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Statement by

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of the

Committee on Government Operations

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I welcome the opportunity to appear before you on behalf of the Federal Reserve System to discuss criminal misconduct and insider abuse in our nation's financial institutions. Let me assure you at the outset that the Federal Reserve shares this Committee's continuing interest in seeing that necessary arrangements are in place to facilitate the effective detection, referral and prosecution of white-collar crime involving financial institutions, arrangements which we hope and expect will also help to prevent such crimes.

In my judgment, many positive steps have already been taken by federal regulatory and law enforcement agencies, in large measure in response to the recommendations of this Committee, and I want to begin by reviewing them with you. Thereafter, I intend to discuss what we have learned from the data on criminal referral and enforcement actions that we have been collecting in the last couple of years and then to address

other questions the Committee raised in its letter inviting me to appear here today.

Actions Taken to Date

Actions that have been taken to deal with criminal offenses that involve financial institutions in large part have been set in motion through the efforts of the Interagency Bank Fraud Enforcement Working Group which is comprised of representatives from each of the Federal financial institution regulatory agencies, the Department of Justice, the FBI, and the Farm Credit Administration. The principal accomplishments of this Working Group, which, of course, required substantial follow-up efforts by the individual agencies, include the following:

- The Working Group developed and then each of the banking agencies implemented a uniform criminal referral form for

use by all financial institutions subject to the regulatory jurisdiction of the agencies. Based on our initial experience in using this criminal referral form, the Working Group recently reviewed and modified it in order to enhance its effectiveness.

- Each agency has developed or is in the final stages of developing an automated system to monitor and track criminal referral information submitted to the agency by its examiners and the financial institutions that it regulates. The statistical information that will be detailed later was made possible by the use of the Federal Reserve's new computer system.

- The Department of Justice developed and implemented the "significant" referral tracking system. This system keeps track of all referrals from the regulatory agencies that involve amounts in excess of $200,000 and/or in which (1) a senior officer or director of a financial institution is suspected or (2) there is concern that an activity might undermine the

integrity of the supervisory process or have systemic implications.

- Lists of contact persons with responsibilities for criminal referral, investigation and prosecution at each of the banking and criminal justice agencies have been prepared and disseminated throughout the regulatory agencies' staffs and those of the FBI and the U.S. Attorneys' Offices.

- Examiner training has been greatly enhanced through the expansion of the Examination Council's White Collar Crime course and joint FBI and banking agency training courses that are held throughout the country. I will discuss these initiatives in greater detail later in my testimony.

- The members of the Working Group are now developing a series of uniform instructions for all agency examiners who are

assigned to assist in criminal investigations in order to better prepare them for their duties.

- Uniform Bank Bribery Act guidelines were developed by the members of the Working Group in compliance with recent legislation.

- With the encouragement of the Working Group, the Department of Justice has made white collar crime involving financial institutions a top priority for investigation and prosecution by the FBI and the various Offices of the U.S. Attorneys.

I believe this record demonstrates that the Federal Reserve and the other regulatory and law enforcement agencies have worked diligently over the last few years to improve their abilities to address the problems of criminal misconduct and insider abuse. These efforts have led to a dramatic increase in

the number of cases--into the thousands--that have been identified and referred to the FBI for investigation, and, when the evidence warrants, to the Offices of U.S. Attorneys for prosecution. One important result of the improvements in this process is that a substantially larger number of criminal cases has been investigated by the FBI. Despite the concerted efforts of the law enforcement agencies, however, the very substantial increase in the numbers of suspected criminal offenses that have been detected and referred has led to the creation of a tremendous backlog of cases to be processed by the FBI and the Department of Justice. Thus, much remains to be done before it can be said that the problem of white-collar crime in our financial institutions has been brought under effective control, and that will no doubt require the allocation of additional resources to the task, particularly at the law enforcement agencies.

Scope and Nature of Problems at State Member Banks and Bank Holding Companies

Mr. Chairman, as I have indicated, the Federal Reserve has put in place an automated system to track referrals from state member banks and bank holding companies. I believe the Committee will find of interest a review of this information. While its focus is on information pertaining to state member banks and bank holding companies, it will shed light on the nature of the problems of criminal misconduct or insider abuse that are being encountered by all regulatory and law-enforcement agencies.

As is true for other agencies, our data for state member banks and bank holding companies show large increases in the volume of criminal referrals. During the last few months of 1985 (when the new criminal referral form was introduced and in use for the first time), the Federal Reserve received only 111

such referrals. But, in 1986, the total number of referrals jumped to 1,154; and, in the first half of 1987 alone, the Federal Reserve received 1,044 such referrals. It is also noteworthy that the number of "significant" referrals that were submitted by the Federal Reserve to the Fraud Section of the Criminal Division of the Department of Justice has risen from 18 in the latter part of 1985 to 49 in 1986 and to 74 so far this year. About one-half of the significant referrals involve insiders, such as officers and directors; and the other half, outsiders, such as bank customers.

Cases of insider abuse that do not involve a criminal offense but instead involve violations of banking laws, rules and regulations or unsafe or unsound practices are addressed by formal enforcement actions on our part have also gone up over this period. Moreover, in keeping with our objective of focusing a greater part of our efforts on ridding the system of individuals who cause harm, an increasing percentage of our total

enforcement actions has been taken against people in their individual capacities rather than against their banks and holding companies. For example, the Federal Reserve staff between 1984 and the present date issued 38 suspension, removal and prohibition orders, compared with only 3 such actions in the 1980 to 1983 period.

While the statistics emphasize the growth that has occurred in the number of problems of criminal misconduct and insider abuse, it is important to put them in the proper perspective by providing a breakdown of their nature and the extent to which they have affected banking organizations. Our data show:

(1) Out of the total of 2300 referrals, 80 percent related to alleged criminal misconduct involving losses or potential losses of less than $10,000. The vast majority of these small crime-related referrals involved teller defalcations,

credit card fraud and mysterious disappearances. An additional 16 percent pertained to losses in the $10,000 to $200,000 range. Thus, "significant" referrals, which either involve crimes in excess of $200,000 and/or involve senior financial institution insiders, accounted for about 5 percent of the total.

(2) The 2,300 referrals involving individuals received by the Federal Reserve since the new uniform criminal referral form was put into use in August 1985 were submitted by 255 state member banks and 29 bank holding companies. Or, put differently, approximately 23 percent of all state member banks and about one-half of one percent of all bank holding companies filed criminal referrals during this period. I might note that the relatively low incidence of referrals involving bank holding companies reflects the fact that banks, rather than bank holding companies, hold the majority of liquid assets--particularly cash--the object of many smaller criminal offenses.

(3) Of the 37 state member banks that have failed since 1984, a review of our records revealed that criminal misconduct was principally responsible in 5 cases.

Assuming our statistics are generally representative of the experience of all agencies, their implications are that the great majority of the cases of criminal misconduct that have been detected and referred to the FBI and Justice Department have involved relatively small sums of money that did not, in any material manner, affect the safety or soundness of financial institutions. In addition, the great majority of state member banks and bank holding companies have not suffered from any instances of criminal misconduct. But, while the cases involving significant offenses constitute a relatively small proportion of all offenses detected, it is important to remember that their absolute number appears to have been growing rapidly and that criminal misconduct and insider abuse have played a significant

role in the failure of some state member banks. Thus, there is obvious need to decisively address the problems.

We would emphasize to the Committee that such actions will require a heavy commitment of resources. All referrals, large and small, must be processed by the FBI and Offices of U.S. Attorneys and such processing and the investigative follow-up, we know from our own experience in carrying out enforcement actions, place a large burden on limited staff resources. As just one example, in a very recent removal action undertaken by the Board, several staff lawyers worked for a month preparing a suspension case, litigating the action in Federal court (with the assistance of a U.S. Attorney's Office) and finally negotiating a settlement of the matter. While the Board successfully removed the individual from the bank where he caused great harm, the effort placed a relatively extensive claim on our limited resources. I am certain that the level of resources needed to investigate and then prosecute an individual under the criminal laws in just one

case must be at least as large--a matter that I am sure representatives from the Department of Justice can confirm.

Thus, it is clear that the FBI and Justice Department are facing a very difficult challenge. We in the Federal Reserve are prepared to provide our assistance in helping to meet this challenge, and indeed have been providing such assistance recently. For example, in one case involving two bank holding companies, two insured banks, an insured Federal savings bank and 10 insiders, the legal and examination staffs of the Board and a Reserve Bank uncovered extensive fraudulent schemes being directed by the individuals through the bank holding companies. As a first step, our staff convened a meeting with representatives from the state banking department, the FHLBB, the OCC and the FDIC in order to coordinate civil enforcement actions and then they worked with the FBI and the U.S. Attorney to explain the complex schemes, which have already lead to the failure of the savings bank and substantial losses to the several

financial institutions, including a Federal Land Bank. We expect indictments in this case very shortly.

In another case, one of our most senior Reserve Bank examiners has been assigned, for the past eighteen months, to assist Federal and state prosecutors in connection with the failures of several state insured thrift associations. To date, the state has won eight convictions of some of the customers and officers and directors of the financial institutions, and extremely long prison sentences have been set as punishments in recognition of the serious nature of the crimes.

Areas of Concern

The Committee has asked me to comment on a number of areas of concern. I will address several of these, but time and space limitations prevent me from giving in-depth answers to each of the questions you raised in your letter. We will provide

written responses to all questions not fully covered in my formal remarks.

The Right to Financial Privacy Act and Rule 6(e)

The first area involves the Right to Financial Privacy Act and Rule 6(e) of the Federal Rules of Criminal Procedure. As Board staff reported to the Committee in response to your October 15 inquiries, we have not found the Right to Financial Privacy Act to be an impediment to the criminal referral process from the point of view of individual banks. Out of the 2300 referrals received at the Federal Reserve between August 1985 and June 1987, in only one case did a referring bank fail to identify the name of a suspect and in only five others did banks limit the amount of information provided in their forms because of perceived problems with the Right to Financial Privacy Act.

The Right to Financial Privacy Act, however, does place limitations and restrictions on the banking agencies in their ability to transfer certain information to the FBI and the Department of Justice. When Federal Reserve examiners find information in the account records of a bank customer that relate to criminal misconduct, the examiners cannot freely provide the information to the criminal justice agencies. We can, by law, tell the OCC and the FDIC, but we cannot tell the FBI without following the cumbersome notification procedures of the Right to Financial Privacy Act.

A recent case demonstrates this problem. Federal Reserve examiners found extensive evidence of reciprocal loans between a state member bank and the officers and directors of several other financial institutions in its area. Several million dollars of poorly documented and apparently fraudulent loans were made by the bank's president to the officers and directors of the other banks and thrift associations in return

for a like amount of loans to the president and perhaps other bank officers and directors. Our examiners immediately contacted the FBI and the U.S. Attorney in order to alert them to the problem; but, we could not relay any account information without the notification of the bank's insiders or the issuance of a Grand Jury subpoena. Since there was no sitting Grand Jury, the FBI could not act quickly because the notification procedures would have alerted the wrongdoers and negatively impacted their investigation of the fraudulent loans.

Interestingly, in connection with this matter, the FBI could not provide information about an important ongoing investigation of the bank's president to us because of the limitations and restrictions of Rule 6(e) of the Federal Rules of Criminal Procedure. Because of these Grand Jury secrecy rules, we had not been advised about an extensive investigation of this individual's activities.

The Committee should consider whether the relevant laws need to be amended. With respect to the Right to Financial Privacy Act, the staffs of the banking agencies recently completed an interagency package of proposed amendments. This legislative proposal was approved by the Board of Governors a few weeks ago and, once it has been approved by the other agencies, it will be submitted to Congress by all of us. Simply, the Right to Financial Privacy Act amendments would permit the free transfer of information that is lawfully in the hands of bank examiners, such as through a bank examination, to the criminal justice agencies.

Availability of Reports of Examination

The Committee is also interested in the recent proposed amendment to the Board's Rules Regarding Availability of Information that deals with the release of reports of examination and inspection of state member banks and bank holding companies

to the bank's agents, such as accountants or counsel. The proposed revision to the Board's regulations in this area would permit the routine release of such reports to a bank's or holding company's agents, if certain procedures are followed by the financial institutions and the agents--procedures that are principally designed to maintain the confidential nature of the reports of examination and inspection prepared by the Federal Reserve.

A final version of the regulation has not been prepared by Board staff because they are still examining public comments. It seems to me that the final regulation should enable the accountants of a financial institution to review the findings of an examination during the course of an audit and should make the release of the report as simple as possible.

I am aware of the letter of October 9, 1987 you sent to us on this matter that recommended that the regulatory agencies

be required to make their examination reports directly available to the auditors of a banking organization. I will make sure that your position is given careful consideration by the Board when it reviews this matter. I might note in this connection that it is our experience that almost all independent public accountants request access to an institution's examination reports and are routinely granted such access.

Audits

The Federal Reserve is well aware of the important role that auditors play in promoting the safe and sound operation of banks. Their reports provide needed information to managers and directors of banking institutions and also to their creditors and stockholders which thus facilitates the influence that market discipline can exert on the operation of institutions. Our examiners also review the reports of auditors when they begin an examination.

Most, if not all, banking organizations of medium and larger size as well as a great many smaller organizations, employ the service of outside auditors. Most of the very smallest organizations, on the other hand, rely on internal auditors to provide needed reports to management and the directors. While the Board encourages the use of outside auditors, we are reluctant to endorse a requirement that all organizations must have an outside audit, because of the added costs that would impose on smaller organizations and because, in general, we believe internal audits can adequately serve the needs of these smaller organizations. In cases where our examiners find internal audit systems to be deficient, we instruct banks to improve them and, under appropriate circumstances, to seek outside audit assistance as well.

Examiner Training and Manpower Levels

Since the Committee first started its examination of the problems associated with criminal misconduct and insider abuse, the Federal Reserve, in cooperation with the other banking agencies, the FBI and the Department of Justice, has greatly expanded its training of examiners in order to enhance their abilities to detect, refer, and, where necessary, assist criminal investigations and prosecutions. Between 1985 and this date, over 25 training sessions of the joint FBI/banking agency bank fraud course and the Examination Council's White Collar Crime course have been held. The Federal Reserve has sent over 100 of its most senior examiners through these courses and has provided very experienced examiners and attorneys to teach them.

With regard to the level of the Federal Reserve's examiner manpower, I am pleased to report that, since the implementation of the Federal Reserve's enhanced supervision

program over the last two years, examiner levels have increased substantially. We require the annual examination of all state member banks and the semi-annual examination of all "problem" state member banks. These additional resources, together with cooperative alternative examination arrangements we have with state banking agencies, have enabled us to meet our major examination goals.

Interagency Sharing of Information and Coordination with Law Enforcement Agencies

The Federal Reserve recognizes the great importance of sharing information with other regulatory agencies and in cooperating with and assisting law enforcement agencies to carry out their duties. Since the Federal Reserve often takes enforcement actions against bank holding companies with national and state nonmember bank subsidiaries, it is particularly important that the OCC and the FDIC be advised of these actions. Likewise, information concerning all removal and prohibition

actions taken by the Board is sent to each of the other Federal financial institution supervisory agencies in order to ensure that the individual subject to the Board's order does not reenter the banking industry at another non-Federal Reserve supervised institution.

Information concerning criminal referrals is shared with the other agencies on a periodic basis. Our current system for the sharing of information about all referrals received by the Federal Reserve is not meant to be a long-term solution to the problem of disseminating such information among all of the banking and criminal justice agencies. We are awaiting the implementation of the FBI's Field Office Information Management System, which is expected to keep track of all criminal referrals submitted to each of the banking agencies, correlate the information, and highlight those repeat offenders who move from one institution to another after committing relatively small crimes.

Obviously, in making and following-up on criminal referrals, communication and cooperation among the agencies is vital. Our examination and supervisory staffs have worked closely with the FBI and the Justice Department and are not aware of any situations in which these agencies have been dissatisfied with the timeliness and adequacy of information provided by the Federal Reserve or our response to requests for assistance. Within the Federal Reserve System, it is our policy that all examiners make all necessary referrals as soon as suspected criminal activities are uncovered, rather than wait until the conclusion of an examination. Moreover, the work papers of our examiners are always maintained at their Reserve Banks and are available to the criminal justice agencies upon request.

Role of Directors

The board of directors plays a critical role in assuring that a banking organization is operated in a safe and

sound manner and is in full compliance with laws and regulations. For this reason, it has long been a fundamental tenant of the law and Federal Reserve policy that directors are accountable for carrying out their legal and fiduciary responsibilities. We have also taken a number of steps to make sure that directors are properly informed of the condition of their institutions. For example, in accordance with procedures that were implemented under the Board's recent enhanced supervision program, a senior official of a Reserve Bank meets with the board of directors of all problem financial institutions immediately following the conclusion of the Reserve Bank's examination. In addition, when informal or formal enforcement action is necessary, the Federal Reserve requires each director of the institution to sign the supervisory enforcement action.

Finally, upon completion of an examination or inspection in which significant problems are uncovered, the Federal Reserve sends a summary report to each director of the

institution setting forth in clear and precise language the nature and severity of the bank's and bank holding company's weaknesses and the responsibilities of the directors to take action to correct them.

We have also supported the FDIC in its efforts to develop guidelines on the responsibility of directors for overseeing the activities of their institutions, and the Board recently approved having the Federal Reserve join with the FDIC and the OCC in issuing such guidelines. This action underscores the Federal Reserve's view of the critical importance of informed and responsible directors for the health of financial institutions.

Conclusion

To sum up, we recognize that insider abuse and criminal misconduct are serious problems that require a timely and effective response by regulators of depository institutions and criminal justice agencies. And, of course, it is also important to stress the critical role of the directors of such institutions in assuring that their institutions are operated in a safe and sound manner and in full compliance with laws and regulations. I believe that it is fair to say that we have made significant progress in dealing with these problems. The steps I have outlined today have improved our ability to identify and refer questionable activities in a timely fashion, and we have also strengthened our ability to assist law enforcement agencies in investigating criminal activities. The support and encouragement of this Committee, it should be pointed out, have been important in our efforts to make these improvements. Moreover, while we

recognize that much has been done, we also know that we have a considerable way to go before we can be fully satisfied with our accomplishments.

In addition to improving our ability to identify and refer questionable practices, the actions we have taken should have another benefit. Over time, we believe that these actions as they are improved and strengthened, together with our more frequent on-site examination schedule, will increase the likelihood that perpetrators of questionable acts will be caught. In the long run, it is our hope that this deterrent effect will serve to discourage or prevent the kinds of illegal or questionable activities that this Committee and the regulatory agencies are working so hard to address.