

Special
FDIC

FDIC Supervisory activities and the enforcement
of statutes applicable to fraud and other
abuses committed by insiders against financial
institutions

STATEMENT OF

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PRESENTED TO

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

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Mr. Chairman and members of the Committee: It is a pleasure to appear before you today on behalf of the Federal Deposit Insurance Corporation and to describe the relation between our supervisory activities and the enforcement of statutes applicable to fraud and other abuses committed by insiders against financial institutions.

My name is Kenneth L. Walker and I am the Regional Director of the Dallas Region of the FDIC's Division of Supervision. The Dallas Region, for purposes of supervision, includes Texas, Colorado, New Mexico and Oklahoma. We are the primary federal supervisor for 967 state-chartered nonmember commercial banks with \$50.1 billion in assets. In addition, the Dallas Region also monitors some 1,297 national and state member banks located within the four state area, and has new substantial responsibilities as back up supervisor of 172 savings associations (this does not include 115 institutions placed in conservatorship). For the most part, my prepared remarks deal with examiner training, examination procedures, administrative enforcement actions, criminal referrals, and cooperation with criminal enforcement agencies. However, to provide a proper framework for these topics, I would first add a few general observations about the mission of the Division of Supervision.

Mr. Chairman, as you know, the FDIC's primary supervisory responsibility is to help ensure the safety and soundness of insured financial institutions, thus protecting the deposit insurance Funds. We attempt to do this by evaluating the respective institution's financial condition, the effectiveness of management and accounting controls, and, when needed, recommending or mandating remedial actions.

We view management and accounting controls as critical elements in the successful operation of a financial institution and for this reason we encourage banks to adopt a program of recurring external audits as a means of ensuring that adequate controls are in place for limiting or preventing losses. In December 1988, the FDIC issued a policy statement urging banks to have an annual external audit performed by an independent party. Then, by way of a follow-up in January of this year, the FDIC adopted a "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks." The follow-up policy recommends basic external auditing procedures as a less costly alternative for banks not choosing to have a financial statement audit.

Unless we have reason to believe otherwise, we do not approach an institution with a preconceived notion that insider fraud and abuses are present. Nevertheless, our examiners are trained to detect the signs of illicit insider actions and when we come upon suspicious circumstances, we pursue the matter.

In fact, in 1987, we developed a list of "red flags" to assist our examiners in the early detection of apparent fraud and insider abuse. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. Examples of the subject areas that the "red flags" cover include: linked financing/brokered transactions, loan participations, offshore transactions, lending to buy tax shelter investments and wire transfers.

Last year, we published a list of additional "red flags" which encompass other supervisory areas (see attachment). In addition, we are now in the process of updating and expanding the 1987 fraud and abuse "red flag" list.

EXAMINER TRAINING

New examination personnel begin their careers as Assistant Examiners and usually serve a minimum of three or more years prior to attending an assessment center evaluation to qualify them as commissioned examiners. During these first three years it is mandatory that Assistant Examiners attend four examiner schools. Among other things, these schools provide training in investigatory techniques, criminal irregularities, and detection of insider abuse. During this period the Assistant Examiner is provided on-the-job training and instruction from supervisors in the detection of insider abuse and fraud.

Our training in connection with insider abuse covers several areas. Among other things, our examiners gain a general familiarity with the principal criminal statutes applicable to insured institutions and with the Right to Financial Privacy Act. They also receive training in how best to complete standard criminal referral forms used by all financial institution regulators. These referral forms were designed to elicit the type of information deemed most important to the FBI and the Department of Justice in assessing the prosecutable merit of the suspected criminal violation. Additionally, examiners receive instruction on potential problems and warning

signs pertaining to bank fraud and insider abuse. The Division of Supervision's Manual of Examination Policies also sets out alternative investigative procedures appropriate to the particular circumstances and addresses the handling of criminal violations when they are discovered.

Training does not stop once an Assistant Examiner is commissioned as an examiner. Additional training includes the "White Collar Crime" school, the "FBI School on Bank Fraud" and various other seminars conducted by federal enforcement agencies, colleges and universities, or private vendors.

Additionally, in January, 1987, the Dallas Region designated nine examiners for special training and use in conducting special investigations of complex fraudulent activities. These examiners are located in field offices throughout the Region and can be called upon to assist when there is evidence of complex fraudulent activities. In addition to having attended the white collar crime school, each of these examiners has been provided additional training to develop their skills in detecting misconduct and insider abuse.

DETECTION OF BANK FRAUD AND ABUSE

Bank management has the primary responsibility for preventing and detecting fraud and insider abuse. When bank management or employees suspect a criminal violation, they are required under Part 353 of the FDIC's Rules and Regulations to make referrals in the form of filing a Criminal Irregularity Report with the U.S. Attorney and the appropriate investigatory agency. If

management does not cooperate or follow through with suspected violations, we will make the referrals ourselves.

Usually referrals by banks are a result from such events as teller shortages, false entries, theft, false statements on loan applications, embezzlement or misapplication of funds, check kiting, mysterious disappearance of bank funds, or money laundering. Since the beginning of 1988, state nonmember banks in the four states that comprise the Dallas Region of the Division of Supervision made 453 criminal referrals.

Apparent criminal violations that are detected by examiners are brought to the bank's attention for reporting by bank management in accordance with FDIC regulations for disciplinary or corrective action by the bank's board of directors. However, in isolated cases, it is appropriate to delay notification to bank officials, for example, where senior bank officials are implicated or the examiner has reason to believe that an official might destroy evidence, warn the target, or otherwise jeopardize an effective criminal or civil investigation. An examiner's detection of management abuse in an operating financial institution generally results in one or more administrative enforcement actions by FDIC and, in some cases, in criminal referrals to the respective U.S. Attorney and the appropriate criminal investigatory agency. Criminal referrals prepared by examiners are reviewed by regional office staff and forwarded to the FBI and U.S. Attorney as soon as possible. However, when examiners detect significant apparent violations, we immediately contact the FBI and the U.S. Attorney by telephone before the

examiner prepares the respective written referral. When requested by the law enforcement agents, our examiners will assist in developing evidence and appearing as expert witnesses. Since the beginning of 1988, examiners of the Dallas Region made 48 criminal referrals, of which 31 involved insiders.

With regard to affiliated parties, such as accountants or lawyers, that are engaged in abusive activities affecting the institution, we are now -- subsequent to FIRREA -- able to subject these persons to civil enforcement actions as they are "institution-affiliated parties." Prior to FIRREA, if these persons engaged in abusive activities , we would order the institution to cease all relationships with the person, if the institution had not done so on its own. If the persons activity rose to the level of criminal activity, the institution, or the FDIC, would refer the case to the U.S. Attorney or appropriate investigatory agency.

In 1988 the Division of Supervision revised its examination policy to increase the level and frequency of on-site supervision of banks. 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).

Additionally, we would likely schedule an examination or visitation of an institution if information comes to our attention, such as information addressed in the Attachment, which might indicate the possibility of insider fraud or abuse.

Mr. Chairman, in your letter of invitation you inquired about the use of investigators. The use of investigators is usually limited to situations where possible fraud or abuse is detected and where there is a need for one of our trained examiners to develop information necessary to make a referral to the U.S. Attorney and the FBI or prepare documentation for possible administrative actions under Section 8 of the FDI Act. Investigations of violations of U.S. criminal statutes are normally performed by representatives of the FBI after a referral has been made. While examiners are available to assist the FBI in these investigations and to serve as a source of information, the responsibility for the criminal investigation rests with the federal law enforcement agencies.

Notwithstanding the preceding, the circumstances underlying a criminal referral by an examiner generally will also call for an administrative enforcement action pursuant to several provisions of the FDI Act. Consequently, examiners will investigate and determine whether we have grounds for possible enforcement actions against insiders for violations of unsafe and unsound banking practices. Once this information is developed, it is reviewed by our attorneys to determine if there is sufficient evidence to proceed. The usual course in such instances is to either order the removal of the offending party from the bank, impose civil money penalties, or both. Since the beginning of 1988, the Dallas Region of the Division of Supervision has recommended 64 removal and 57 civil money penalty actions; of these numbers 21 and 23 cases, respectively, are still pending. We have been successful in obtaining 11 final orders of removal and 7 orders assessing money penalties.

The remainder have been terminated for such reasons as parallel procedures were concluded by another regulatory agency, the subject was removed from the bank through other means or restitution was made to the bank.

In cases involving potential losses of \$200,000 or more to an institution, or which involve senior officials of an institution, the case is forwarded by the FDIC's Washington Office to the Department of Justice's Criminal Tracking System. Under the Tracking System, we are easily apprised of the status and outcome of these cases.

Our relations with the criminal enforcement and other supervisory agencies has always been good. Recent developments within the Dallas Region of the Division of Supervision promise to make our cooperative efforts more efficient.

We are participating in local Bank Fraud Working Groups that have been organized by the U.S. Attorneys in three of the federal judicial districts within the Dallas Region. We are also participants in the Dallas Bank Fraud Task Force. These working groups encourage the exchange of information, improve coordination of criminal investigations and open channels of communication prior to and after a formal referral is made. Informal meetings and contacts occur regularly and are encouraged so that dialogue between regulators and law enforcement agencies begins before a formal referral is contemplated.

In one judicial district, the bank regulatory supervisors are meeting with the FBI to create a consolidated index of referrals that are made within the district. This will enhance our ability to identify and exchange information on individuals of concern to more than one agency within the district.

In another district, the agencies are organizing an inter-agency committee for recommending a priority list of cases to the FBI and the U.S. Attorney for investigation and prosecution. For each case on the list, the referring agency will stand ready to provide examiners to assist with additional investigations or act as expert witnesses.

We support this move to give the supervisors some input into the prioritizing of cases for prosecution. We anticipate that our meeting with the inter-agency group next month will result in these cases being actively prosecuted. In your letter of invitation, Mr. Chairman, you also asked us to provide case studies or examples. At the aforementioned meeting we will recommend high priority for several referrals that Division of Supervision examiners submitted concerning a person who was an insider at several banks.

Among other things, the referrals center on the insider's use of his influence and position to cause a series of transactions through which the banks made loans to nominees and paid unjustified renumeration to the nominees as a means for these borrowers to keep the loan payments current. The nominee used the loan proceeds to purchase stock of the parent bank holding company from the insider at a time when the insider was having financial difficulties. This scheme resulted in significant losses to the banks.

We will also recommend priority in prosecuting the same insider for his alleged involvement in maneuvering his banks into signing data processing contracts for rates far and above what was available from the same vendor. In this instance, the insider received direct payments from the vendor for various stated reasons.

We believe that the recent changes made by FIRREA in the enforcement area have been very positive. For example, the "logjam" that we were experiencing in section 8(e) management removal actions has been broken and we are reactivating some of these actions. Also, FIRREA amends section 8(e) of the FDI Act to make it clear that a removal order disqualifies the person from present and future associations with any other insured institution.

In conclusion, the Division of Supervision is vitally concerned with the threat that fraud and insider abuses pose to the continued safety and soundness of insured institutions. We believe the increased penalties and stronger enforcement authority, in general, will prove to be a formidable deterrent to both insider fraud and abuse and fraud by other institution-affiliated parties.

Thank you Mr. Chairman. I will be pleased to answer any questions the Committee may have.