORE THE
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CERTIFIED PUBLIC ACCOUNTANTS
ELEVENTH NATIONAL CONFERENCE ON BANKING,

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GOOD MORNING, IT CERTAINLY IS A PLEASURE TO BE HERE WITH YOU TODAY.

I HAVE TWO BANKING - CPA SUBJECTS I'D LIKE TO TALK WITH YOU ABOUT. ONE CONCERNS THE VERY COSTLY PROBLEM OF BANK FRAUD, PARTICULARLY FRAUD PERPETRATED BY INSIDERS, AS WELL AS OTHER FORMS OF INSIDER ABUSE. WHAT ARE THE APPROPRIATE ROLES FOR REGULATORS, AND THE INDEPENDENT CPA, WITH REGARD TO THOSE WHO WOULD ABUSE THEIR POSITIONS OF TRUST? A SECOND ISSUE RELATES TO THE INTENSIFYING PROBLEM OF MAINTAINING AN ADEQUATE STAFF OF FEDERAL BANK EXAMINERS. WHAT CAN THE CPA'S DO TO HELP US MEET THIS NEED?

FIRST, INSIDER FRAUD AND ABUSE. WHILE THE GREAT MAJORITY OF BANKERS ARE PEOPLE OF HIGH INTEGRITY, A FEW ARE NOT. THUS, FRAUD AND ABUSE ARE SIGNIFICANT PROBLEMS WHICH DESERVE INCREASED ATTENTION. AUDITORS AND BANK EXAMINERS CAN, AND SHOULD, PLAY AN IMPORTANT ROLE IN THE PREVENTION OF FRAUD AND ABUSE. MY MESSAGE -- WE CAN NO LONGER SIMPLY SAY "IT'S NOT MY JOB".

FRAUD AND ABUSE ARE COSTLY TO THE BANKING INDUSTRY AND, WHEN THEY CONTRIBUTE TO A BANK FAILURE, COSTLY TO THE FDIC. HOW COSTLY? IT'S HARD TO GET A HANDLE ON EXACT NUMBERS, BUT THERE ARE SOME GOOD ESTIMATES.

IN 1985, THE FBI COMPLETED APPROXIMATELY 7,000 SEPARATE BANK FRAUD AND EMBEZZLEMENT INVESTIGATIONS, INVOLVING LOSSES OF \$841 MILLION. THE FBI'S LOSS FIGURE FOR COMPLETED BANK FRAUD INVESTIGATIONS FOR THE FIRST HALF OF 1986 ALREADY EXCEEDS ALL OF 1985, AND IS ALMOST A BILLION DOLLARS. THE FBI ESTIMATES THAT OVER 80 PERCENT OF THESE CASES INVOLVE ALLEGATIONS OF WRONGDOING ON THE PART OF A BANK OFFICER, OR EMPLOYEE, AS OPPOSED TO EXTERNAL SOURCES OF FRAUD. THE SURETY ASSOCIATION OF AMERICA REPORTS THAT LOSSES COVERED UNDER THEIR BLANKET BONDS HAVE BEEN GROWING EACH YEAR.

FRAUD AND ABUSE ARE IMPORTANT FACTORS IN BANK FAILURES. EXAMINERS HAVE NOTED SIGNIFICANT INSIDER FRAUD OR ABUSE IN ABOUT ONE-THIRD OF THE BANKS THAT HAVE FAILED THIS YEAR. FURTHER, OUR LIQUIDATORS, WHO DO A VERY DETAILED INVESTIGATION AFTER A FAILURE, ESTIMATE THAT A BONDING CLAIM FOR LOSS DUE TO FRAUD CAN BE MADE IN AS MANY AS 40 TO 50 PERCENT OF BANK FAILURES.

A HANDFUL OF CORRUPT BANK OFFICERS CAN DO A LOT OF DAMAGE. CONSIDER THE RECENT EXAMPLE INVOLVING JACOB (JAKE) F. BUTCHER, WHO CONTROLLED SEVERAL BANKS IN TENNESSEE AND KENTUCKY. THE FRAUD COMMITTED BY HIM, AND HIS ASSOCIATES, CAUSED THE FAILURE OF TWELVE BANKS, WHICH HAVE COST THE FDIC INSURANCE FUND OVER \$850 MILLION.

WHERE THERE ARE WEAK CONTROLS AND INATTENTIVE DIRECTORS, INSIDERS (MANAGEMENT, DIRECTORS AND/OR SUBSTANTIAL SHAREHOLDERS) HAVE A

GREATER OPPORTUNITY TO USE BANK RESOURCES TO FURTHER THEIR OWN ENDS. IN PROBLEM INSTITUTIONS, NEARLY SEVEN PERCENT OF INSIDER CREDITS ARE ADVERSELY CLASSIFIED BY EXAMINERS -- WHILE THE INDUSTRYWIDE RATIO IS LESS THAN ONE PERCENT. MOREOVER, IN SMALLER PROBLEM BANKS (LESS THAN \$100 MILLION), WHICH TEND TO BE MORE CLOSELY CONTROLLED, THE RATIO OF CRITICIZED INSIDER LOANS IS 11 PERCENT. I DON'T MEAN TO IMPLY ALL CRITICIZED INSIDER LOANS RESULT FROM SELF-SERVING OR ABUSIVE MANAGEMENT. HOWEVER, INSIDE BORROWERS DO PRESENT A POTENTIAL CONFLICT OF INTEREST. A TEMPTATION TO APPLY LESS THAN NORMAL CREDIT STANDARD IS ALWAYS PRESENT. ONCE THIS PROCESS BEGINS, IT IS AMAZING HOW RAPIDLY IT CAN EXPAND, OCCASIONALLY RESULTING IN THE BANK'S INSOLVENCY WITHIN A FEW YEARS AND SOMETIMES IN A MATTER OF MONTHS.

LET'S TAKE A LOOK AT A TYPICAL INSIDER PROBLEM. THE BANK'S FAILURE STEMMED FROM A CHANGE OF OWNERSHIP. THE NEW OWNERSHIP INSTALLED A CEO WHO BEGAN TO INCREASE THE LOAN PORTFOLIO AGGRESSIVELY. MANY OF THESE NEW LOANS WERE FOR THE BENEFIT OF THE CONTROL GROUP. THE LOANS WERE POORLY DOCUMENTED AND REPRESENTED NUMEROUS VIOLATIONS OF THE LAW. EVENTUALLY, LOSSES ON THESE LOANS CAUSED THE INSOLVENCY OF THE BANK.

THIS BANK HAD BOTH INTERNAL AND EXTERNAL AUDITORS. THE INTERNAL AUDITOR DISCOVERED THE PROBLEM, BUT HE REPORTED TO MANAGEMENT -- NOT THE DIRECTORS. THE OUTSIDE AUDITOR'S DRAFT REPORT ALSO ADDRESSED THESE PROBLEMS, BUT BANK MANAGEMENT INSISTED ON THEIR REMOVAL FROM THE FINAL REPORT TO THE BANK'S BOARD.

THE BOARD PROVIDED NO GUIDANCE, OVERSIGHT, OR CONTROL OVER MANAGEMENT. TYPICAL OF SUCH BOARDS, WAS THE FACT THAT THE INTERNAL AUDITOR DID NOT REPORT DIRECTLY TO THE BOARD OR ITS COMMITTEE. MANAGEMENT WAS ABLE TO EFFECTIVELY INSULATE THE DIRECTORS FROM THE FINDINGS OF BOTH INTERNAL AND EXTERNAL AUDITORS. A COMPETENT BOARD, OF COURSE, WOULD NOT HAVE TOLERATED THIS SITUATION.

HOWEVER, WE CANNOT IGNORE THE FACT THAT EXAMINERS AND AUDITORS WERE IN THIS BANK WHILE IT WAS BEING VICTIMIZED. AUDITORS ARE FREQUENTLY IN BANKS BEFORE THEY FAIL. ABOUT HALF OF ALL BANK FAILURES HAD FULL AUDITS CONDUCTED BY CPAS, AND EVEN A HIGHER PERCENTAGE HAD SOME FORM OF LIMITED REVIEW. THE FDIC, AS RECEIVER, INVESTIGATES EACH FAILURE TO SEE IF THERE IS ANY BASIS FOR A NEGLIGENCE CLAIM AGAINST THE OUTSIDE AUDITOR. ACTIONS HAVE BEEN BROUGHT IN LESS THAN TEN PERCENT OF THE CASES. THE FACT REMAINS, HOWEVER, THAT FRAUD AND INSIDER ABUSE HAVE GONE UNDETECTED BY EXAMINERS AND AUDITORS.

I RECOGNIZE, FULL WELL, THAT FRAUD OR ABUSE DETECTION IS NOT STATED TO BE A PRIMARY OBJECTIVE OF AN AUDIT. IN FACT, AUDITING STANDARDS EXPLICITLY DISAVOW ANY SUCH RESPONSIBILITY. WE HAVE TAKEN THE SAME POSITION WITH REGARD TO OUR EXAMINATIONS. HOWEVER, AS THE INSURER OF BANKS, WE CANNOT IGNORE THE COST IMPLICATIONS OF FRAUD. AND, AS A FEDERAL AGENCY WE CANNOT, AND SHOULD NOT, IGNORE THE CONCERNS

RAISED BY CONGRESS THAT WE DO MORE IN THIS AREA. ACCOUNTING PROFESSIONALS ARE ALSO FACING PRESSURE FROM CONGRESS AND THE COURTS. LIKE IT OR NOT, WE CANNOT ESCAPE THE PUBLIC PERCEPTION AND EXPECTATION THAT OUR WORK SHOULD SEEK TO UNCOVER MAJOR FRAUD AND ABUSE. I AGREE WITH THE VIEW EXPRESSED BY THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (WHICH THE AICPA SPONSORS) THAT AUDITORS' RESPONSIBILITY TO DETECT FRAUD NEEDS TO BE CLARIFIED. AUDITING (AND BANK EXAMINATION) STANDARDS MUST ACKNOWLEDGE SOME AFFIRMATIVE RESPONSIBILITY TO DETECT FRAUD/AND INSIDER ABUSE.

WHAT ARE WE THE REGULATORS DOING ABOUT FRAUD AND INSIDER ABUSE? SEVERAL THINGS.

TOGETHER, WITH THE OTHER FINANCIAL REGULATORY AGENCIES, WE HAVE DEVELOPED A TRAINING COURSE ON WHITE COLLAR CRIME. THE COURSE IS BEING OFFERED FOR THE FIRST TIME THIS WEEK. FOR 1987, A TOTAL OF 480 EXAMINERS FROM ALL MEMBER AGENCIES, AND SOME STATE REGULATORS ARE SCHEDULED TO COMPLETE THIS INSTRUCTION. AMONG OTHER THINGS, THE COURSE OFFERS AN OVERVIEW OF THE LAW AND CRIMINAL JUSTICE SYSTEM, AND SPECIFIC SEGMENTS ON COMPUTER FRAUD, SECURITIES FRAUD, REAL ESTATE FRAUD, AND INSIDER TRANSACTIONS.

WE ARE ALSO DEVELOPING A SYSTEM OF "REG FLAGS" TO AID OUR EXAMINERS IN THE DISCOVERY AND INVESTIGATION OF FRAUD AND ABUSE. THIS IS A HANDY REFERENCE, A CHECKLIST (AS IT WERE), INDICATING WARNING SIGNS OF DIFFERENT KINDS OF FRAUD AND INSIDER ABUSE, WITH SOME GUIDANCE IN INVESTIGATIVE TECHNIQUES. THESE STEPS SHOULD HELP OUR EXAMINERS, AND LEAD TO A MORE EFFECTIVE REVIEW OF INSIDER TRANSACTIONS IN THE EXAMINATION PROGRAM.

WE ARE DEVELOPING SPECIAL "FRAUD TEAMS" TO HANDLE MAJOR PROBLEMS WHERE SUSPECTED. WE ARE ESTABLISHING A FORMALIZED PROGRAM WHERE SELECTED EXAMINERS WOULD BE GIVEN EXTRA TRAINING AND EXPERIENCE IN CONDUCTING SPECIAL INVESTIGATIONS. NEW SOPHISTICATION BY ABUSERS REQUIRES NEW TECHNIQUES BY REGULATORS.

THE FDIC, THE FEDERAL RESERVE BOARD, THE COMPTROLLER OF THE CURRENCY, THE FEDERAL HOME LOAN BANK BOARD AND THE JUSTICE DEPARTMENT FORMED A BANK FRAUD ENFORCEMENT WORKING GROUP. THIS GROUP DEVELOPED A STANDARD CRIMINAL REFERRAL FORM. ALL AGENCIES USE THIS FORM TO TRANSMIT INFORMATION TO THE JUSTICE DEPARTMENT AND THE FBI. THEY ALSO AGREED ON NEW MECHANISMS FOR INTERAGENCY FOLLOW-UP ON THE WORST CASES, AND CALLED FOR LEGISLATION TO ELIMINATE LEGAL RESTRICTIONS ON THE SHARING OF RECORDS.

THE FDIC IS ALSO THINKING ABOUT SOME OTHER THINGS. AS YOU MAY BE AWARE, THE FEDERAL HOME LOAN BOARD REQUIRES EACH FSLIC-INSURED INSTITUTION TO BE AUDITED ANNUALLY, BY AN INDEPENDENT PUBLIC ACCOUNTANT OR AN ACCEPTABLE INTERNAL AUDITOR. FURTHER, THE OUTSIDE ACCOUNTANT MUST AGREE TO ENSURE THAT THE BANK BOARD IS NOTIFIED OF ANY DEFALCATION THAT HE BECOMES AWARE OF DURING THE AUDIT. THE HOME

LOAN BANK BOARD ALSO REQUIRES THAT IT BE NOTIFIED BY ITS INSTITUTIONS OF ANY CHANGE IN PUBLIC ACCOUNTANTS. THESE PROCEDURES SEEM TO MAKE A LOT OF SENSE. WE ARE EVALUATING THE FEASIBILITY OF ADOPTING COMPARABLE MEASURES FOR COMMERCIAL BANKS, BUT THERE ARE IMPORTANT COSTS TO CONSIDER, AS WELL AS THE AVAILABILITY OF QUALIFIED BANKING AUDITORS.

WE ARE ALSO CONSIDERING REQUIRING THAT COPIES OF AUDIT REPORTS, INCLUDING THE MANAGEMENT LETTER, BE SENT TO THE REGULATORS. AS A PRACTICAL MATTER MANY BANKS MAKE THIS NOTIFICATION NOW ON THEIR OWN. BUT, AS YOU WOULD EXPECT, NOT THE BANKS WHERE INSIDER PROBLEMS ARE DISCUSSED IN THE AUDITOR' REPORTS.

WE SEE GREATER POSSIBILITIES IN LIMITED SCOPE INDEPENDENT REVIEWS, PARTICULARLY FOR SMALL BANKS. ADDITIONAL PRIVATE SECTOR WORK (OF FULL OR LIMITED SCOPE) IS BECOMING EVEN MORE CRITICAL TO USE SINCE WE DO NOT HAVE THE RESOURCES TO CONDUCT ONSITE EXAMINATIONS AS FREQUENTLY AS IN PAST YEARS. BANKS THAT APPEAR TO BE IN SATISFACTORY CONDITION CAN GO SEVERAL YEARS BETWEEN EXAMINATIONS.

AS WE PURSUE THESE NEW INITIATIVES, WE WILL BE SEEKING YOUR VIEWS.

REGARDLESS OF WHAT EXAMINERS OR AUDITORS DO, WE ARE NOT GOING TO ELIMINATE FRAUD LOSSES. HOWEVER, BY INCREASING OUR EFFORTS AND AWARENESS, AND COOPERATING WITH EACH OTHER, WE CAN HAVE A POSITIVE IMPACT, AND REDUCE BOTH THE FREQUENCY AND MAGNITUDE OF OCCURRENCES OF FRAUD AND INSIDER ABUSE.

MY SECOND ISSUE - ADDITIONAL EXAMINATION SUPPORT. THIS IS ANOTHER AREA WHERE WE SEEK YOUR ASSISTANCE. THIS IS ALSO AN AREA WHERE WE HOPE TO "GIVE YOU SOME ACCOUNTING BUSINESS."

AS I HAVE NOTED, WITH THE DRAMATIC INCREASE IN THE NUMBER OF FAILED AND PROBLEM BANKS, THE FDIC IS FINDING IT NEEDS TO INCREASE THE FREQUENCY OF EXAMINATIONS. THIS IS ESPECIALLY TRUE IN THE SOUTHWEST AND FARM BELT, WHICH ARE SUFFERING THROUGH TOUGH ECONOMIC TIMES. IN THESE AREAS, THERE ARE OFTEN AS MUCH AS 48 MONTHS BETWEEN EXAMINATIONS. THIS IS TOO LONG IN THE BEST OF CIRCUMSTANCES. IN THOSE AREAS, WHERE BANKS ARE FIGHTING OFF THE EFFECTS OF A WEAK ECONOMY, IT IS JUST UNACCEPTABLE. OFFSITE SURVEILLANCE HAS IDENTIFIED AN UNACCEPTABLE PERCENTAGE OF BANKS THAT NEED IMMEDIATE EXAMINATIONS.

WE ARE BOLSTERING OUR STAFF AS QUICKLY AS OUR ABILITY TO ABSORB AND TRAIN NEW PEOPLE WILL ALLOW. WE HIRED ABOUT 360 EXAMINERS IN 1985, AND EXPECT TO ADD 400 MORE IN 1986. IF GRAMM-RUDMAN ALLOWS, WE HOPE TO BRING ON ANOTHER 600 EXAMINERS NEXT YEAR.

WHILE OUR ADDITIONAL NEW PERSONNEL WILL HELP, THEY CANNOT MEET OUR IMMEDIATE NEEDS. QUALIFIED, EXPERIENCED EXAMINERS ARE NOT READILY AVAILABLE IN THE MARKETPLACE. WE NEED ASSISTANCE NOW.

I HOPE THE PUBLIC ACCOUNTING PROFESSION WILL HELP US WITH THIS PROBLEM. WE SEEK A PROGRAM OF CONTRACTING WITH PUBLIC ACCOUNTING FIRMS TO PROVIDE US WITH A STAFF TO SUPPLEMENT OUR EXAMINATION FORCE. AUDITORS WOULD WORK ALONGSIDE OUR EXAMINERS UNDER THE SUPERVISION OF AN FDIC EXAMINER-IN-CHARGE. WE ENVISION DOING THIS DURING YOUR SLACK PERIODS WHEN, HOPEFULLY, YOU CAN GIVE US AFFORDABLE RATES AND STILL WELCOME THE BUSINESS. COST WILL BE AN IMPORTANT FACTOR TO US. WE PRESENTLY ARE WORKING OUT THE DETAILS OF THIS PROGRAM. THE NEXT STEP WILL BE A PILOT PROGRAM. IF SUCCESSFUL, WE WILL EXPAND THE PROGRAM PROMPTLY. WE WOULD EXPECT TO DEAL WITH A SUBSTANTIAL NUMBER OF CPA FIRMS.

WE CAN LEARN FROM ONE ANOTHER. BY WORKING TOGETHER WE CAN REDUCE BANK FRAUD AND INCREASE OUR EXAMINATION CAPABILITY. BY WORKING TOGETHER WE CAN BENEFIT THE BANKING INDUSTRY AND THE COUNTRY.

THANK YOU VERY MUCH.